

The role of innovation in the compensation of American executive leaders.



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CEO salaries have been steadily on the rise since 1980. In 2006, the 20 highest paid executives from quoted U.S. companies earned an average of 36.2 million dollars a year. That figure represents three times the average of European counterparts. Today, as the average annual salary for high-level executives in major American companies tops the 10 million dollar mark, public opinion seeks increasing justification for why these executives deserve such a heavy share of the earnings. Public opinion also seeks answers for why American CEO's tend to have much higher salaries than their European colleagues, even when the latter manage companies that are 40% larger on the average than their American equivalents.

In a recent study directed at these issues titled, *Executive compensation in North American high-technology firms: A contextual approach*, Marianna Makri, Luís Gómez Mejía and the author of this article identify the four contextual factors that explain why American CEO salaries have increased so much and why they are higher than those of their European counterparts. These four contextual factors include the U.S. legal system, U.S. government intervention in legislation, country-risk in the USA, and U.S. cultural and social idiosyncrasies.

As far as the legal system is concerned, it is important to consider just how crucial the issue of patents is to the technology industry. Legal security, anti-monopoly protection and the safeguarding of intellectual property rights combine to facilitate investments in R&D for U.S. companies. This in turn allows executive profits to be viewed under criteria that reward the quality of innovation over the quantity of innovation. This translates into generating better short-term and long-term financial indicators, and thus CEO salaries increase accordingly.

The role of the U.S. government in legislation is also crucial to the area of patents. The Patent Reform Law passed by Congress in April of 2007 is a good example of how political action in the United States favors entrepreneurial innovation. And this also has repercussions in the remuneration of CEOs.

“Country-risk” refers to the level of economic and political uncertainty that tends to be relatively low in the United States, aside from exceptional junctures such as the present crisis. Even so, it does influence the uncertainty of results for innovation projects. Therefore, if CEOs are asked to accept additional risks, they are accustomed to demand higher compensation in return.

A country’s cultural and social idiosyncrasies also influence CEO salaries. National culture can be broken down into four aspects: a) power distance or social stratification; b) the individual-collective dynamic, i.e. the desire of the individual to promote himself above the group; c) the masculine-feminine dynamic, i.e. orientation to work and/or relationships; and d) the need for regulations and procedures to combat ambiguity and uncertainty. U.S. companies operate in a culture that values creativity, presents a low level of power distance, features a high level of individualism and is known for its low level of aversion to uncertainty. This confluence of factors impacts executive salaries in a very favorable way.

The study also analyzes a topic that has been researched very little: the effects of family ownership on salaries of CEOs working for U.S. technology companies. It is well known that family businesses play an important role in the creation and financing of new companies as well as the development of economic and technological advances. As a matter of fact, funding families are present in over a third of Standard & Poor’s top 500 companies. They are also present in many technology sector companies including Microsoft and HP, both of which owe their starts precisely to heavy interest and investment by such families. The data from our study reveal that, in general, CEOs related to funding families normally value job security over salary and, therefore, tend to compete less in the global market. However, this is not the only factor that explains why they are used to getting paid less than their colleagues at non-family businesses. They also tend to make more cautious decisions in R&D projects. Given that the latter are so important to the technology sector, family businesses in this sector offer much higher salaries to CEOs who are not part of the family and come from the global

market. These “outsiders” are expected to strengthen their companies’ potential for innovation. As such, the close relationship between CEO remuneration and business innovation is evident in this company segment as well.

R&D tends to be responsible for growth and market dominance to the extent that CEOs must take risks when making final decisions on which projects and investments to undertake. To stimulate the development of innovative projects that render new products, greater efficiency or market control, companies opt for highly attractive remuneration packages. As such, the need for innovation is directly behind the seemingly inexplicable CEO salary spike. This is certainly worth remembering in order to avoid oversimplifying the debate concerning American executive salaries.