CEO Pay Reform: A Point/Counterpoint

Prepared by the Institute for Policy Studies and the Center for Corporate Policy

March 2, 2007

The debate in Congress over executive pay is heating up, with those who support the status quo on the defensive. To stop any serious redrawing of the compensation landscape, they've been busy rallying statistics and arguments to "prove" that CEO pay ought not be a matter for congressional concern. This memo sums up — and dissects — the major arguments against significant congressional action on CEO pay.

Justification #1

Executives are making more because corporations are performing better.

"Yes, corporate compensation has gone sky high, but the result is better-run, better performing companies than the United States has ever had."— *Washington Post commentary by Roy C. Smith, New York University, January 21, 2007*[1]

Overall corporate profits have risen sharply over the past several years, but there is no evidence to suggest that this is because massive executive pay packages have motivated CEOs to do better work. A 2006 Corporate Library study found that high increases in compensation did not reflect significant long-term improvements in company performance.[2] One of the most outrageous examples was Edward Whitacre, CEO of AT&T, who made $34 million over the years 2004 and 2005, despite a 40-point drop in his company's stock from 2001-2005. Similarly, the CEO of BellSouth made a total of $23 million even though his stock dropped more than 26 points. More recently, Pfizer chief Hank McKinnell and Home Depot's Robert Nardelli made headlines by walking away with about $200 million each, despite steep slides in their companies' stock. A July 2005 Moody's study suggested that firms that paid excessive compensation could actually face higher credit risks. The investor service found that firms which had large unexplained bonuses and option grants during the period 1993-2003 experienced dramatically higher default and downgrade rates.[3]

Justification #2

Executives are making more because corporations are bigger.

"CEOs get paid more because they run bigger, more valuable companies … If a good CEO can boost profits by $200 million, he's easily worth $10 million, or more." — *James K. Glassman, American Enterprise Institute, December 26, 2006*[4]

A 2006 study by MIT and NYU economists argues that the rise in CEO pay between 1980 and 2003 was "fully attributable" to the increase in the size of U.S. companies during that period.[5] In their view, as executives increased firm value, they justifiably reaped larger rewards. However, as David Wessel pointed out in the *Wall Street Journal*, U.S. companies also experienced tremendous growth from the 1940s through the 1970s, but CEO pay during that period didn't rise much faster than worker pay. By contrast, today's CEO-worker pay gap stands at 411-to-1, compared to only 42-to-1 in 1980.[6] Moreover, much of the growth in firm size during the past two and a half decades was due to mergers that, according to Miami University professor James Brock, have had dismal results in terms of efficiency. Brock points out that the estimated $20 trillion spent "shuffling paper ownership shares for existing facilities and firms" could have been invested in developing new products, production methods, and plants equipped with state-of-the-art technologies."[7]

Justification #3

Marketplace realities explain why CEOs make what they do. The demand for top-quality CEOs is simply a lot higher than the supply.

"CEOs are paid what they are worth to their companies, and their high pay reflects the extraordinary value of their talent."—*Greg Mankiw, former Economic Advisor to President Bush, October 14, 2006*[8]

With more MBA's than ever before, it's hard to believe that executive talent is in such short supply. Other factors are the real drivers of pay escalation:

Out of Control Options

The biggest component of compensation is stock options, which are often touted as a way to align the interests of managers and shareholders. In reality, options allow CEOs to reap massive payouts from short-term stock spikes or industry-wide movements – even if their own company's performance is poor. They can also drive executives to "cook the books" or take other actions that boost short-term share prices at the expense of long-term returns. As former SEC Chair Arthur Levitt, Jr. put it, "these compensation packages set up a system in which executives have I believe the wrong incentives. Too often they are managing the numbers for short-term gain and personal payout and not managing the business for long-term growth and shareholder value."[9] Options have also been widely abused. The SEC is investigating more than 100 companies for options backdating -- retroactively setting the price of an option at an earlier date to maximize the executive's unearned profits, at shareholder expense.

