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Compensation and recruiting: private universities versus private corporations

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Abstract

This paper attempts to shed light on the continuing debate regarding executive compensation by comparing the income of S&P 500 CEOs with that of the presidents of elite private universities. The results reveal that university presidents are paid only a fraction of what CEOs are paid less than 5% in 2000. Nonetheless, universities are able to attract leaders with qualifications and accomplishments equivalent to that of the most distinguished CEOs. Furthermore, university presidents appear to be willing to work as hard and as much in the interests of their constituents as corporate CEOs despite the lack of any meaningful incentive clauses in their contracts. These results suggest that the standard principal-agent model used in evaluating compensation needs to be extended significantly before it can be applied to situations in which a few select people are recruited for highly paid jobs that offer the chance to lead major institutions.

JEL classification: G30; G32
Keywords: Corporate finance; Executive compensation; Principal; Agent

1. Introduction

In his extensive review article, Murphy (1999) observes that by 1998 CEO compensation had become a political "hot button" and had attracted widespread scholarly interest. Little did he know that the interest was about to accelerate sharply. The huge compensation packages paid to executives prior to the collapse of companies, such as Enron and Global Crossings, have led to unprecedented attention being focused on executive

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compensation. Even the President of the United States has weighed in on the subject. The popular press routinely portrays CEOs as grossly overpaid. However, the scholarly literature demonstrates that reaching such a conclusion is fraught with complexities. Given the massive resources controlled by major corporations, bad or improperly incentivized, leaders can cost firms billions of dollars. In addition, as Lazear and Rosen (1981) originally explain and as Martin (2001) emphasizes, the pay packages of company leaders may serve functions beyond compensating and incentivizing the CEO. They can function as tournament prizes that provide incentives for employees throughout the organization who are in a position to compete for the prize, not just the executive who obtains it.

Despite the extensive research on CEO compensation, Murphy (1999) points out that some of the most basic questions have not been adequately addressed. In particular, there is little evidence to document that increases in financial incentives lead CEOs to work harder, smarter, and more in the interest of shareholders. More importantly, it remains unknown whether companies could find and recruit people who would work as hard, smart, and effectively if they were to cut CEO compensation by a factor of two or more.

A fundamental empirical roadblock to answering these questions is developing an appropriate baseline for assessing the level of CEO compensation. One approach, popularized by Crystal (1991), is to compare CEO compensation with that of staff employees at the same company. By this standard, CEO compensation has risen dramatically. Murphy (1999) reports that in 1970 the average S&P 500 CEO made about 30 times more than the average production worker. By 1996, that factor had increased to 90 times, excluding compensation received from exercising stock options. If option exercises are included, the factor rises to 210 times.

Another approach, taken by Abowd and Bognanno (1995), Cosh and Hughes (1997), Kaplan (1995), and Zhou (2000), among others, is to use international data. Although the specific conclusions of the international studies depend on the sample period and the comparison countries, every study finds that US CEOs are the most highly compensated both in absolute terms and relative to staff employees.

While comparisons to staff workers and international CEOs show that US CEOs are very highly compensated, it does not demonstrate that they are "too" highly paid. It is possible that circumstances unique to the American economy and American companies lead to the higher level of compensation. For instance, size and total compensation are related in virtually every country, and American companies tend to be larger in terms of market capitalization. In addition, Abowd and Bognanno (1995) stress that international comparisons can be affected by taxes, purchasing power parity, and public benefits. Nonetheless, after adjusting for these factors they still find the US CEOs the most highly compensated. From a less positive perspective, it is also possible that American corporations are particularly susceptible to what Bertrand and Mullainathan (2000) call "skimming"[1]. The skimming hypothesis holds that the separation of ownership and

[1] For a discussion of the impact of the American form of corporate organization on the control of companies, see Roe (1997).