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Abstract: American CEOs rank among the highest-paid executives globally, while European CEOs managing similarly sized companies earn significantly less than their U.S. counterparts. This paper examines the factors contributing to the disparities in executive compensation between the U.S. and Europe. The findings suggest that tax policies, company valuations, and cultural perspectives on wealth accumulation help explain some of these differences.

Keywords: executive compensation; CEO pay; corporate governance

Introduction

American CEOs today earn substantially more than CEOs in any other country. Disparity between American CEO compensations and those of foreign companies has almost always existed, but the disparity has widened in recent years. As of 2023, the median FTSE 100 company CEO pay (excluding pension) in the UK was £3.81 million ($4.84 million at the exchange rate of $1.27 = 1 GBP), corresponding to 109 times the median full-time worker's pay of £34,963 in the UK (High Pay Centre, 2023). The average CEO pay for S&P 500 company CEOs in 2022 was $16.7 million – more than three times the UK figure. The pay ratio for S&P 500 companies in 2022 was 272:1, suggesting that, on average, an S&P 500 CEO earned a multiple of 272 on the median worker wage – more than twice the same ratio in the UK. American CEOs also outearn their British counterparts by 45% in cash pay and 190% in total pay, even after controlling for various factors (Conyon & Murphy, 2000). According to the same study, the highest-paid UK executive would only rank as the 97th highest among US chief executives.[1]

American CEOs outearn not only their UK counterparts but also their Japanese colleagues. Adjusting for firm size, this pay difference is substantial: Japanese CEOs make only about one-fifth of the pay their American peers who manage companies of similar size make (Nakazato et al., 2011). American executives also receive greater stock and option incentives compared to Japanese company CEOs. This difference in compensation levels is usually influenced by factors such as firm performance, corporate governance practices, and the structure of executive pay packages (Jaiswall & Raman, 2021) Nevertheless, it is a well-established fact that US company executives are compensated a lot more dearly compared to CEOs of foreign companies.

What factors contribute to US executives receiving higher compensation compared to executives in other countries? At the root of this disparity lies a theoretical conviction that has been widely accepted among finance and business administration departments in the United States. Understanding this theoretical foundation can also help us understand CEO pay in America.

A fundamental problem for any company run by a manager: The principal-agent problem

The principal-agent problem is a fundamental concept in economics and organizational theory that arises from the divergence of interests between a principal and an agent. The principals, in this case, are the shareholders of a company, and the agent is the CEO. The principal-agent relationship involves one party, the principal, delegating decision-making authority to another party, the agent, to act on their behalf. However, due to information asymmetry[2] and differing incentives, the agent may not always act in the best interests of the principal, leading to potential conflicts and inefficiencies. In the context of corporate governance, the principal-agent problem is particularly relevant. CEOs, as agents, are entrusted by shareholders, the principals, to manage the company and make decisions that maximize shareholder value. Motivated by their own self-interest, agents may "make themselves better off by deviating from their cooperative behavior," which maximizes

[1] The study highlights that the highest-paid UK executive, Chisolm, earned a £6.8 million pay package, which would only rank as the 97th highest among US chief executives.

[2] Information asymmetry refers to a situation in which one party involved in a transaction or relationship possesses more or superior information compared to the other party. This imbalance in information can lead to challenges, as the party with less information may be at a disadvantage when making decisions or negotiating terms.

the firm's welfare (Baiman, 1990). This may give rise to agency costs as the board tries to control and reign in potential conflicts of interest. CEO compensation and its structure come into the picture especially at this point. A well-structured pay package can influence the CEO and incentivize him/her to manage the company in a way that increases shareholder value. A poorly structured pay package, in the meantime, can lead to bad management and loss of shareholder value.[3] Studies on CEO pay for this reason have always been an important part of the discourse in managerial economics and corporate governance as CEO pay structure has the potential to solve but also to worsen the agency problem in companies.

Although CEOs in America are compensated way better than their counterparts in other countries and compared to workers in their companies, some are paid more dearly than others based on a number of factors. These factors can range from a CEO's characteristics such as age, gender, and background to those of the company they work for, such as the size of the firm.

