Selfish Interest

How Much Business Roundtable CEOs Stand to Lose from Real Reform of Runaway Executive Pay

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The Institute for Policy Studies is an independent center for research and education, founded in Washington, DC in 1963. It has produced an annual study of executive compensation for the past 13 years.

The Center for Corporate Policy is a nonpartisan public research and advocacy organization working for corporate accountability.

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Key Findings

Chief executives in the Business Roundtable, who are leading the fight to block CEO pay reforms in the U.S. Congress, would have much to lose from real compensation reform.

- In 2006, the *Wall Street Journal* reports, the typical big-time CEO in the United States received $6,548,000 in direct compensation. The comparable median direct compensation total for the 83 CEOs in the *Journal* sample who serve on the powerful Business Roundtable: $9,863,700.
- Pay for Business Roundtable CEOs is rising much faster than for American workers overall. In 2006, the CEOs in the Business Roundtable saw their pay jump 10.6 percent, nearly three times more than the average wage increase of 3.7 percent that went to typical U.S. white collar workers.
- Five CEOs in the Business Roundtable collected pay increases over 85 percent last year. Michael Ward, the top exec at railway giant CSX led the pack with a 336 percent pay hike.
- Merck & Company, the third-largest American drug manufacturer, last year led the American corporate world in "worker pain, CEO gain." Merck CEO Richard Clark pocketed a 167 percent pay increase in 2006 after announcing, in November 2005, over 7,000 job cuts.
- Perks continue to figure prominently in CEO pay packages. The Business Roundtable chief executive with the most lucrative collection of perks in 2006 — Boeing CEO James McNerney — collected $1.1 million for moving expenses last year. McNerney moved all of 400 miles, from his former job at the Minnesota-based 3M to the Chicago-based Boeing.
- Many Business Roundtable CEOs appear to be wildly over-compensated, even by the narrow definition of "performance" usually employed in corporate circles. Anadarko Petroleum CEO James Hackett's 2006 total direct compensation rose 78 percent in 2006, despite a 7.4 point drop in total shareholder return, a measure that combines stock appreciation and dividends.

The Business Roundtable and other corporate interests are mounting a vigorous effort to persuade Congress not to meddle in the CEO pay system. Instead, elected officials should see through the self-interest and give careful consideration to the whole range of legislative options related to executive pay.

I. Introduction

Does CEO pay in the United States need any more fixing?

The 160 corporate CEOs who make up the Business Roundtable — the nation's single most influential business lobbying group — don't think so. The Business Roundtable is currently leading the corporate charge against congressional efforts to legislate new checks on executive compensation.

Reforms already in place, Business Roundtable President John Castellani told a congressional hearing last month, are more than adequately addressing the concerns many Americans have expressed over recent corporate behavior.

"A wave of reforms over the past five years," as Castellani testified at a March 8, 2007 hearing of the House Financial Services Committee, "has resulted in improved investor confidence in our corporations, growth in the stock market, and continued shareholder returns."

Chief executives in the Business Roundtable have one additional — and personally powerful — reason to feel comfortable with today's corporate status quo. In 2006, our analysis of just released national CEO pay data documents, these executives enjoyed median total direct compensation of $9.9 million, compared to $6.5 million for CEOs of large U.S. companies as a whole.

Business Roundtable executives are doing even better compared to American workers. In 2006, the CEOs who belong to the Business Roundtable saw their pay jump 10.6 percent, nearly three times more than the average wage increase of 3.7 percent that went to typical U.S. white collar workers.

The new CEO pay figures published April 9, 2007 by the *Wall Street Journal* offer the first comprehensive look at CEO pay nationally since the Securities and Exchange Commission announced new executive pay disclosure requirements last summer.

The Business Roundtable publicly supports this new SEC disclosure standard, as well as the 2002 Sarbanes-Oxley overhaul of corporate accounting standards. The Business Roundtable also promotes, as evidence of the organization's commitment to reform, the "principles" of corporate governance and executive compensation that the group has adopted to help corporate boards "hold CEOs accountable for company performance."

But the Business Roundtable has steadfastly opposed any congressional efforts at CEO pay reform that go beyond disclosure or any other reforms already in place.

Two such congressional efforts are now pending.

'Say on Pay' Bill

In the House, the Shareholder Vote on Executive Compensation Act (H.R. 1257), introduced by Rep. Barney Frank (D-Mass.), has already gained the approval of the Financial Services Committee. This legislation, if enacted, would give shareholders the right to take a "nonbinding," advisory vote on CEO pay plans.

