

Are CEO salaries justified?

• SIMONE SEPE • RETHINKING CORPORATE GOVERNANCE

Director of the IAST law program, Simone Sepe is a specialist in law and economics. Developed to supplement the traditional doctrinal analysis of law, in which the major task is simply to interpret the law, the research method used by Simone and other scholars in law and economics is to analyze problems using economic modeling and focusing on implementation. Following this approach, we must first identify our goals for society, then design legal mechanisms to pursue those goals efficiently.

EXECUTIVE PAY

You organized the IAST conference on Inequality, Law and the Social Sciences in December. What were some of the highlights of the event?

This was the second joint conference held by Notre Dame Law School and IAST, which saw the participation of top scholars from different fields — including legal scholars, economists, and philosophers — consistent with IAST's goal of promoting interdisciplinary research.

You gave a talk at the conference titled 'CEO Pay Redux,' drawing on your earlier research into corporate governance and the balance of power between shareholders and boards (recently published in the *Journal of Financial Economics*). Are CEO salaries justified?

The dominant view in law and economics — referred to as managerial power theory — is that the disproportionate explosion of CEO pay is due to the growing power of managers and their ability to determine their own compensation because the board is dominated by the executives. The normative claim to improve executive compensation proposed by most law and economics scholars is thus to empower shareholders.

“To reduce inequality, taxation may be more desirable than regulating executive compensation”

Yet, prominent economic theories suggest that the problem of executive compensation is not a problem of the organization, but rather a reflection of optimal contracting given some market constraints — essentially, competition. In other words, the rise in CEO pay would be largely a reflection of increased competition for scarce managerial talent. Further, if one can realistically assume that the executive compensation

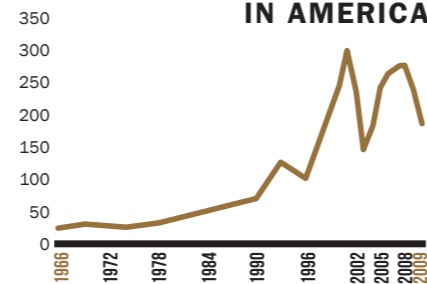
contract is 'dynamic' — that is, it develops across multiple periods rather than just one period — paying executives high rents might provide them with a continuation value that efficiently bonds executives to long-term firm value creation. Hence, to answer your question, CEO salaries do seem to be economically justified.

“Boards are quite good at designing incentives, as higher executive pay is associated with higher firm value”

How did you test these different hypotheses?

In several ways. First, I show that the adoption of defensive measures — which epitomize entrenched boards for managerial power scholars — does not impact executive compensation. Second, I show that competition for managerial talent has a major impact on executive compensation levels and structures. Third, to address endogeneity concerns, I looked at the effect of a 2005 change in accounting rules.

GROWTH OF CEO PAY IN AMERICA



Ratio of average compensation of CEOs and production workers, 1965–2009. Source: Economic Policy Institute. 2011. Based on data from Wall Street Journal/Mercer, Hay Group 2010.



This change leveled the playing-field between the use of stock and options from an accounting perspective. I found that firms that were granting more options after this change suffered a reduction in value. This suggests that if there is a problem with executive compensation, it lies with the structure of pay arrangements, as boards seem to have overused options over stocks to provide equity incentives. This result goes strongly against the entrenchment hypothesis, which suggests that equity incentives should take the form of options, because stocks would leave managers excessive rents (as to some extent stock payoffs are independent from performance).

So what is your advice to policymakers? Why should we halt what you describe as 'the shareholder empowerment crusade'?

There is no clear empirical basis to support the idea that empowering shareholders is an efficient way to improve executive compensation. In fact, boards emerge as quite good at designing incentives, as higher executive pay levels are associated with higher firm value. So it's plausible that the explosion of compensation for executives is not a problem of governance. Rather, the problem seems to be that the marginal product of CEOs exploded in the past 20 years, while the marginal product of labor remained essentially the same. To reduce the current inequality from labor income, traditional redistributive policies such as taxation may thus be more desirable than regulating executive compensation, as governments have done in the aftermath of the financial crisis.

SIMONE SEPE ON IAST LAW

How does the law program contribute to the IAST mix?

The understanding of legal problems almost always requires us to cross boundaries and think across a vast range of disciplines. The IAST law program addresses this need by promoting joint research and teaching programs in law and several other fields, including economics, political science, philosophy, history, sociology, and psychology.

The IAST law program has a special focus on law and economics. What are the advantages of joint research in this area?

The application of the economic method to the study of law is a well-established interdisciplinary field. Nowadays, economic theory is used in almost all areas of law to assess legal issues from a normative perspective. At the same time, there is a growing recourse to empirical economics as a method to evaluate the positive impact of existing legal rules.

Are collaborations with other disciplines (besides economics) bearing fruit?

Yes! The IAST law program has recently expanded its interdisciplinary collaboration to both political science and philosophy. In particular, last year, we have finalized a visiting position for Professor **Thomas Christiano**, from the Department of Political Philosophy at the University of Arizona.

What does the future hold for law at IAST?

One of our objectives is the integration of teaching and seminar programs at the Toulouse Law School with the programs offered by the Toulouse School of Economics. Graduate courses that we aim to offer in the future include Game Theory and the Law, Law and Economics of Financial Regulation, Contract Theory and Contract Law, and the Economics of Organizational Law. The IAST law program also aims to serve as an international forum for law and economics scholarship.