The Executive Compensation Controversy: A Transatlantic Analysis

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The recent financial crisis has created a public uproar over top-executive pay packages and has led to calls for reform of executive pay in Europe and the USA. The current controversy is not the first – nor will it be the last – time that executive compensation has sparked outrage and led to regulation on both sides of the Atlantic. In this report, we trace the evolution of executive compensation, its controversies and its resulting regulations, which have typically come in the form of tax policies, disclosure rules, and accounting standards. We show that many features of current executive compensation practices reflect the often-unintended consequences of regulatory responses to perceived abuses in top-executive pay, often stemming from relatively isolated events or situations.

Based on a comprehensive comparison of pay spanning six years and covering approximately 1,500 USA firms and 1,100 firms from ten European countries, we show that USA CEOs are paid significantly more than their European counterparts even after controlling for company size, industry, and a variety of other firm and managerial characteristics. Moreover, we find that pay is more tightly linked to performance in the USA than throughout most of Europe, and that American executives hold more wealth in company stock and options than do their European counterparts. Indeed, we conclude that most of the difference in cross-continental pay levels is attributable to the higher use of stock and options in the USA, which in turn is related to a variety of tax, accounting, and social policies that have encouraged option grants in the USA.

The "bright spot" for incentives for European CEOs occurs in an unlikely place: the banking sector. We document a statistically strong relation between bonuses and shareholder returns for European banks, and an insignificant relation in non-banks. We also find that banking executives on both sides of the Atlantic suffered large personal losses during the recent crisis compared to their non-banking counterparts. Our evidence is inconsistent with claims that excessive risk taking in that sector was caused by the "banking bonus culture."

While pay design can always be improved and there will always be isolated abuses, we urge governments to resist temptations to further regulate pay in both banking and non-banking sectors. Part of the problem is that regulation – even when well intended – always creates unintended (and usually costly) side effects. Moreover, regulation is often designed to be punitive rather than constructive, and is inherently driven by politicians more interested in their political agendas rather than creating shareholder value. Ultimately, we conclude that improvements in executive compensation will best emanate through stronger corporate governance, and not through direct government intervention.