Requiring this advisory vote, Business Roundtable President Castellani objected last month, "would seriously erode" corporate board responsibilities.

"Corporations," Castellani told Congress, "were never designed to be democracies."

Cap on Deferred Compensation

In the Senate, meanwhile, lawmakers have passed — as part of their minimum wage increase compromise package — a tax code change that sets a $1 million cap on the amount of annual compensation corporate executives can have "deferred" and shielded from income tax.

Deferred compensation has become, in recent years, a prime driver behind excessive executive pay. Earlier this year, deferred compensation arrangements helped departing Home Depot CEO Robert Nardelli and Pfizer chief Hank McKinnell walk off with severance packages worth about $200 million each. McKinnell served as Chairman of the Business Roundtable November 2003 through July 2006.

The Business Roundtable is working to keep the Senate cap on deferred pay out of any minimum wage compromise between the House and Senate. At last month's House Financial Services hearing, the Business Roundtable's Castellani tagged the Senate deferred pay cap and the House shareholder vote proposal as equally objectionable.

Objections from the Business Roundtable carry considerable weight in policy-making circles. The chief executives who constitute the Business Roundtable membership lead companies that employ over 10 million workers and account for "nearly a third of the total value" on U.S. stock markets. One example of the Roundtable's power is their success in blocking a 2003 SEC proposal that would give shareholders a role in nominating candidates for corporate boards.[1]

This enormous Business Roundtable clout on Capitol Hill, if truly focused on ending the corporate pay abuses that have average Americans upset and alarmed, could make a real difference. That's a difference that CEOs in the Business Roundtable, so far at least, apparently don't feel they can "afford" to make.

II. Business Roundtable Member Pay

Of the 160 CEOs who belong to the Business Roundtable, 140 lead publicly traded companies required to report executive pay data to the Securities and Exchange Commission (12 others head privately held companies, and eight serve as CEOs of foreign firm subsidiaries).

Of the 140 CEOs of publicly traded companies, 83 appear in this year's *Wall Street Journal* executive pay survey of 350 U.S. corporations with revenues of $1 billion or more. Not all CEOs of public companies appear in the *Journal* survey because many companies do not file their proxies in time to be included.

- **Business Roundtable Execs Do Better than Peers and American Workers**

The Business Roundtable executives in the new *Wall Street Journal* survey enjoyed $9.9 million in median total direct compensation last year. CEOs of large U.S. companies as a whole collected substantially less. Their median pay: $6.5 million. Total direct compensation includes salary, annual bonuses, stock option grants, restricted stock, performance-based grants, and restricted cash not disclosed elsewhere. Many executives also pocketed substantial sums from exercising stock options. Those amounts are included in Total Realized Long-Term Incentives (see appendix for details).[2]

Business Roundtable executives are doing even better compared to American workers. In 2006, the CEOs of the Business Roundtable saw their pay jump 10.6 percent, nearly three times more than the average wage increase of 3.7 percent that went to typical U.S. white collar workers.

	2006 Median Total Direct Compensation (000)
Business Roundtable Executives	$9,863.7
350 Large Company CEOs	$6,548.8
	Median % Increase in Pay over 2005
Business Roundtable Executives	10.6
White Collar Workers	3.7

- **Finance Execs Come in on Top**

Of the top five highest-paid executives in the Business Roundtable, four worked in the financial sector. In addition to total direct compensation, all four of these financial leaders — led by Goldman Sachs CEO Lloyd Blankfein — received considerable amounts from realized long-term incentives, a category that includes gains from exercising stock options.

Top 5 Highest-Paid Business Roundtable Executives

Company	CEO in 2006	2006 Total direct comp	2006 total realized LTI (000)
Goldman Sachs	Lloyd C. Blankfein	54,812.4	15,679.6
Merrill Lynch & Co.	E. Stanley O'Neal	48,986.0	16,666.6
Morgan Stanley	John Mack	40,233.5	36,206.8
General Electric Co.	Jeffery R. Immelt	29,037.6	3,238.8
JP Morgan Chase & Co.	James Dimon	26,973.1	42,681.8

- **Private Sector Pays**

Among Business Roundtable executives, railroad giant CSX CEO Michael Ward scored the biggest pay increase in 2006. He collected $12.1 million, a 336 percent pay hike over the previous year. Ward became CSX CEO in 2003 when John Snow left the company to become the U.S. Secretary of the Treasury. Snow resigned his public sector post in July 2006 and now chairs the New York-based Cerberus Capital Management, a mammoth private investment group.