Cozy Corporate Boards

The NYSE and NASDAQ now require listed companies to have a majority of their board made up of "independent" directors. But this just means they cannot be employed by or have a business relationship with the firm. CEOs still have enormous power to hand-pick their directors, and once selected, few of them want to risk losing their coveted slots by questioning excessive executive pay. Case in point: Enron's board members were largely independent, among them the Dean of the Stanford Business School. Proxy rules continue to make it cost prohibitive for shareholders to run their own director candidates.

Compensation Consultants Aim to Please

Corporate boards often hire compensation consultants to help justify high executive pay packages through peer surveys. To keep their customers happy, these consultants have an incentive to skew their research by including one-time hiring bonuses and other pay anomalies. Then boards typically place their CEOs' pay at an above-average level, say the 75th percentile, which might sound "reasonable," but results in a steady ratcheting upwards of compensation. According to Orin Kramer, Chairman, New Jersey Investment Council, "The theoretical role of the compensation consultant is to make an independent assessment of what senior executives are supposed to be paid. The business model of being a compensation consultant is based on satisfying the interests of the people about whom they're supposed to be making that independent judgment."[10]

Justification #4

Congress should not be setting salaries in the private sector.

"Government should not decide the compensation for America's corporate executives." — *President George W. Bush, January 31, 2007*[11]

Critics often mischaracterize proposed pay reforms as iron-clad ceilings on CEO pay. In reality, there is no proposal under discussion on Capitol Hill that would set limits on how much firms could pay their CEOs. The bill initiated by Rep. Barney Frank (D-MA), Chair of the House Financial Services Committee, focuses on giving corporate owners (the shareholders) new powers. It would allow shareholders a nonbinding annual vote on compensation plans and increase SEC reporting requirements related to pay. The other major proposal on the table is the measure in the Senate version of the minimum wage bill that would put a $1 million per year limit on how much executives could put into tax-deferred executive compensation plans. This and other similar tax reforms that have been discussed in Congress over the years aim to lessen the burden on average taxpayers of executive privileges in the tax system.

Justification #5
If there's a problem, shareholders can flex their market power to fix it.

"As a shareholder, as I am in certain companies that I disclose, I have the ability to use the marketplace and walk."[12] — *Rep. Patrick McHenry (R-NC), May 25, 2006*

According to Prof. Jim Hawley, director of the Center for the Study of Fiduciary Capitalism at Saint Mary's College, large institutional investors don't have much power to "walk" because of their increased investment in the growing number of index funds. The bulk of today's trading is done by a limited number of hedge funds. Moreover, as Christianna Wood, of the California Public Employees' Retirement System (CALPERS), explained at a Congressional hearing, "It would be against our fiduciary duty to sell those securities and just walk away. We would lose our voice, and we would impair the returns of the fund."[13] Brandon Rees, of the AFL-CIO, added that "if I wanted to screen the companies that I invested in, based on those that paid reasonable compensation, I would have a very difficult time finding enough companies to get a diversified portfolio. The problem is that this is a systematic problem."

Justification #6
Nobody complains about sports or movie stars making a lot of money. Why should amply rewarded CEOs bother us?

"This whole idea that they don't deserve their pay, or a false incentive, what about the pay of a guy throwing a baseball, whether it's 90 miles an hour or 100? He has a tremendous incentive to work. And he makes $10,000 a pitch. I mean, who gets hysterical about that?" — *Rep. Ron Paul (R-TX, May 25, 2006)*[14]

Of course some of the payouts to celebrities are absurd. It's hard to fathom why Tiger Woods would need to make his reported $100 million per year or what possible good use soccer star David Beckham could have for the estimated $250 million he is expected to make through his new U.S. contract and endorsements. But at least it's pretty easy to measure the individual performance of an athlete. As Rep. Brad Sherman (D-CA) put it: "To say that whether the Miami Heat win the playoffs depends upon Shaq is mostly true. To say that whether a Buick works depends to the same degree on the chairman of General Motors is to ignore the hard work, dedication, and skill of tens of hundreds of thousands of GM employees."[15]

Another difference is that celebrity stars themselves are part of the brand value. As Wharton marketing professor Americus Reed II puts it, "Part of what makes Beckham a unique brand is that he is one of the few sports icons who combines this whole package of a glitzy and glamorous fantasy world -- a good athlete, Hollywood good looks, a good-looking wife...Moving his brand to the United States gives him the opportunity to extend his 15 minutes." Also, Beckham isn't making more than the owner of his new team, Phil Anschutz, who made $1.9 billion by cashing out most of the stock options he held at Qwest before it crashed.

