According to research published recently by the Washington-based Institute for Policy Studies, the 20 highest-paid corporate executives earned on average $36 million in total compensation last year. The typical CEO of a Fortune 500 company didn't do quite as well, but at $10.8 million didn't do so badly -- that's more than 364 times the pay of an average employee. Forty years ago, top CEOs earned 20 to 30 times what average workers earned.

The trend has ignited a flurry of attention in Washington. Last year the Securities and Exchange Commission ordered companies to reveal more detail about executive pay, but it's still hard for investors to decipher what companies disclose. SEC chairman Christopher Cox recently complained that a typical remuneration report is "as tough to read as a Ph.D. dissertation." In April, the House approved a proposal for a mandatory "say on pay" vote by shareholders. Although the White House opposes it and it has little chance of becoming law, expect Democrats to hammer away at the theme this election year.

Hold on.

There's an economic case for the stratospheric level of CEO pay which suggests shareholders -- even if they had full say -- would not reduce it. In fact, they're likely to let CEO pay continue to soar. That's because of a fundamental shift in the structure of the economy over the last four decades, from oligopolistic capitalism to super-competitive capitalism. CEO pay has risen astronomically over the interval, but so have investor returns.

The CEO of a big corporation 40 years ago was mostly a bureaucrat in charge of a large, high-volume production system whose rules were standardized and whose competitors were docile. It was the era of stable oligopolies, big unions, predictable markets and lackluster share performance. The CEO of a modern company is in a different situation. Oligopolies are mostly gone and entry barriers are low. Rivals are impinging all the time -- threatening to lure away consumers all too willing to be lured away, and threatening to hijack investors eager to jump ship at the slightest hint of an upturn in a rival's share price.

Worse yet, any given company's rivals can plug into similar global supply and distribution chains. They have access to low-cost suppliers from all over the world and can outsource jobs abroad as readily as their competitors. They can streamline their operations with equally efficient software culled from many
of the same vendors. They can get capital for new investment on much the same terms. And they can gain access to distribution channels that are no less efficient, some of them even identical.

So how does the modern corporation attract and keep consumers and investors (who also have better and better comparative information)? How does it distinguish itself? More and more, that depends on its CEO -- who has to be sufficiently clever, ruthless and driven to find and pull the levers that will deliver competitive advantage.

There are no standard textbook moves, no well-established strategies to draw upon. If there were, rivals would already be using them. The pool of proven talent is small because so few executives have been tested and succeeded. And the boards of major companies do not want to risk error. The cost of recruiting the wrong person can be very large -- and readily apparent in the deteriorating value of a company's shares. Boards are willing to pay more and more for CEOs and other top executives because their rivals are paying more and more for them. Former Home Depot CEO Robert Nardelli to the contrary notwithstanding, the pay is usually worth it to investors.

The proof is in the numbers. Between 1980 and 2003, the average CEO in America's 500 largest companies rose sixfold, adjusted for inflation. Outrageous? Not to investors. The average value of those 500 companies also rose by a factor of six, adjusted for inflation. In 2005, for example, Exxon Mobil reported $36 billion in profits. Its former chairman, Lee R. Raymond, retired that year with a compensation package totaling almost $400 million, including stock, stock options and long-term compensation. Too much? Not to Exxon's investors, who enjoyed a 223% return over the interval, compared to the average 205% return received by shareholders of other oil companies, a premium of about $16 billion. Raymond took home just 4% of that $16 billion.

As the economy has shifted toward supercapitalism, CEOs have become less like top bureaucrats and more like Hollywood celebrities who get a share of the house. Hollywood's most popular celebrities now pull in around 15% of whatever the studios take in at the box office. Clark Gable earned $100,000 a picture in the 1940s, roughly $800,000 in present dollars. But that was when Hollywood was dominated by big-studio oligopolies. Today, Tom Hanks makes closer to $20 million per film.

Movie studios -- now competing intensely not only with one another but with every other form of entertainment -- willingly pay these sums because they're still small compared to the money these stars bring in and the profits they generate. Today's big companies are paying their CEOs mammoth sums for much the same reason.

If you assume shareholders would rein in CEO pay, take a look at the United Kingdom. Since 2003, changes in British securities law have given investors more say over what British CEOs are paid. Nonetheless, executive pay there has continued to skyrocket, on the way to matching the pay of American CEOs.

Companies listed on the London stock market have done sufficiently well that British investors don't care what CEOs are paid. Full disclosure with shareholder approval might make it harder for a CEO to claim to be worth it if his company's shares have lost ground during his tenure or risen no more than the average share prices of other companies in the same industry. But given the intensity of competition for star performers, disclosure and approval might cause CEO pay to soar even higher.

This economic explanation for sky-high CEO pay does not justify it socially or morally. It only means that investors think CEOs are worth it. As citizens, though, most of us disapprove. About 80% of Americans polled by the Los Angeles Times and Bloomberg in early 2006 said CEOs are overpaid. The reaction was roughly the same regardless of the respondent's income or political affiliation. But if America wants to rein in executive pay, the answer isn't more shareholder rights. Just as with the
compensation of Hollywood celebrities or private-equity and hedge fund managers, the answer -- for anyone truly concerned -- is a higher marginal tax rate on the super pay of those in super demand.

Mr. Reich, professor of public policy at the University of California at Berkeley and former U.S. Secretary of Labor under President Clinton, is author of the just-published "Supercapitalism: The Transformation of Business, Democracy, and Everyday Life" (Alfred A. Knopf).

URL for this article:
http://online.wsj.com/article/SB118972669806427090.html

Copyright 2007 Dow Jones & Company, Inc. All Rights Reserved
This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our Subscriber Agreement and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit www.djreprints.com.

RELATED ARTICLES AND BLOGS
Related Articles from the Online Journal
• Scholars Link Success of Firms To Lives of CEOs

Blog Posts About This Topic
• How Much Should CEOs Be Paid?  financialrounds.blogspot.com
• More on Outrageous CEO Pay  willblogforfood.typepad.com

More related content  Powered by Sphere