

# THE CORPORATE PAY GAP: DO WE NEED A MAXIMUM WAGE?

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Our future will likely depend, in no small part, on how effectively and efficiently our enterprises operate. Tomorrow's enterprises will need to behave responsibly and consume resources sustainably. These enterprises, to succeed at this challenging level, will almost certainly have to tap the wisdom of everyone within them, from front-line staff to top-ranking executives.

Unfortunately, America's most prominent enterprises appear to be falling a bit short on the wisdom front. As a group, over recent years, they have come across as anything but effective and efficient. Their behaviors have often seemed far more reckless than responsible. Our automakers have lobbied against fuel efficiency standards.<sup>1</sup> Our pharmaceutical firms have rushed unsafe drugs to market.<sup>2</sup> Our financial giants have ignited a global economic meltdown.<sup>3</sup>

Where should we place the blame for all this recklessness? A growing number of analysts are faulting excessive executive pay. This past November, former Federal Reserve chair Paul Volcker "blamed excessive pay packages" for our global financial breakdown.<sup>4</sup> In January, a report on that breakdown from the Organization for Economic Co-operation and Development, the research center for the world's top democracies, charged that executive "compensation schemes

have often led to excessive risk taking."<sup>5</sup> "It is the compensation system," as former Federal Home Loan Bank Board litigation director William Black sums up, "that has proved to be the weak point in everything critical that went wrong, that has produced a global catastrophe."<sup>6</sup>

This perspective on executive excess now even resonates in the White House. In February, President Obama promised a "long-term effort" to examine how executive pay patterns "have contributed to a reckless culture and quarter-by-quarter mentality that in turn have wrought havoc in our financial system."<sup>7</sup>

Outrageously high rewards, executive pay critics contend, give top executives an incentive to behave outrageously not just in high finance, but also throughout the economy. The greater the potential reward, the greater the temptation to grab that reward by any means necessary—by wild wheeling and dealing, by shortchanging worker training and slashing R&D, by hammering consumers, or, should all else fail, by simply cooking the books.

## CEO Pay Reform

Outrage over these sorts of behaviors has elevated CEO pay into a top-tier political concern. But this outrage has not yet translated into any consensus over solutions. CEO pay reformers have essentially split into two distinct camps. See table 1 for a comparison.

One camp looks to shareholders for salvation. Reformers in this camp are demanding a “say on pay” for shareholders—the right to take advisory votes on executive pay—as well as changes in corporate governance that give dissident shareholders a real shot at unseating incumbent directors.

Reformers in the second camp support this shareholder empowerment. But they question the shareholder camp’s unspoken assumption, the notion that we can rely on shareholders, and shareholders alone, to restore common sense to executive compensation. “Why should we let shareholders be the ultimate arbiter on the size of CEO rewards,” as one second camp report has noted, “when these rewards can and do create incentives for CEO behaviors that hurt people who aren’t shareholders?”<sup>8</sup>

Consumers, workers, and communities all have a stake in how corporations pay CEOs, this “stakeholder camp” argues.

Shareholders, from this perspective, count as just one stakeholder among many, with interests that may not align with the interests of other stakeholders. One example: A community that hands a corporation generous tax breaks to boost local employment will not be pleased if that corporation’s CEO proceeds to aggressively outsource. Shareholders will react differently—if the outsourcing raises the company share price.

As a society, we actually do already recognize this divergence of stakeholder interests. We do not, for instance, leave solely to shareholders the responsibility for making sure that corporations refrain from fouling the environment. Instead, we

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legislate how corporations can behave environmentally. By the same token, we do not expect shareholders to monitor the fairness of corporate employment practices. Instead, we deny our tax dollars—in government procurement—to companies that discriminate by race or gender. Our tax dollars, we believe, should not subsidize enterprises that widen race or gender inequality. “Stakeholder camp” reformers extend this analogy to executive compensation. Our tax dollars, they maintain, should also not subsidize enterprises that widen economic inequality. Our tax

dollars today undeniably do. Billions of tax dollars annually flow to companies that pay executives far more than workers—and far more than executives used to collect. A generation ago, CEO pay averaged 40 times worker take-home. The gap in 2007: 344 times.

### What Should the Gap Be?

Until his death four years ago, the founder of modern management science, Peter Drucker, argued that any executive compensation over 20 or 25 times worker pay fundamentally undermines enterprise effectiveness.<sup>9</sup> Some lawmakers are building on Drucker’s insights. Rep. Barbara Lee (D-California) has introduced legislation that denies corporations tax deductions on all executive pay over 25 times the pay of a company’s lowest-paid worker. Rep. Janice Schakowsky (D-Illinois) has proposed granting a preference in federal contract bidding to companies that compensate executives at no more than 100 times worker pay.

Until the federal bank bailout, “maximum wage” measures like these seldom registered on America’s political radar screen. But a steady diet of headlines

