Study: Benchmarks and 'leapfrogs' drive up CEO pay

May 25 2010

Why have CEO salaries skyrocketed over the past 20 years? Much of the blame lies in the practice of compensation benchmarking, say the authors of a study to be published next week in the *American Journal of Sociology*.

Benchmarking is a standard practice in American corporations. When setting pay, compensation committees use peer groups of executives at comparable firms to establish a "fair" market wage their CEOs. But according to the study, led by sociologist Thomas DiPrete from Columbia University, a few CEOs each year "leapfrog" their peers by getting huge raises that have little to do with the performance of their companies. Other companies then use the oversized pay of leapfroggers in subsequent benchmarks. Over time, this ratchets up pay for everyone through a "contagion effect."

"We show that rising CEO pay is not simply a function of what individual companies do, but is influenced by the behavior of leapfroggers at other firms," DiPrete said.

DiPrete and his colleagues (including a former CEO) used procedures laid out in compensation handbooks to reconstruct likely peer groups for CEOs listed in Standard and Poor's annual compensation surveys. They could then look for evidence of leapfrogging in those likely peer groups over time. Their simulation shows that leapfrogging explains about half of the overall increase in CEO pay from 1992 to 2006.

The researchers say that the finding broadens the debate about what is driving CEO salaries upward. Opinions on the subject have generally fallen into two camps: those who think CEOs are overpaid because of failures in corporate governance at individual firms, and those who think CEOs are paid what they deserve based on the profits they deliver to shareholders and a "superstar" labor market. However, this study shows that ill-gotten raises for a few CEOs can lead to "legitimate" pay increases for others. "[T]he linkages among firms produced by the benchmarking process guarantee that firm-level governance failure becomes a factor in the environment of other firms," the researchers write.

Following the Enron and WorldCom scandals of the early 2000s, the Securities and Exchange Commission changed its rules to require firms to disclose benchmarking information. The research team is now using the new data mandated by the SEC to better understand how the network structure of peer groups affects executive pay setting in American corporations.

"Whether the SEC regulatory change reduces the ratcheting effect of leapfrogging on CEO pay -- creating more transparency about who is in the peer group and at what level the company is benchmarking -- is an important question for future research" says DiPrete.

More information: Thomas A. DiPrete, Greg Eirich and Matthew Pittinsky, "Compensation Benchmarking, Leapfrogs, and the Surge in Executive Pay." American Journal of Sociology (May 2010).

Provided by University of Chicago