Intelligence MEMOS

From: Marcel Boyer

To: Canadians Concerned with Executive Compensation

Date: February 3, 2020

Re: **PUTTING CEO PAY IN PERSPECTIVE**

The CEO pay ratio, measured as the ratio of CEO pay over the median salary of a firm's employees, is the most commonly quoted number when the popular press discusses executive compensation.

This ratio reached 281 last year for S&P 500 firms.

Since early 2018, US-listed companies have been required to disclose their CEO pay ratio. This Securities and Exchange Commission rule, part of the Dodd-Frank disclosure requirements, compels companies to provide information on the pay of their CEO and the median salary paid to their employees. This information yields the aforementioned CEO pay ratio.

While often decried as excessive, the ratio may not be the most informative and economically relevant measure of what a CEO might be worth to the firm and their fellow employees. For one thing, firms greatly differ in size and the median CEO pay ratio (170) might be more representative of the typical firm than the average ratio for all firms.

In a recent paper, I propose a ratio I name B-ratio, signifying Plan B, which measures CEO pay over the estimated total payroll of the firm (measured by the number of employees times the median salary), to provide a more rounded view. Indeed, as calculated, the B-ratio is a prudent (over)estimate of the CEO pay as a percentage of the total payroll.

Viewed through the B-ratio, a typical employee of an S&P 500 firm implicitly "contributes" $273 or 0.5 percent of their salary to the salary of his/her CEO. Seen differently, if we were to divide the CEO pay equally among all employees, the employees would see an increase of $273 in their annual pay. If we do it proportionately to the employee salary, the resulting pay increase for employees would be half of one percent.

To assess whether such a contribution to the CEO pay is worthwhile, one must determine the value of the CEO for the organization and its workers and stakeholders.

Suppose we ask employees the following two questions:

Question #1: Would you be ready to contribute one half of one percent of your annual salary ($250 for a salary of $50,000; $500 for a salary of $100,000) to hire the best CEO we can find to manage your firm and in particular to ensure and enhance its profitability, sustainability, and growth, and, in so doing, to protect your job, now and in the future, including your pension?

Question #2: Would you find appropriate to pay your CEO some 281 times the median salary in your firm to manage your firm and in particular to ensure and enhance its profitability, sustainability, and growth, and, in so doing, to protect your job, now and in the future, including your pension?

I expect that many more employees would say yes to question #1 than to question #2.

If so, it would be a revealing example of the need to inform the question appropriately. Only the former question, the "one half of one percent question," makes sense information-wise as well as economically and socially. People can easily understand a question directly tied to their salary. A question framed as a 281 multiple of a median salary is much more difficult to tie to the value to employees, stakeholders, or the organization as a whole of having an effective CEO in the first place.

In turn, as I show in the paper, that economic value of the CEO will differ by industry, firm or country, and is tied to the need for the CEO to manage exposure to risk and promote exposure to upside opportunities for the firm – in other words to create valuable "real options" for the firm as a whole.

Of course, historically, some CEOs have in retrospect been spectacularly unsuccessful, and others spectacularly successful. The point I make is simply that any economically meaningful discussion of CEO pay should take into account the role of the CEO to manage risks and create opportunities for the firm, its employees and all its stakeholders.

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