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REMUNERATION

Do CEOs deserve their high salaries?

A mismatch between a CEO's skills and a company's requirements could be costly to that company. But does that justify the high salaries that South African CEOs earn?

Last year, Bloomberg reported that South African CEOs earn the seventh-most of any country in the world – at R102m per person per annum, equivalent to 541 times the income of average South Africans. The study, understandably, caused some outrage.

These numbers have been disputed, mostly because they include CEOs who earn in foreign currency. A study by 21st Century Consultants found that the CEO salary of the median large-cap South African firm in 2016 was less than R6m, roughly 5% of the Bloomberg average. PwC found the median between R3.1m and R7.7m.

But even at these levels, many ask whether CEOs *deserve* what they earn. Does the value that they add outweigh the millions spent on salaries and bonuses? This is an incredibly complex question. Economists have no laboratory where they can randomly assign CEOs their salaries, and see what the outcome might be. Instead, we have CEOs that respond to the firm's internal and external demands in various ways, planning, strategising, meeting and organising. Which of these activities adds more value seems impossible to determine.

That is, until now. A new study by four economists – Oriana Bandiera (LSE), Stephen Hansen (Oxford), Andrea Prat (Columbia Business School) and Raffeala Sadun (Harvard Business School) – measure the behaviour of CEOs in Brazil, France, Germany, India, the UK and the US, and compare these to their firm's performance. They used a two-stage method: first, they collect the weekly diaries of 1 114 CEOs in the six countries. Diaries include detailed information about the hourly activities of each CEO: meetings, the number and duration of plant/shop-floor visits, business lunches, how many people joined, the functions of these participants (were they in finance or marketing, for example, or clients or suppliers).

Their finding is that CEO activities differ remarkably across firms. While CEOs spend most of their time in meetings, they "differ in the extent to which their focus is on firms' employees versus outsiders, and within the former, whether they mostly interact with high-level executives versus production employees". The authors then use a machine learning algorithm to create an index of CEO behaviour. At low values of the index, CEOs spend more time with production and in one-on-one meetings with employees and suppliers. At high values CEOs spend more time with executives and in meetings with more participants.

The authors note that there is no theoretical reason for one type of behaviour to lead to better outcomes. Different types of behaviour may just be a consequence of firms requiring different types of CEOs. Some firms will do better with a low-index CEO, and others with a high-index CEO. When CEOs are perfectly matched – or "assigned" – to the type of firm that suit their style, there should be no correlation between the index-value of a CEO and the firm's performance. A low-index CEO matched to the correct firm would perform just as well as a high-index CEO matched to a firm that will benefit from this CEO style type.

The results, however, shows the opposite. High values on the CEO index are strongly correlated with higher firm productivity, a measure of firm performance. CEOs who spend most of their time in meetings with senior executives, engage in communication (phone calls, videoconferences, etc.), bring together inside and outside functions, and bring together more than one function of a kind are also more likely to lead more productive firms.

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Their results also show that CEOs are often not matched to the right firm: "…while low-index CEOs are optimal for some of the sample firms, their supply generally outstrips demand, such that 17% of the firms end up with the 'wrong' CEO".

In the two developing countries in their sample – Brazil and India – matching is especially bad: 36% of firms in those countries end up with the 'wrong' CEO compared to the 5% in the developed countries. "The productivity loss generated by the misallocation of CEOs to firms equals 13% of the labour productivity gap between high and low income countries."

The authors do not speculate on why this difference exists. A reason is weaker competition for top jobs within a thinner talent pool owing to the unequal levels of education in these countries. Or that appointments happen for reasons other than merit.

The study shows that the choice of CEO is critical for firm success. Although some firms benefit from a CEO who frequently has one-on-one conversations and visits the production floor, most firms benefit from a CEO who spend their days leading large meetings with top executives from different fields.

That helps to explain the high salaries for CEOs in SA too. A mismatch between CEO and firm is costly and seems to happen quite frequently. The small talent pool means that most firms are willing to pay exceptional salaries to those rare individuals with a high CEO index-value. If they don't, the firm is likely to suffer far more costly productivity losses.

It also points to the dangers of policies that hope to place an upper-bound on managerial remuneration. Lower levels of remuneration will likely lead to fewer CEOs with high index-value, and to higher levels of mismatch between CEOs and firms. That, as the authors show, will be devastating for firm-level productivity, and economic development. Beware the unintended consequences of policies made with good intentions. ■

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