**Table 1: CEO Pay Reform: Comparing the Two Basic Approaches**

	The Shareholder Perspective	The Stakeholder Perspective
<b>The Problem</b>	Executives who perform poorly are walking off with excessive rewards.	Grotesquely excessive rewards give top executives a powerful incentive to behave grotesquely.
<b>The Victims</b>	The people who hold stock directly or through pension plans and 401(k)s.	Everyone with a stake in the decisions that corporations make: not just shareholders but workers, consumers, and taxpayers. To score windfall paydays, CEOs engage in behaviors that hurt all these stakeholders.
<b>The Solution</b>	Through regulation and legislation, reform corporate governance procedures and give shareholders the information and power they need to hold corporate boards accountable.	Empower shareholders, but don’t stop there. Leverage the power of the public purse to limit CEO pay. Deny corporations that overpay executives government contracts, subsidies, and tax breaks.
<b>The Ultimate Executive Pay Goal</b>	A corporate America where no executive at a poorly performing company makes out like a robber baron.	A corporate America where no executive makes more in a day—or a week—than a worker can make in a year.
<b>Academic Advocates</b>	Business profs who study corporate governance.	Business profs who study what makes enterprises effective and efficient.
<b>Public-Interest Community Advocates</b>	Council of Institutional Investors The Corporate Library	Institute for Policy Studies Center for Corporate Policy

about private jets and bonus billions has substantially altered the political climate. In late January, Senator Claire McCaskill (D-Missouri) won national kudos for her proposal to cap pay in bailed-out companies at \$400,000, the President's salary. Only days later, President Obama announced a \$500,000 pay cap for certain bailout situations.

President Obama's current \$400,000 salary, interestingly, equals nearly 25 times the lowest federal pay grade. This 25-to-1 ratio, some legislators believe, could well serve as the basic standard in all situations that involve tax dollars. In Connecticut, earlier this year, two state lawmakers introduced legislation that would deny "state assistance" to any corporation that pays executives over 25 times what the company's lowest-paid worker is earning.<sup>10</sup>

This Connecticut legislation doesn't define "assistance." But if lawmakers at the state and federal level were to apply this 25-times principle to every transfer of tax dollars to the private sector—if they were to deny, for instance, government contracts to bidders with executive pay over 25 times worker pay—the impact on corporate compensation would be immediate and enormous. Corporations, faced with the prospect of losing access to government procurement, would almost instantly recalibrate how they structure their pay patterns.<sup>11</sup>

Could American business function with a 25-times pay ceiling? Why not? Many major corporations in Japan and other developed economies operate within a 25-times standard. And before the 1980s, here in the United States, enterprises functioned quite nicely for years with top rewards that seldom exceeded 25 times worker compensation.

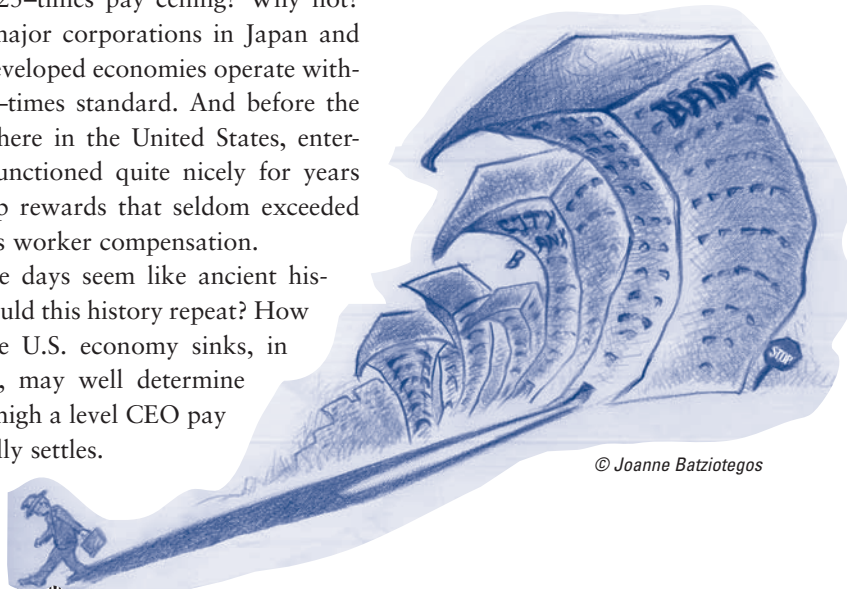
Those days seem like ancient history. Could this history repeat? How deep the U.S. economy sinks, in the end, may well determine at how high a level CEO pay eventually settles.

## NOTES

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3. See P. Muolo and M. Padilla, *Chain of Blame: How Wall Street Caused the Mortgage and Credit Crisis* (Indianapolis: Wiley, 2008).
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5. G. Wehinger, "Lessons from the Financial Market Turmoil: Challenges ahead for the Financial Industry and Policy Makers." Organization for Economic Co-operation and Development (OECD) Financial Market Trends No. 95, January 8, 2009.
6. T. Frank, "Wall Street Bonuses Are an Outrage," *Wall Street Journal*, February 4, 2009, <http://online.wsj.com/article/SB123371071061546079.html> (accessed February 26, 2009).
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9. Until his death four years ago, notes Drucker Institute director Rick Wartzman at Claremont Graduate University, Peter Drucker "never gave up on the 20-to-1 rule for CEOs, touting it as the right thing for the good of the organization, as well as for the general health of society." R. Wartzman, "Put a Cap on CEO Pay," *Business Week*, September 12, 2008.
10. H.B. No. 5922, Session Year 2009, An Act Concerning Commitments of Responsible Corporations, [http://www.cga.ct.gov/asp/cgabillstatus/cgabillstatus.asp?selBillType=Bill&bill\\_num=5922&which\\_year=2009](http://www.cga.ct.gov/asp/cgabillstatus/cgabillstatus.asp?selBillType=Bill&bill_num=5922&which_year=2009) (accessed February 26, 2009).
11. The federal government, in one sense, is already enforcing a "maximum wage" on government contractors. The Office of Management and Budget annually establishes a maximum benchmark for contractor compensation, \$612,196 in FY 2008. But this benchmark merely limits the executive salary a company can directly bill the government for reimbursement. The benchmark in no way limits the stock-related executive pay windfalls that government contracts regularly help generate.

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