Do CEO’s deserve what they earn?

As financial careers become more lucrative and as the income gap between the rich and poor grow larger, one must ask whether workers are earning the amount of pay that they deserve. In particular, the heart of the issue is whether it is ethical for CEOs to earn roughly 231 times the average worker.\(^1\) To determine the answer to this question, first I will assess the definition of desert and explain the logic behind the idea of a salary. Then, I will suggest that a worker’s pay increase depending solely on value created along a scale of three tiers. In conclusion, I will analyze a CEO’s salary based on my proposed approach and evaluate whether the compensation is justified.

Assessing What One “Deserves”

Purpose of Salaries

Human beings are rational creatures who act on self-interests. We are motivated to engage in activities that will result in a state where we are better off. Whether we directly reap the rewards or gain a transfer of equal value, we expect to benefit from the fruits of our labor in one way or another. Thus arises the concept of a salary, in which workers do not acquire the effects of their labor, but instead, are compensated with an

equivalent monetary sum. For example, a professional chef is not rewarded by the food he cooks, but by a fixed payment in currency. Employees receive a salary from their employers in exchange for the work they are asked to perform. Economists would reason that this business transaction occurs because employees need an incentive to work and thereby voluntarily forgo the opportunity cost of participating in an alternative activity, namely leisure. As a result, a worker’s salary must take into account the value of the work achieved and the size of the incentive to attract the appropriate talent for the job. The reason I have chosen to disregard the value of effort exerted is because every individual has varying mental and physical capacities. In the end, it is only the outcome that matters. Achieving the desired result is preferable to a worker who exerts one hundred percent of his effort, but does not accomplish the intended task. Effort is more of a self-rewarding external benefit, for which the effect is increased utility if an individual tried his best and succeeded.

Method of Acquisition

People should be compensated for the work they perform, however, only on the grounds that the method of acquisition was by moral means. The three criteria of a moral acquisition are 1) everyone has an equal opportunity, 2) there are enough opportunities left for others to create value, and 3) the compensation is equal to the value of the product.² Theoretically, the office of the CEO is open to all individuals even though the position is usually given to the person with a higher mental capacity. One may argue that this does not fit the concept of equal opportunity since those

characteristics depend on inherent abilities and the environment in which the person was raised. For this reason, Hayek claims merit is more deserving of praise than the value of the achievement. Merit, the attributes of conduct, or the moral character of the action, is not based on qualities that are determined by a higher power such as intelligence, which is an innate advantage. “If we know that a man has done his best, we will often wish to see him rewarded irrespective of the result; and if we know that a most valuable achievement is almost entirely due to luck or favorable circumstances, we will give little credit to the author.”³ Contrary to this perspective, I believe compensation is deserved not solely based on moral character, but more so by the size and kind of value created by the action. More often than not, our judgments are distorted by our wanting of more favorable circumstances or desirable qualities for ourselves. While donating to charity is more commendable than purchasing luxury goods, society cannot prevent a person from enjoying the fruits of his labor as he wishes. My proposal to focus through the lens of value will compensate for our discounting of merit when looking at value added to society. Furthermore, the focus should be on the end product because it is the foundation of the value chain. If the outcome is worthless, then the compensation should reflect its small value. Our natural differences present each individual with capacities of varying degrees to help us contribute to society in different ways. Our diverse levels of skill counteract each other thereby creating a balance. If we were all math geniuses, then our literacy would be deficient. If we were all Einsteins, everyone would be capable of accomplishing the work he created, making it relatively ordinary and comparably of less value. Moreover, we would not be as knowledgeable about the

³ Hayek, 95.
humanities. Thus, if we all engaged in activities that maximized the use of our capacities, we would be incentivized to willingly perform the work to capture and be rewarded the maximum value. Consequently, society would naturally progress.

**Measuring Value**

Now that we agree on the terms that employees deserve to be compensated for their work, the next step is to decide to what extent that work is worth. Specifically, is the value of the CEO’s salary equal to six figure digits or 231 times the average worker’s? Since a worker’s salary is comprised of the value of the work achieved and the size of the incentive to attract the appropriate talent for the job, it would be logical to establish a measurement for these two factors. While society does not have the ability to determine the exact monetary value of one’s work, there are other ways to get a close estimate. Allowing society to declare a precise number to value someone’s work is not a valid means to measure its worth because preferences vary from one person to another. However, I believe we do have the capacity to recognize the value of one’s accomplishments relative to another along a scale of three tiers: value created, value added to the company, and value added to society.

