Event Report: ‘Market or Racket: do we need a new approach to executive pay?’

Reflections on pay and performance - Discussion

Steve Kaplan, Neubauer Family Distinguished Service Professor of Entrepreneurship and Finance, University of Chicago Booth School of Business
In conversation with Will Hutton, Principal of Hertford College, University of Oxford

Steve Kaplan was interviewed by Will Hutton.

Hutton began the discussion by talking about the increase in private firms, a phenomenon he said is particularly marked in the UK and US. He said he found it interesting that the introduction of say-on-pay coincided with the growth of restricted stock and the diminution of the old option packages. He said there are many reasons why private equity has become one of the driving elements in American and British capitalism and said the rewards system reinforces that. Kaplan responded that private equity firms have benefited from increased unpleasantness from being a public company. He said there used to be far less constraints on public company CEOs and if they went private, they would have private equity investors that were tough on them. Now as a public company, according to Kaplan, public company CEOs face far more restrictions and scrutiny. He said that being private is still tough, but the relative difference is much closer. Kaplan said that in the last 15 years, private equity firms have put many resources into developing operational engineering to help executives run companies. He argued that this means the relative attractiveness of being private is higher than it used to be. Hutton said that the public model, where companies are held accountable by shareholders and have to conform with the public is what he prefers to see. He made the point that, as the rewards in private equity start being pulled up, it is going to become more problematic to get good people at the helm of public companies. Kaplan said he agreed with this and that what he wants in the long run is for capitalism to drive efficiency and productivity, which will generate the most benefit for most people. He said the difficult part is having a strong safety net for the bottom of the income distribution, and in his view that this is the realm of the government. However, he said that the evidence on private equity at a firm level, is that it makes firms more productive both in the US and UK.

Hutton said capitalism is on the back foot, and that it is an open question whether it is delivering the efficiencies needed. He argued that the tension between democratic accountability and the regulatory framework in which firms operate helps capitalism. Hutton believes capitalism is mutating in a way in which capital and labour is combined to harness efficiency and innovation has become degraded, exhibited partly in executive pay which is very high. Kaplan responded with optimism, saying that the number of people who are living below subsistence has declined from a third of the world in 1980 to less than 10% today. He also said that the big China shock has now happened and some of the advantages of now doing business in China, or outsourcing to China, have gone away, so it is possible that developed countries may do better going forwards. He said that criticising CEOs for this is misguided as it’s a broader phenomenon, and the solution is not to hurt public companies by making it less rewarding to be a CEO. Hutton said that companies are made great by the people who run them and a highly purposed culture driving toward objectives combining societal benefit and profit, and believes that people within the company should be paid fairly.

Hutton said that from the boards he has sat on and the companies he has written about, he has been very struck by the fact that if you are a CEO, you must have a strong story or narrative to tell with a vision of the company’s future. He said he is uneasy about narratives overly focused on the stock price or decisions that may be taken that could affect the share price. For Hutton, this raises
questions about perverse incentives for the CEO. Kaplan agreed there are some bad actors and bad behaviours, but that overall CEO pay has been declining and CEO pay relative to profits has also decreased. He said that boards have become much better and activist shareholders have become more commonplace, helping to drive out bad behaviours.

Looking at the S&P 500 CEO remuneration data Kaplan had shown in his presentation, Hutton said he was surprised to hear that CEO pay has come down by around 30% in real terms since 2001. Kaplan said it is consistent with data on others in the top 0.1%, with both groups having been impacted by technological developments and globalisation. Hutton said he would also add the structures of contemporary capitalism to this as an influencing factor. A participant in the audience said you could also argue that reduced corporate taxation, weakening competition and increased concentration in many industries could arguably have delivered a windfall. He asked Kaplan if he was aware of any data that seeks to strip out some of those concentration effects, how this has fed through the size and whether there has been a windfall element with listed companies. Kaplan said this has been very much in debate. On taxes and tech companies in particular avoiding taxes, he said there has maybe been a windfall, although on the other hand given the tax rules CEOs are doing what they are supposed to be doing. On the concentration side, he said there has been a debate in particular around big tech becoming more concentrated by being really good competitors and delivering huge amounts of value to consumers. He said he would not call this a windfall, but the companies doing what they are supposed to do and “they crushed it competitively.” In terms of a solution he said it would be to look at antitrust rather than CEO pay.

Hutton said he was not convinced that companies needed to pay such high pay levels for CEOs at bigger firms, and said the role there is much more bureaucratic and sometimes with lower risk than at companies that are growing very rapidly. Kaplan said that there is much competition at even large companies and that there is a strong empirical regularity that at larger firms the CEO gets paid more. He also said that if you want someone to be a public company CEO, rather than work in the private markets which may be an easier role, you need to pay them well.

A participant in the room asked how one could measure the outrage constraint, and if pay levels have been flat over time whether the outrage has been flat. Kaplan said that in the UK, clearly feelings about executive pay are very strong, whereas in the US this has become muted over time. He said the difference in the US may be because the tech CEOs have done so well and have earned their compensation packages, and there are fewer of the outliers where their pay does not make sense. Kaplan said he was not sure how to measure the outrage constraint but that it is more of a factor in the UK than the US.

Kaplan’s analysis of CEO pay compared to others in the top 0.1% was of particular interest to a participant in the room. He asked what Kaplan’s thoughts were on the rest of the 0.1%, such as actors and lawyers. Kaplan said he looks at things from a market perspective and said that technology and globalisation has made people in other top 0.1% professions more valuable also. Hutton asked Kaplan if he sees a ‘winner take all’ effect. Kaplan responded that this is indeed what is happening and reiterated how difficult it is to make sure developed economies have a safety net, particularly for people on lower incomes.

A compensation consultant said pay differentials for CEOs and other senior executives is much starker in the US than at a European company. He said that in Europe a CEO would get one and a half to two times the CFO or COO, whereas in the US this might be three or four times. He said there are obviously some differences in terms of governance and board structures but asked if Kaplan understood where these differences come from. Kaplan responded that he did not necessarily have
an answer on this but was curious about what happens on the private equity side in Europe compared to the US.

On why CEO pay has levelled off, Kaplan said there are several factors. He said the average levels in 2000 were probably too high, with some bad actors. He said that executive pay has got to the current level and has stayed there. He said if anything perhaps CEO pay could rise a little higher, as earnings have increased. However, Kaplan said the outrage constraint may be keeping it from going up more, or perhaps it is even at a correct level now.