Capstone Project

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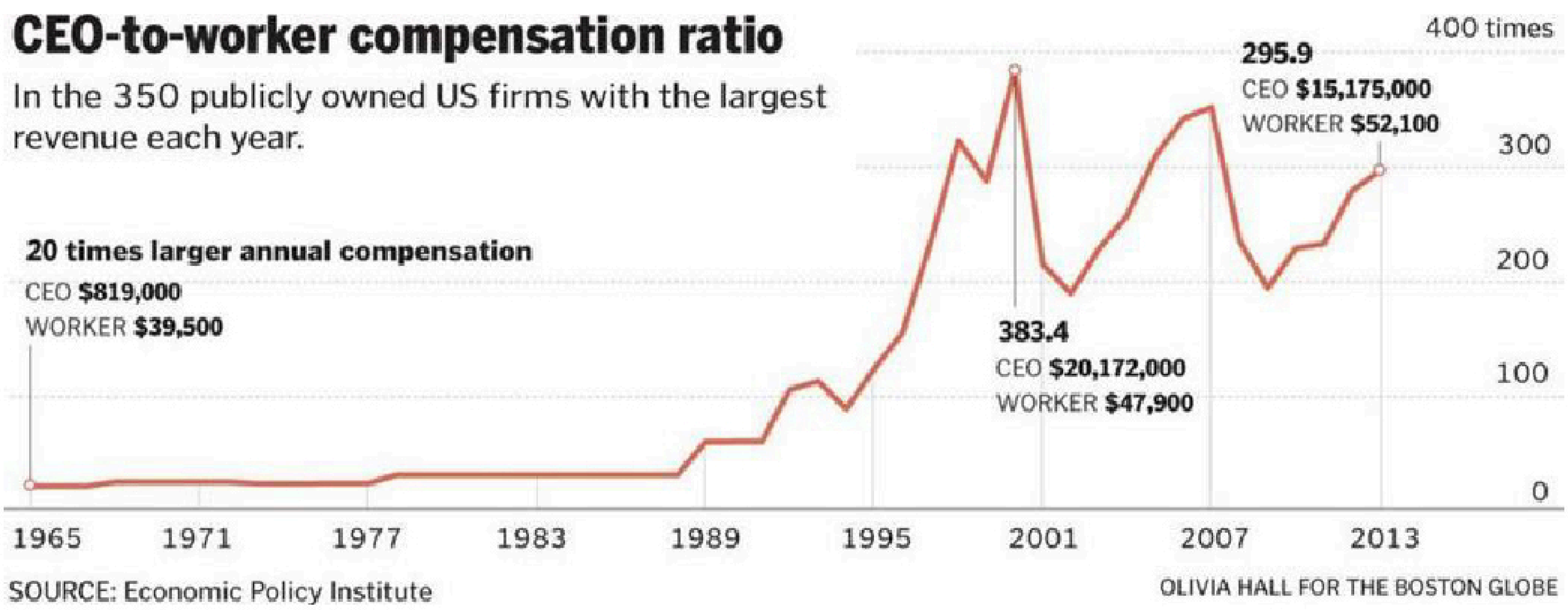
EXECUTIVE SUMMARY

The pay of American CEOs keeps soaring, while that of everyone else remains further behind. It creates a wage gap between the executives of the corporate America and the middle-class managers and workers. This report provides an analysis of the growth of the CEOs' pay in America from 1965 to 2013. In this paper, the actual and the studies from literature are compared. The results of the analysis show that the executives' pay keeps rising over the years, while that of the average employees remains much lower. The average compensation paid to the top executives is 110 times greater compared to ordinary workers. This evidence explains the impact of vast wage gap on the economy and the significance of addressing this issue. The paper recommends further studies to understand the reasons of high levels of compensation of American CEOs and monitor their performance, industry mix, and firm size.

Growth of Chief Executive Officer's (CEO) Pay in America



Source: http://www.bostonglobe.com/business/2014/10/25/growing-effort-limit-ceo-pay/1VKKZCuZMkXJvaQRmUb4RN/story.html

ANALYSIS

From the output above, it is evident that the CEO's pay is much higher than that of the average worker. A CEO is paid about 20 times more than the workers per year. Therefore, an average CEO earns about $815,000 compared to the regular worker's payment of $39,500. It creates income inequality in the country that hurts economy. With such distribution of assets, wealth is concentrated rather than broadly distributed. As a result, the spending of the lower- and middle-income consumers is curtailed. Hence, the country's economy does not exhibit expected levels of growth (Johnston, 2014).

