

[23 Things We're Telling You About Capitalism XIV](#) [1]

Written by [Tim Worstall](#) [2] | Friday 24 May 2013

Our fourteenth thing is simply that American executives get paid far too much money and that this is wrong. In itself this is proof that a market manner of doing things is ineffective: just the simple fact that the average US CEO gets 300 times the wage of one of his workers proves this.

And we should admit that Chang has some useful points to make here. It's entirely possible that there is rent seeking in the way that CEO pay is determined. Interlocking boards, where you scratch my back with a pay rise and I'll approve your's next month could be partly to blame. The agent/principal problem may well be in play as well. While the shareholders are the legal owners of the company we can all find examples of organisations being run for the benefit of the managers, not the owners. So there is some truth to the processes which Chang points to as raising US CEO incomes.

However, not enough truth for his contention that these pay rates are in some manner wrong or unjustified.

For example, the comparison between the 30 or 40 times average wages that CEOs used to be paid and the 300 they are now. Back when the average US CEO was running a US domestic market company. This simply isn't the case now: the large corporations there (as with the large corporations everywhere in fact) are now global companies. They're massively larger than they used to be so it's not entirely surprising that pay for those running them has gone up.

The two major mistakes made though are not quite so simple.

The first is that Chang wants to claim that people are paid according to their marginal productivity: only if a CEO is worth 300 times the average worker should he be paid that. But that's really not quite how labour markets work. Yes, average wages in a country are going to be determined by average productivity, this is true. But the wages of individuals are going to be determined by supply and demand of those particular skills. Given the mess certain CEOs make of running large corporations we can also see that the supply of the necessary skills is fairly small. We'd thus expect a high price to be paid for them.

But even this is still understating the point. The job of a CEO is not just to make profits for the shareholders: it's to avoid making losses for them. The value therefore of a CEO is not just the profit booked at the end of the year: it's the losses avoided. And those losses can, of course, amount to the entire value of the firm itself as Chrysler and GM shareholders found out.

The second is that Chang hasn't recognised that CEO compensation is like that of traders or footballers. We're in a tournament here. There's no static benchmark by which we measure the performance: that performance is only ever relative to everybody else in the same field. You can be a very fine footballer indeed and never make it to the Premiership simply because there are a couple of hundred players who are better than you are. You could make a perfectly adequate CEO: but you'll not get there if there's a few hundred to a few thousand who are better at it than you are. So CEO pay isn't being based upon some critical appraisal of some abstract standard: it's all about whether you're actually better than the other candidates or not.

And we do very much know one thing about what happens to pay in such tournament markets. It soars: because being 5% better than the other guy means that the employer wants to have you, not the other guy.

And that's really what is behind high executive pay. Yes, there's undoubtedly rent seeking, there's certainly some aspect of larger companies paying larger amounts and so on. But the real point is that it is indeed a tournament and as I say, the one thing we know very well about tournament markets is that they pay massively to those who win the tournaments.

[blog comments powered by Disqus](#) ^[4]

Source URL: <http://www.adamsmith.org/blog/economics/23-things-were-telling-you-about-capitalism-xiv>

Links:

[1] <http://www.adamsmith.org/blog/economics/23-things-were-telling-you-about-capitalism-xiv>

[2] <http://www.adamsmith.org/taxonomy/term/5833>

[3] http://disqus.com/?ref_noscript

[4] <http://disqus.com>