



The CEO Pay Debate: Myths v Facts

This fact sheet sums up — and dissects — the major arguments against public policy action on CEO pay.

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Myth #1

In a multi-trillion-dollar economy, what CEOs are earning amounts to a mere pittance, with no significant economic impact.

“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*¹

Impact on earnings: Two Harvard University researchers 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 percent 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.²

Impact on taxpayers: U.S. taxpayers subsidize excessive executive compensation — by more than \$20 billion per year — via a variety of tax and accounting loopholes. For example, there are no meaningful limits on how much companies can deduct from their taxes for the expense of executive compensation. The more they pay their CEO, the more they can deduct. A proposed reform to cap tax deductibility at no more than 25 times the pay of the lowest-paid worker could generate more than \$5 billion in extra federal revenues per year.

Employee morale: 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.³ 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.⁴

Myth #2

Lawmakers have no business setting salaries in the private sector.

“Government should not decide the compensation for America’s corporate executives.” — *President George W. Bush, January 31, 2007*⁵

Lawmakers mandate limits on corporate behavior all the time. They limit how much pollution corporations can spew out. They limit the chemicals companies can sneak into their products. They limit the hours they can force employees to labor. They set these limits because they recognize that irresponsible corporate behaviors threaten our communities. Excessive executive pay, the Wall Street meltdown has demonstrated ever so vividly, endangers our public well-being as surely as any

pollutants. Jackpots have become so huge that executives will do anything to hit them. They'll even destroy our economy. Thus, particularly when corporations are benefiting from government assistance, whether through subsidies, contracts, or tax breaks, it is responsible policy to set limits on executive pay.

Myth #3

Executives are making more because corporations are performing better.

“Corporate compensation has gone sky high, but the result is better-run, better performing companies than the United States has ever had.”— *Washington Post op-ed by Roy C. Smith, New York University, January 21, 2007*⁶

The financial meltdown that escalated in 2008 exposed the falsehood of this long-held myth. Executives chasing after windfalls in the mortgage market misled and even defrauded millions of families and sent the economy into the ditch. Instead of rewards for good performance, outrageously high rewards give executives an incentive to behave outrageously. The nine major banks that were the first to receive massive capital infusions from the Treasury Department paid their CEOs a combined \$289 million in 2007, including stock options.

Myth #4

Executives are making more because corporations are bigger.

“CEOs get paid more because they run bigger, more valuable companies.” — *James K. Glassman, American Enterprise Institute, December 26, 2006*⁷

As David Wessel pointed out in the *Wall Street Journal*, U.S. companies 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 344-to-1, compared to only 42-to-1 in 1980.⁸ 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.⁹

Myth #5

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*¹⁰

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.”¹¹ Options have also been widely abused. In recent years the SEC has investigated 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."¹²

Myth #6

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."¹³ — *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. A limited number of hedge funds do the bulk of today's trading. Moreover, as Christianna Wood, of the California Public Employees' Retirement System, explains, "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."¹⁴ 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."

Myth #7

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)*¹⁵

Of course some celebrity payouts 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 \$250 million he is expected to make through his new U.S. contract and endorsements. But at least it's pretty easy to measure an athlete's individual performance. 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 GM is to ignore the hard work, dedication, and skill of tens of hundreds of thousands of GM employees.”¹⁶

Myth #8

Corporate critics are exaggerating how much CEOs make.

“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, 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. The CEO association claims this is proof that executive pay is aligned with corporate performance. *New York Times* business columnist Gretchen Morgenson skewered the study, pointing out that it left out some of the biggest components of executive compensation. 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

About IPS

The Institute for Policy Studies, a progressive multi-issue think tank founded in 1963, has published 15 widely publicized annual reports on executive pay. The latest, [Executive Excess 2008](#), found that five tax loopholes that benefit top executives cost taxpayers more than \$20 billion per year. For more IPS analysis on executive pay, see: www.ips-dc.org.

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NOTES

¹ 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.

² Lucian A. Bebchuk and Yaniv Grinstein, “The Growth of Executive Pay,” *Oxford Review of Economic Policy*, Summer 2005.

³ *Industry Week*, April 15, 1991.

⁴ Lynne M. Andersson and Thomas S. Bateman, “Cynicism in the Workplace: Some Causes and Effects,” *Journal of Organizational Behavior*, September 1997.

⁵ White House, State of the Economy Report, January 31, 2007. See: <http://www.whitehouse.gov/news/releases/2007/01/20070131-1.html>

⁶ Roy C. Smith, “Worth Every Last Million,” *Washington Post*, January 21, 2007.

⁷ 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

⁸ “Executive Excess 2008,” Institute for Policy Studies and United for a Fair Economy, August 25, 2008.

⁹ James Brock, “Merger Mania and Its Discontents,” *Multinational Monitor*, July/August 2005.

¹⁰ Greg Mankiw’s Blog, <http://gregmankiw.blogspot.com/2006/10/gabaix-on-ceo-pay.html>.

¹¹ Symposium on Bebchuk and Fried’s Pay Without Performance, *Journal of Corporation Law*, Volume 30, Number 4, Summer 2005, p. 749.

¹² *Ibid.*, p. 774

¹³ Transcript, Hearing Before the Committee on Financial Services, U.S. House of Representatives, May 25, 2006.

¹⁴ *Ibid.*

¹⁵ *Ibid.*

¹⁶ *Ibid.*

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.