Justification #7
Corporate critics are exaggerating how much CEOs make.

"Misleading reports that large numbers of CEOs make hundreds of millions of dollars every year are simply untrue. Executive compensation has closely followed the growth that companies have experienced in the last ten years."— *John J. Castellani, President, Business Roundtable*[16]

"The media has been flooded with a multitude of distorted, misleading and oftentimes erroneous statistics to portray U.S. CEOs and board governance in a negative light."— *Fred Cook, founding director of compensation consulting firm Frederic W. Cook & Co.*[17]

The Business Roundtable released research in July 2006 that it claimed "sets the record straight on executive compensation."[18] The key finding was that median CEO compensation had risen at about the same rate as shareholder returns during the period 1995-2005. This, the association of CEOs claims, is proof that executive pay is aligned with corporate performance. *New York Times* business columnist Gretchen Morgenson skewered the study, pointing out that the author left out some of the biggest components of executive compensation from his calculations. Missing were amounts for restricted stock, pension benefits, deferred compensation, and severance pay. It left out dividends from the CEO side, even though they are included in shareholder returns. The report also ignored the value of stock option exercises, the source of the most massive CEOs payoffs. Morgenson concluded that the Roundtable report "does exactly what it has accused pay critics of doing: picking and choosing numbers to bolster their views."[19] In a later article, Morgenson pointed out that the author of the Roundtable study, compensation consultant Frederic W. Cook, was hardly an impartial number-cruncher. His firm had advised companies with some of the most controversial CEO pay packages of the past decade, including the $1.1 billion stock award for three top Computer Associates executives, as well as Hank McKinnell's notorious $83 million pension plan at Pfizer.[20] McKinnell was Chairman of the Business Roundtable at the time Cook undertook the research.

Justification #8

Let's stop obsessing about CEO pay. In a multi-trillion-dollar economy, what CEOs are earning amounts to a mere pittance, with no significant economic impact one way or the other.

"While overly generous executive pay may be maddening, it is a drop in the bucket compared to the size of these companies and the impact it has on shareholder prices and employee compensation." — *Anne Kim, et al, The Third Way think tank, February 2007*[21]

That argument has been effectively rebutted by two Harvard University researchers who looked at a large set of public firms and found that the compensation paid to their top five executives was hardly pocket change. During the period 2001 to 2003, the earnings of the top five executives at these firms amounted to nearly 10% of corporate earnings. And that was almost double what it was during that period 1993 to 1995. If these pay levels were more reasonable, the gains to investors would have a real impact on corporate earnings.[22]

There are additional reasons to be concerned about excessive executive compensation. Management guru Peter Drucker, echoing the view of finance magnate J.P. Morgan, believed that the ratio of pay between worker and executive could be no higher than 20-to-1 without damaging company morale. Several studies have supported this belief. A poll of *Industry Week* subscribers, the majority of whom are managers themselves, revealed that over half felt that soaring salaries at the top had a depressing effect on their morale and productivity.[23] Another study published in the *Journal of Organizational Behavior* found that high levels of executive compensation generated cynicism in white-collar workers. The research further found a correlation between cynicism and tendencies toward unethical behavior.[24]

The ever-widening gap between CEO and worker pay also raises concerns about the health of our democracy. Concentrated economic power can translate into concentrated political power to push through policies that benefit the few at the expense of others. And finally, there are those who see the growing gap as a fundamental issue of fairness and ethics. William McDonough, chair of the Public Companies Accounting Oversight Board and former Federal Reserve Bank of New York President, calls the rise in executive pay "grotesquely immoral."[25]

Authors

Institute for Policy Studies:

Sam Pizzigati, IPS Associate Fellow and Editor, *Too Much* online.
Contact: editor@toomuchonline.org, 301-933-2710.
Sarah Anderson, IPS Global Economy Project Director.
Contact: saraha@igc.org, 202 234 9382 x 227.
IPS, an independent center for research and education, has produced an annual study of executive compensation for the past 13 years. Web: http://www.ips-dc.org.

