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ECONOMIC VIEW

Should Congress Put a Cap on Executive Pay?

By ROBERT H. FRANK

IT'S no wonder that voters' outrage over exorbitant executive pay is mounting. After all, the government just had to bail out financial firms that paid big bonuses last year to many of the same executives who helped precipitate the current financial crisis.

Nor is it any wonder that Congress is considering measures to limit executive pay — not just in the financial industry, but economywide. So far, the only formal legislative proposal is "say on pay," which would require a nonbinding shareholder vote on executive pay proposals. But critics complain that this would have little impact and are hungry for stronger measures.

One popular proposal would cap the chief executive's pay at each company at 20 times its average worker's salary. But while Congress may well have compelling reasons to limit executive pay in companies seeking bailout money, voter anger is not a good reason to extend pay caps more generally.

To be sure, executive pay in the United States is vastly higher than necessary. Executives in other countries, whose pay is often less than one-fifth that of their American counterparts, seem to work just as hard and perform just as well. The same was true of American executives in the 1980s.

So why not limit executive pay? The problem is that although every company wants a talented chief executive, there are only so many to go around. Relative salaries guide job choices. If salaries were capped at, say, $2 million annually, the most talented candidates would have less reason to seek the positions that make best use of their talents.

More troubling, if C.E.O. pay were capped and pay for other jobs was not, the most talented potential managers would be more likely to become lawyers or hedge fund operators. Can anyone think that would be a good thing?

In large companies, even small differences in managerial talent can make an enormous difference. Consider a company with $10 billion in annual earnings that has narrowed its C.E.O. search to two finalists. If one would make just a handful of better decisions each year than the other, the company's annual earnings might easily be 3 percent — or $300 million — higher under the better candidate's leadership. That same candidate couldn't possibly make as much difference at a company with only $10 million in earnings.

That's why companies where executive decisions have the greatest impact tend to outbid others in hiring the ablest managers.

Critics complain that executive labor markets are not really competitive — that chief executives appoint friends to their boards who approve unjustifiably large pay packages. But C.E.O.'s have always appointed friends, so that can't explain recent trends.

One reason for these trends is that companies themselves have become bigger. As the New York University economists Xavier Gabaix and Augustin Landier argue in a 2006 paper, C.E.O. pay in a competitive market should vary in direct proportion to the market capitalization of the company. They found that C.E.O. compensation at large companies grew sixfold between 1980 and 2003, the same as the market-cap growth of these businesses.

Beyond growth in company size, executive mobility has also increased. In past decades, about the only way to become a C.E.O. was to have spent one's entire career with the company. With only a handful of plausible internal candidates, pay was essentially a matter of bilateral negotiation between the board and the chosen. Increasingly, however, hiring committees believe that a talented executive from one industry can also deliver top performance in another.

A celebrated case in point was Louis V. Gerstner Jr. Having produced record earnings at RJR Nabisco, he was hired by I.B.M., where he led the computer giant, then struggling, to a dramatic turnaround in the 1990s.

This new spot market for talent has affected executive salaries in much the same way that free agency affected the salaries of professional athletes.

If the market for executive talent is competitive, critics ask, why are C.E.O.'s in an industry paid about the same, regardless of performance? That's because no one knows with certainty how a particular executive will perform. But most hiring decisions are based on well-researched predictions, and always with hope for success. Executives whose record predicts good performance command a high rate. Their leash, however, has grown shorter.

In the past, a C.E.O. could often stay in the job for many years despite lackluster performance. Today, a C.E.O. who fails to deliver is often dismissed after a year or two.

In short, evidence suggests that the link between pay and performance is tighter than proponents of pay caps seem to think. Since the fall of the former Soviet Union, no one has seriously challenged the wisdom of relegating a high proportion of society's most important tasks to private markets. And the market-determined salary of a job generally offers the best — if imperfect — measure of its importance.

THE financial industry, however, may be an exception. A money manager's pay depends primarily on the amount of money managed, which in turn depends on the fund's rate of return relative to other funds. This provides strong incentives to invest in highly leveraged risky assets, which yield higher average returns. But as recent events have shown, these complex assets also expose the rest of us to considerable systemic risk.

On balance, then, the high pay that lures talent to the financial industry may actually cause harm. So if Congress wants to cap executive pay in financial institutions receiving bailout money, well and good.

Elsewhere, however, the more prudent response to runaway salaries at the top is to raise marginal tax rates on the highest earners, irrespective of occupation. Again, relative salaries drive job choices. The jobs with the highest pretax salaries will still offer the highest post-tax salaries, just as before, so this step will not compromise the price signals that steer talented performers to the most important jobs.

In answering voter outrage about executive pay, Congress should recall the words of Marcus Aurelius: “How much more grievous are the consequences of anger than the causes of it.”

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