CEO pay characteristics

CEO pay characteristics vary significantly and are influenced by a multitude of factors. One of the premises of this book is that CEO pay, is largely determined by firm performance. That is, CEO compensations must be closely linked to the performance of the company before any other factor. CEOs who outperform their peers in the industry should be compensated more generously by their boards compared to others. Previous research has confirmed this causal link (such as Joskow & Rose, 1994), but other research has also shown that performance is not the only factor in determining CEO pay. Factors ranging from gender (Chen et al., 2022) to CEO's human capital and skills (Datta & Iskandar-Datta, 2014), to firm characteristics (Faghani & Gyapong, 2018), to CEO tenure (Hou et al., 2016), to CEO talent (Jung & Subramanian, 2012), and to CEO personal characteristics (Wu, 2021) also matter. We summarized some of these below.

CEO gender

In the United States it is now common knowledge that women earn less than their male counterparts in almost all professions. A study done by the Pew Research Center showed that in 2022 women earned an average of 82% of what men earned across all professions (Pew Research, 2023). What is interesting is that the same wage gap also applies at the highest end of the corporate hierarchy. On average, male CEOs globally earn more than their female counterparts. A 2022 study by Chen et al. evaluated executive compensation data from 27 countries over the 2001 to 2016 period and found a 3.3% average difference in the level of executive compensation between male and female CEOs around the world.[4] Male CEOs earned more than their female counterparts not only in the United States but also globally. However more recent studies have shown that this disparity is decreasing. Equilar and the Associated Press have been conducting an annual analysis of CEO pay at S&P 500 companies since 2010. Their latest study, released in 2024, examined

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[3] Even this underlying premise is debated in light of recent academic work. Although, in theory, incentive compensation should lead to better performance because of incentive alignment, the reality may be different (Haubrich, 1994).

[4] Their results were robust when controlled for CEO education, age, and work experience and still held when US firms are excluded from the sample.

compensation patterns among long-serving chief executives - specifically those who held their positions at S&P 500 firms for a minimum of two years through the end of fiscal 2023. The 2024 report analyzed compensation for 341 CEOs, including 25 female executives. Female CEOs received median compensation of $17.6 million in 2023, exceeding the overall index median by 7.7%. Among women chief executives, AMD's Lisa T. Su maintained her position as the highest earner for the fifth straight year. Su's compensation package of $30.3 million surpassed that of General Motors' Mary T. Barra, who received $27.8 million. (Equilar, 2024)

We also know through empirical research that the CEO’s gender may influence compensation paid to other officers within the company. According to a study[5] published in 2015 by David Newton (Newton & Simutin, 2015) of the Federal Reserve Bank of St. Louis and Mikhail Simutin of the University of Toronto, female officers working for a male CEO earn, on average, $46,500 per year less than male officers. In the meantime, the age of the male CEO is also an important determinant of how much the female officers below him are paid. Older male CEOs are even more likely to underpay female officers. Older male CEOs reward female officers $360 less per year of age than they do their male counterparts.

In summary, the CEO’s gender is not just a determinant of his/her pay package but also those of other officers who are working for him/her in the company.

Generalist vs specialist CEO

The generalist and specialist CEO distinction is based on the breadth and depth of knowledge and experience possessed by a CEO. Generalist CEOs typically possess a broad set of managerial knowledge and skills. They can navigate diverse industries and managerial challenges effectively. You can find a generalist CEO managing a fashion company who might have transferred from a telecommunications firm. Generalist CEOs are characterized by their ability to move across industries and adapt to different organizational contexts due to their varied industry experience (Ma et al., 2021). It is not unusual to find generalist CEOs in the fashion industry who managed nonfashion companies in the past. For instance, Bob Martin of Gap Inc. previously worked as the chairman and CEO of Walmart’s international business. Richard Hayne of Urban Outfitters started his career at a food company before founding Urban Outfitters in 1970. CEO Calvin McDonald had worked at Sears, Walmart, and Sephora prior to managing Lululemon Athletica in 2018. Under his leadership, Lululemon Athletica became one of the few companies in the fashion industry that was able to grow its sales during the pandemic.