Center for Corporate Policy:

Charlie Cray, Director of the Center for Corporate Policy. Contact: ccray@corporatepolicy.org, 202-387-8030. CCP is a nonpartisan public research and advocacy organization working for corporate accountability. Web: http://www.corporatepolicy.org

NOTES

[1] Roy C. Smith, "Worth Every Last Million," *Washington Post,* January 21, 2007.
[2] Paul Hodgson, Ric Marshall, "Pay for Failure: The Compensation Committees Responsible," The Corporate Library, June 2006. See: http://www.thecorporatelibrary.com/tcl-store/PressReleases/865mm_in_ceo_compensation_while.htm
[3] "Special Comment--Takeover Defenses and Credit Risk," Moody's Investor Service, July 2005, cited in Corporate Accountability Report, September 23, 2005. See: http://sitemaker.umich.edu/options-backdating/files/bnapaper.htm
[4] James K. Glassman, "Well-Paid CEOs Enrich U.S.; With 5% of World's Population, USA Home to Half of Largest Companies," American Enterprise Institute, December 26, 2006. See: http://www.aei.org/publications/pubID.25354,filter.all/pub_detail.asp
[5] Xavier Gabaix and Augustin Landier, "Why Has CEO Pay Increased So Much?" July 22, 2006. See : http://www.princeton.edu/~bcf/Seminar06/GabaixPaper.pdf
[6] "Executive Excess 2006," Institute for Policy Studies and United for a Fair Economy, August 30, 2006.
[7] James Brock, "Merger Mania and Its Discontents," *Multinational Monitor*, July/August 2005.
[8] Greg Mankiw's Blog, http://gregmankiw.blogspot.com/2006/10/gabaix-on-ceo-pay.html.
[9] Symposium on Bebchuk and Fried's Pay Without Performance, *Journal of Corporation Law*, Voume 30, Number 4, Summer 2005, p. 749.
[10] Ibid, p. 774
[11] White House, State of the Economy Report, January 31, 2007. See: http://www.whitehouse.gov/news/releases/2007/01/20070131-1.html
[12] Transcript, Hearing Before the Committee on Financial Services, U.S. House of Representatives, May 25, 2006.
[13] Ibid.
[14] Ibid.
[15] Ibid.
[16] Business Roundtable, press release, July 5, 2006. See: http://www.businessroundtable.org/newsroom/Document.aspx?qs=5906BF807822B0F1AD2408522FB51711FCF50C8
[17] Transcript, Hearing Before the Committee on Financial Services, U.S. House of Representatives, May 25, 2006.
[18] Business Roundtable, press release, July 5, 2006. See : http://www.businessroundtable.org/taskForces/taskforce/document.aspx?qs=6FF5BF159F949514481138A74EA1851159169FEB56A39B7AF
[19] Gretchen Morgenson, "Is 'Total Pay' That Tough To Grasp?" *New York Times*, July 9, 2006.
[20] Gretchen Morgenson, "Corporate America's Pay Pal," *New York Times*, October 15, 2006.
[21] Anne Kim, Adam Solomon, Bernard L. Schwartz, Jim Kessler, and Stephen Rose, "The New Rules Economy: A Policy Framework for the 21st Century," The Third Way, February 2007.
[22] Lucian A. Bebchuk and Yaniv Grinstein, "The Growth of Executive Pay," *Oxford Review of Economic Policy*, Summer 2005.
[23] *Industry Week*, April 15, 1991.
[24] Lynne M. Andersson and Thomas S. Bateman, "Cynicism in the Workplace: Some Causes and Effects," *Journal of Organizational Behavior*, September 1997.
[25] *Seattle Post-Intelligencer*, April 26, 2004.