

The comment period closed yesterday on the [Securities and Exchange Commission's \(SEC\) proposed rule](#) requiring disclosure of the ratio of CEO pay to the median pay of all workers in the firm. In a [public interest comment filed with the SEC](#), I argue there is little economic justification for this disclosure, which appears to be motivated by a desire to “shame” companies with high wage inequality inside the firm.

While the benefits are tenuous, the costs are clear. Firms must already report on CEO pay, but gathering information on median compensation is harder than it sounds. The systems in place in current corporations are not equipped to collect this information. In the final rule, the SEC may allow firms to base estimates of median pay on samples, which could reduce costs, but there will be dramatic differences across firms in sampling methodology and implementation, making no two disclosures easily comparable.

The indirect costs of the requirement are likely to be more problematic. The guiding presumption behind the rule, which is required by the Dodd-Frank Act, appears to be that executive pay is too high, and disclosing the pay ratio will serve as a form of “inequality measure” that will pressure corporations into lowering executive pay. If, contrary to this presumption, executive pay is appropriate and economically efficient, however, political and public pressure can induce the firm to move away from efficiency and write a suboptimal compensation contract. When this happens, revenues and profits will suffer as well as stock price.

My own research supports the theory that compensation is set in a labor market, where, like all markets, there are both buyers and sellers. In this labor market for executive talent, managers shop around for the right firm, and firms seek to find the best manager they can afford. The wage is set in the marketplace, through the interaction of supply and demand. What emerges is what economists call an equilibrium – the delicate balance between how much firms are willing to pay managers, and the supply of managers in the marketplace available to the firms.

This market-based view of compensation has obtained increasing attention in academic circles. It explains the large increase in executive pay over the last quarter century. Evidence suggests that executives are paid more because firms are growing and must compete for managerial talent. In that competition, the best managers receive some of the surplus from this corporate growth in the form of compensation. Thus, executives are paid more simply because firms are larger and more productive.

The SEC rule can have severe unintended consequences. If there is indeed a market penalty for high pay ratios, then firms will have incentives to lower the ratio. While one way would be to



lower CEO pay, another would be to raise the median pay. Firms can do this by hiring fewer low-wage workers. But doing so could have negative effects on the economy, since large firms are the major employers of low-wage workers, especially in the retail and service sectors. The SEC rule effectively provides an incentive for firms not to create jobs.

There are a host of other accounting and statistical problems with the calculation of the pay ratio. There is a little uniformity in sampling for the median, or in defining who counts and who does not. A firm with a large part-time labor force will have low median pay, and thus the SEC effectively discourages firms from hiring part-time workers. But a part-time work force can be economically efficient, especially if employees want flexibility in their schedule and the firm does not need a full-time employee on staff. Hiring abroad brings additional problems. Companies with large multinational workforces will need to compare compensation across countries, which can be difficult not only because of different currencies, but also the valuation of benefits.

The list can go on. The bottom line is that compensation does not fall out of thin air, but rather is set in a marketplace. Ultimately, the CEO and the factory worker are not competing for the same job, but are each competing in separate labor markets across firms and sometimes industries; it is thus meaningless to compare executive and worker pay. Let the firms decide for themselves how much their labor is worth. If a highly paid CEO has strong incentives to generate value, this will translate into greater goods and services provided to customers, and more resources for all employees, including the ones on the shop floor.