In contrast to generalist CEOs, specialist CEOs have a narrower but deeper set of knowledge and skills that are closely tied to a particular industry, firm, or domain. They excel in specific areas where their expertise is highly specialized, making them valuable assets in industries requiring in-depth knowledge and focused skills (Nasirov et al., 2021). While some mass-market brands hire generalist CEOs, most high-end luxury fashion houses tend to promote CEOs with specialized backgrounds within the fashion/luxury sector itself. For instance, Marco Bizzarri of Gucci worked

[5] Their study covered 2,548 large, publicly traded US companies for the period from 1996 to 2011. Even when considering various factors influencing executive compensation, such as a company’s financial performance metrics like stock performance, volatility, and return on assets, the study reveals that the age and gender of CEOs play a significant role. Specifically, corporate officers of the opposite gender to their CEO tend to receive lower compensation. This effect is most pronounced when the CEO is male.

at other luxury brands like Stella McCartney, Valentino, and Cerrutti before becoming Gucci's CEO in 2015, while Cédric Charbit, the CEO of Balenciaga was a longtime fashion executive who previously led Yves Saint Laurent before taking over as Balenciaga's CEO in 2021. Similarly, Jonathan Akeroyd joined Burberry as CEO in 2022 after having spent over 25 years in the industry working for luxury brands such as Alexander McQueen, Versace, and Ralph Lauren.

Research[6] indicates that generalist CEOs are often less risk averse than specialist CEOs. They can take on more risks and pursue more innovative strategies. There are reasons behind this. One argument is that generalist CEOs' failures in one firm may not significantly impact their career paths due to their ability to transition across industries (Ma et al., 2021).This means a generalist CEO may switch to industry Y after having completed an unsuccessful career at a firm in industry X. Transitioning across industries gives them a clean slate.

Generalist CEOs are also not as entrenched in industry conventions as CEOs who have risen through the ranks. They are outsiders, and this outsider perspective could make them more open to taking bold risks and challenging traditional business models or creative directions. Generalist CEOs also lack those ingrained loyalties, potentially making them more willing to take bigger strategic risks.[7] In addition, many generalist CEOs are brought in specifically to shake up stagnant companies and inject new innovative thinking. To achieve transformational change, they may be more inclined to embrace riskier, high-reward initiatives. However, it is important to note that individual CEOs may deviate from these general tendencies, and other factors, such as the specific industry context and the CEO's personal characteristics, can also influence their risk-taking behavior.

When it comes to compensation, empirical research shows that generalist CEOs usually receive higher pay than specialist CEOs (Liu & Shi, 2021). This might be a result of their rewarding risk-taking behavior or an outcome of the value placed on their broader skill set and adaptability across different business environments.

Insider vs outsider CEO

An insider CEO is typically someone who has been within the organization and has a history with the company, often possessing in-depth knowledge of its operations, culture, and industry dynamics. In contrast, an outsider CEO is an individual who comes from outside the organization, bringing a fresh perspective and potentially different experiences from other industries or companies. Most outsider CEOs also fall under the generalist CEO category mentioned in the above section. The differentiation between insider and outsider CEOs can impact various aspects of corporate governance, decision-making, and strategic direction. Insider CEOs may leverage their familiarity with the company to drive continuity and capitalize on internal resources, while outsider CEOs might introduce novel ideas and strategies but may face challenges in understanding the organization's intricacies and gaining employee trust. The choice between an insider and outsider CEO often reflects the company's objectives, the need for change or stability, and the board's assessment of the leadership qualities required to navigate the organization effectively. Research has shown that an outsider CEO usually earns a premium compared to the insider CEO

[6] Such as Ferreira and Matos (2013), Ma et al. (2021), and Mishra (2014).

[7] Specialist CEOs who came up through a company's ranks may feel more beholden to long-standing design philosophies, supplier relationships, etc. A generalist CEO does not have to oblige to such pressures.