Privately held firms do not have to report their executive pay data, but Snow is undoubtedly making more at Cerberus Capital than during this Treasury days. The current Secretary of the Treasury makes $183,500 per year.[3]

Top 5 Biggest Compensation Increases

Company	CEO in 2006	2006 Total direct comp (000)	% change from 2005	2006 total realized LTI (000)
CSX Corp.	Michael J. Ward	12,109.6	335.6	19,116.9
Solectron Corp.	Michael R. Cannon	4,337.5	173.9	2,737.5
Merck	Richard T. Clark	8,003.2	167.3	0.0
Con-Way	Douglas Sotlar	3,336.4	95.8	1,216.6
Fluor Corp.	Alan L. Boeckmann	8,491.9	86.4	11,993.5

- **Layoff Leaders and High Pay**

Over the last decade, Americans have witnessed the unseemly juxtaposition, within the same corporation, of massive worker layoffs and massive gains in CEO pay. This "your pain, my gain" leadership style contributes to the public perception that corporate executives have no ethic of shared sacrifice. Our two 2006 worker-pain, CEO-gain leaders: Merck and Motorola.

Merck and CEO Richard T. Clark

In November 2005, Merck & Company, the third-largest American drug manufacturer, announced a massive wave of over 7,000 job cuts.[4] During the subsequent year, CEO Richard Clark received a 167 percent pay hike. Asked what he would tell employees worried about their future jobs, Clark uttered: "You have a right to be concerned."

Motorola and CEO Edward J. Zander

In October 2005, Motorola began a wave of 1,900 layoffs at 29 different U.S. and international locations, part of a growing shift of cell phone manufacturing out of the United States to Mexico.[5] In 2006, Motorola chief executive Edward J. Zander received a generous $15 million pay package.

Motorola seems determined to remain a layoff leader this year. In January 2007, the company announced a stunning plan to lay off 5 percent of its workforce, eliminating an estimated 3,500 jobs.[6] Another shadow cast across Motorola's future: Investor activist Carl Icahn is waging a proxy fight to win a seat on the Motorola board. Icahn has a history of pushing companies to downsize to increase shareholder value.

- **The Perk Picture**

This year's proxies contain a great deal more detailed information on executive perks than ever before. The new SEC disclosure rules that took effect for corporate fiscal years ending after December 14, 2006 require companies to reveal all top executive perks worth either $10,000 or more apiece, up from the previous threshold of $50,000, or 10 percent of salary and bonus. But companies still don't have to list the value of each perk separately, unless a perk's value stands at $25,000 or 10 percent of total perks. This loophole in the new disclosure rules makes knowing exactly how much companies are spending on individual perks like country club dues or executive physicals almost impossible.

Some companies seem to be responding to the new perk reporting rules by shifting pay out of perks into pots that might attract less public scrutiny. Alcoa, for instance, is no longer reimbursing executives for club dues, income tax preparation services, and financial planning benefits. In lieu of these perks, top Alcoa executives will each receive a $6,500 salary increase in 2007. Alcoa CEO Alain Belda sits on the Business Roundtable.

But perks, overall, are continuing to pour into executive pockets. A Mercer study of 2006 proxies found that 55 percent of 350 large companies allowed personal use of company aircraft, 50 percent paid for financial counseling, 43 percent for company cars, and 27 percent for club dues.[7] Other typical perks include executive physical exams (also for the spouse), home security systems, and tax "gross-ups" – reimbursements for personal income taxes incurred for bonuses and benefits. According to insurance giant Travelers, such benefits are intended to ensure that executives "remain appropriately focused on their job responsibilities without unnecessary distraction."[8]

A review of Business Roundtable member compensation reveals that most companies have done nothing to moderate their lavish executive perks. We offer here a few standout examples.

Perk Leaders of the Business Roundtable

The Prince of Perks: James McNerney, Boeing

In 2006, James McNerney received $2,063.5 in perks, placing fifth in that category in the *Wall Street Journal* survey and No. 1 in the Business Roundtable. More than half of this sum came from relocation costs. Last year, McNerney left the Minnesota-based 3M to take the helm at Boeing, some 400 miles away in Chicago. To help McNerney make the modest move, Boeing handed its new CEO $1.1 million, the highest reimbursement for moving costs given last year to any Business Roundtable member. That might seem a bit steep, but with the "War on Terror" turbocharging military spending, Boeing has plenty of taxpayer dollars to burn. In 2005, the company — the nation's No. 2 defense contractor — collected $19 billion in Pentagon spending. McNerney, incidentally, sold his Minnesota home for $6.45 million to Timberwolves basketball star Kevin Garnett.[9]

Most in Need of Financial Planning Help: Andrew Liveris, Dow

Average Americans turn to accountant in-laws, or maybe their local H&R Block, when they have trouble with their tax forms. Corporate leaders get considerably higher-priced help. They typically receive thousands of dollars from their companies to cover the cost of tax return preparation and personal financial planning. Dow CEO Andrew Liveris led the Business Roundtable pack in this category, with $39,445 for financial advice, followed closely by EDS chief Michael H. Jordan, with $38,569.