*Value Created and Value Added*

Conducting an appraisal of the value of the work performed along the three tiers will help determine how much an individual should be compensated. The first tier focuses on the product itself, the second tier is from the overall company’s perspective,
and the third tier is from the lens of society. Naturally, the greater the value created or added, the larger the pay.

The first tier involves the value created in general, which can be represented by a base pay. If a worker consents to completing a task in exchange for compensation, he must be paid an amount that equals the value of his contribution towards the end product. The total value of the end product is typically the price at which it was sold, or the equilibrium when the buyer’s willingness to pay and the worker’s willingness to sell intersect. After deducting the extraneous costs such as input materials and taxes from the price, the remaining profit should be divided proportionally amongst the workers based on the value of their contribution to the end product. Difficulty of the task, relevance of the outcome, and productivity should all be minor considerations when determining how much a person should be compensated for his work. Nevertheless, the most important component is the value created by the particular contribution, which can be compared relative to the other contributions towards the end product. For instance, if we think of the price the buyer pays as the total value of the pie created, the value of each person’s contribution is a slice of that pie. How big that person’s slice of pie is depends on how much of the pie he created. Also along the base pay in the first tier is the incentive pay, which motivates workers to take the job and perform it well. As Haslett once said, “in order to get people to be productive, society needs instead to entice them to produce.” My beliefs diverge from his, however, when he further suggests that “the most effective way of enticing people to produce is to distribute income and wealth according to productivity.” Productivity, which is defined as the rate

at which things are produced, in my opinion, is not a good indicator for how much one should be rewarded. One can be very productive, but if the contribution is not relevant to the purpose of the end product, then there wasn’t any value created for the employer to be obliged to compensate the worker.

Once the value of the first tier base and incentive pay has been established, the employee’s pay can rise to the second tier if his work adds value to the company, and even reach the third tier for a bigger bonus if the work adds value to society. In other words, workers should be compensated for the resulting external benefits in addition to the basic value created. Value added to the company can be thought of as positive growth that expands the pie as a result of one’s work. Examples include a better company image or reputation and higher shareholder confidence. A step up to the third tier would be the consequence of value added to society, or as Hayek would say, the value they create for others.\footnote{F.A. Hayek, The Constitution of Liberty, (Chicago, IL: University of Chicago, 1978).} Even though the added value may be due to a person’s extra capacities, any improvement to society is always a benefit and even the least advantaged person is better off than the position he was in before.\footnote{John Rawls, A Theory of Justice, (Cambridge, MA: The Belknap Press of Harvard University Press, 1971).} If a worker were not rewarded for his value added to society, it might be a disincentive for him to use his natural gifts. If he did not act, then the extra benefit would not be realized at all and society would be stagnant and socially regressive. Therefore, a salary should reward value in terms of the end product, growth to the company, and merit to advance society. A larger compensation would reflect a greater value for each of these tiers.
Are CEO’s worth 231 times the average worker?

To close, we return to our original question: Do CEO’s deserve what they earn (231 times the average worker)? Since we’ve established that workers should be rewarded proportionally to the value they create, let’s evaluate the value CEOs create along the three tiers stated above. The role of a Chief Executive Officer is largely a management position. The value the CEO creates is dependent on how effectively he can manage the company. The value the CEO adds to the company is enormous because without this position, the management structure would break down. Therefore, the position and the purpose of the CEO are extremely valuable assets. To remove the CEO from the equation would mean disorganization and the compensation will reflect a lower value as a result. As a consequence of a CEO’s standing along the management chain, a higher pay would also indicate authority and control. It is necessary to convey leadership and reward the work that he has contributed. While the first and second tiers of the CEO position are more well-defined, the value to society is completely dependent on each individual CEO and his actions. For instance, a CEO who recycles waste paper generates more value than a CEO who just discards the resource. In conclusion, CEOs should be the highest paid employee of a company, but to say that they are worth 231 times the average worker may be exaggerated although it is relative to the firm’s net income and the value the created.