(Brockman et al., 2016). But when it comes to performance, evidence is mixed. While some studies (such as Karaevli & Zajac, 2013) showed that performance wise outsiders are no different from insiders at the helm[8], other research has shown that firms with insider CEOs tend to be more profitable compared to those with outsider CEOs[9] (Lee, 2023).

Firm size

Another important determinant of CEO pay is firm size and market value. There is a significant difference between CEO pay when it comes to the size of the company the CEO is working for. Bigger companies can afford to offer more attractive compensation packages to their executives. An interesting study (Gabaix et al., 2014) tested this theory following the financial crisis of 2008. By using data from 2004 to 2011, which included the crisis period, this study demonstrated that CEO pay (measured before the crisis) closely tracked the changes in average firm value. During the crisis, when firm value fell by 17%, CEO pay dropped by 28%. Conversely, during the recovery period, firm value increased by 19% and CEO pay went up by 22%. These proportional changes provide evidence that CEO pay is linked to the firm's market value. We also see this pattern in our analysis of fashion companies. Larger firms usually pay higher compensation to their CEOs. (See discussion in upcoming chapters)

CEO tenure

CEO tenure refers to the duration a CEO has been in their position within a company. It is a critical metric reflecting the CEO's experience, knowledge, and leadership capabilities within the organization. The length of the CEO tenure impacts CEO compensation: those CEOs who have been at the helm longer are usually compensated better compared to those who have been in their positions for shorter periods (Han & Mun, 2023).

CEO's personal characteristics

Studies have also highlighted the impact of CEO age, tenure, education, founder status, and celebrity status on CEO pay (Li & Srinivasan, 2011). Older CEOs tend to receive higher pay compared to younger ones. This positive correlation between the age of the CEO and his/her pay, however, ends when the CEO reaches the retirement age (Brookman & Thistle, 2013).

Gender composition of the board

Another determinant of CEO pay is the gender composition of the board of directors within the company. Previous research suggests there might be differences in CEO compensation packages when boards are male or female dominated. A study by Usman et al. (2018) focused on gender diversity in compensation committees and found that having independent female directors can

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[8] The authors of this study indicate that external and internal CEO appointments show comparable performance levels during their first three years. However, external hires tend to achieve better results under specific conditions. They are more likely to succeed when taking over companies facing performance challenges or operating in rapidly growing industries. Additionally, outside CEOs who bring in their own executive teams typically outperform internal successors. Notably, the study challenges common assumptions by revealing that rapid strategic shifts implemented by new external CEOs in their early tenure often lead to declining company performance.

[9] This might possibly be due to the fact that insider CEOs acquire more firm-specific skills from prior experience than outsiders (Choi et al., 2022).

limit CEO cash compensation and strengthen the link between CEO pay and firm performance, suggesting that board composition is important in moderating CEO compensation.

CEO power

An important idea that explains how CEO pay is determined is the ***managerial power theory***, as proposed by Bebchuk, Fried, and Walker in 2002. This idea posits that executives possess the power to influence their own compensation arrangements, allowing them to extract rents,[10] and that boards do not act independently when determining executive pay but rather succumb to the influence of executives, leading to the extraction of excessive pay that may not be in the best interest of shareholders. Executives, leveraging their power, can manipulate compensation structures to camouflage rent extraction, potentially resulting in inefficient pay arrangements that do not optimize incentives and ultimately diminish shareholder value (Bebchuk et al., 2002).

The managerial power theory challenges the principal-agent theory perspective by emphasizing the significant role of executives in shaping their compensation packages. It suggests that executives, being at the apex of power within organizations, can exert influence over directors and compensation decisions, thereby affecting their own pay levels. This theory implies that executive compensation practices are not solely driven by aligning managerial interests with those of shareholders but can also serve as a means for executives to extract rents from the company, potentially at the expense of shareholder value (Bebchuk & Fried, 2003). In summary, the managerial power theory highlights suboptimal pay arrangements that may not align with shareholder interests.

[10] Economic rent in this context refers to payments to the owner of a factor of production (in this case, labor and human capital owned by the CEO) that exceed the costs required to keep that factor in its present use. Put another way, it represents surplus payment beyond what is required to retain the services of a CEO.

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