A high level of compensation of the American CEOs is partly a result of compensation arrangements between the CEOs and the directors of the respective companies. Based on the arm's-length bargaining model, whereby the demand for executives rises, for example, during the period of market booms, the companies are forced to pay more in order to hire and retain executives. The CEOs need more pay to compensate for the high level of effort they put into the enterprise (Bebchuk & Grinstein, 2005). The high pay given to the CEOs is explained by high demand for their services in the market and the need to compensate them appropriately.

The bull market effects guide one more explanation of the high levels of compensation for the CEOs. According to this theory, the bull market increases the wealth of the executives and, consequently, increases their reservation wage through the rise in the monetary amount required to induce them to work. The assumption of this theory is that the primary choice of executives is between the consuming and working leisure (Bebchuk & Grinstein, 2005). As shown in the graph provided above, the executives are compensated at a much higher level than the average employees. The reason is gained expertise in contrast to the ordinary workers, whose skills are more readily available.

The evidence shows that executives' salaries have been rising sharply since the late 1990s. Even though the inequality between the average workers and the executives had been declining before the 1970s, the ratio started to increase in the mid-1970s. By 2005, data had showed that a median officer's income was 110 times higher than the earnings of an average worker. The study also shows that "the growth of CEO pay was significantly rapider than that of the other officers in the study." (Bertrand, 2009, p.130). Since the 1980s, the ratio has been increasing steadily so that, as of early 2000s, it has reached 2.6. The output provided in the graph supports the analysis. From 1980s, the ratio of compensation of the executives and the average workers have been increasing to reach a climax in 2001 (Johnston, 2014). The compensation of executives has been higher than that of the average employees for years.

Based on the graph above, the CEO's compensation affects the U.S. economy significantly. Frydman and Jenter (2010) point out that in the 1980s, the U.S. economy demonstrated poor performance in comparison to the competitor nations. The reason was the fact that "the pay of the United States' CEOs far outpaced that of the CEOs in other countries"

(Mishel & Frankel, 1991, p.121). The high executive pay compared to the average employee is the cause of the growing income gap between the executives, wealthy investors, and the working Americans. For this reason, the soaring CEOs' salaries and the stagnant wages of the working population hinder the economy from achieving the necessary growth (Mehran, 1995).

The graphs also shows that the CEOs' pay in America has been growing over the years. For example, from 1980s, their pay has increased gradually to reach its peak in 2001 (Johnston, 2014). Kelly (2000) analyzed a survey of approximately 30 major firms in the U.S., which showed that CEOs received a compensation that was about 212 times higher in comparison to the pay given to an average American employee. This rate is about fivefold rise since 1965. From 1979 to 1989, there was a pre-tax increase in pay for the CEOs of 19%. It was higher than that of the competitor countries, such as the United Kingdom, Germany, and France, which exhibited a growth of 3%, 17%, and 13%, respectively. Within 10 years, the "after-tax CEO pay increased far faster in the U.S. than in Japan, Germany, or France" (Mishel & Frankel, 1991, p.121). As evident from the graph, the incomes of American CEOs have been growing at a very high rate compared to the other developed countries.

CONCLUSION / RECOMMENDATION

The issue of CEOs' high pay in America has been the concern of economists and the society as a whole because of the potential hazards it has on the economy. Although executives are paid much higher than the working employees, this fact has been triggered by the existing market conditions. The high demand for their services is the reason for the high pay, and the companies feel that if the executives are self-interested, they are bound to pursue their individual well-being at the expense of the enterprise.

A more extensive study of the CEOs' pay is underway, and there is much more to learn. Immense information exists about the biographical features of those who become the top echelons of the American corporate society. There is a need to gain a deeper understanding of the detailed profiles of those who end up becoming CEOs. One of the recent studies of 2008 indicated that the luck influenced the career paths of investment bankers. The study found that MBA students graduating during the stock-market boom have a higher chance of starting their careers on Wall Street and are more likely to continue working on Wall Street several years after their graduation (Bertrand, 2009).

Further, a detailed profile of CEOs should be obtained in order to understand whether their compensation is as a result of circumstances or their performance. The salary levels of the CEOs can be a consequence of the increased performance, firm size, and differences between industries. It is important to gain a better understanding of the extent of rise in compensation in order to find out whether it is a product of demand for their services, or changes in performance, industry mix, and the size of the company.