Most Insecure: William B. Harrison, Jr., JP Morgan Chase

JP Morgan Chase Chairman William B. Harrison, Jr., proved to be one high-maintenance executive asset last year. His company laid out $536,495 in personal security costs to keep Harrison safe, in addition to $224,405 for personal trips aboard the corporate jet, as required by the company's security policy. Harrison chaired the firm in 2006 before resigning at year's end. He had served as JP Morgan Chase CEO for the preceding five years.

- **Pay for "Non-Performance"**

Even by the corporate world's overly narrow definition of performance — returns to shareholders — many of the Business Roundtable CEOs appear to be wildly over-compensated. A few examples:

- Anadarko Petroleum CEO James Hackett's 2006 total direct compensation rose 78 percent in 2006, according to the *Wall Street Journal*. Total shareholder returns (stock appreciation plus dividends) dropped 7.4 points in 2006.

- Sara Lee CEO Brenda C. Barnes' pay rose 56.7 percent in 2006. Shareholder returns fell more than 15 points.

- Electronics services firm Solectron gave its CEO, Michael R. Cannon, a hike in pay of 173.9 percent in 2006. The company's shares lost more than 23 points in value last year.

- At freight services firm Con-Way, CEO Douglas Sotlar's salary rose 95.8 percent. The company's shareholder returns dropped by more than 20 points.

III. Dissecting the CEO Pay Debate

The Business Roundtable is not alone in its opposition to CEO pay reform. Quite a number of academics, thinks tanks, and politicians have been busy rallying statistics and arguments to "prove" that CEO pay ought not be a matter for congressional concern. This section 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.

"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*[10]

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.[11] 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 (and former Business Roundtable Chairman) 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.[12]

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*[13]

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.[14] 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.[15] 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."[16]

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*[17]

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."[18] 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."[19]

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*[20]

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."[21] — *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."[22] 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)*[23]

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."[24]

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 the value of the stock 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."— *John J. Castellani, President, Business Roundtable*[25]

"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.*[26]

The Business Roundtable released research in July 2006 that it claimed "sets the record straight on executive compensation."[27] 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."[28] In a later article, Morgenson pointed out that the Roundtable study author, 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.[29] 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*[30]

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 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.[31]

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.[32] 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.[33]

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."[34]

IV. Legislative Options

Excessive compensation for corporate executives first emerged as a national concern in the early 1980s, about the same time that deep cuts in the top marginal federal income tax rate took effect. Until then, high top-bracket federal income tax rates — 91 percent on income over $400,000 until 1964, then 70 percent on income over $200,000 until 1981 — helped keep what might be called a “cultural cap” on CEO pay. Corporate boards could offer million-dollar pay packages, but what would be the point? The bulk of any pay over the top-bracket income floor would simply be taxed away.

This tax pressure on excessive executive compensation has faded over the past quarter-century. The top marginal tax rate dipped, at one point, to 28 percent and currently sits at 35 percent. High pay now pays, even after taxes. Compensation for top executives in the United States, consequently, has soared, from 30 to 40 times average worker pay a generation ago to over 400 times average worker compensation today.[35]

This enormous gap has prompted a search for legislative initiatives that seek to address, either directly or indirectly, executive excess. This section highlights these efforts.

Proposed Legislation

1. Shareholder Vote on Executive Compensation Act (H.R. 1257)

Introduced March 1, 2007 by House Financial Services Chair Rep. Barney Frank (D-Mass.), this bill would require public companies to allow an annual nonbinding shareholder vote on executive compensation packages. In addition, the legislation requires disclosure of “golden parachutes” that unfurl upon the sale or purchase of company assets. A separate shareholder vote would be required on these compensation packages.

H.R. 1257 is a scaled-back version of Frank’s 2005 bill, the “Protection Against Executive Compensation Abuse Act” (H.R. 4291). In addition to the shareholder votes described above, that bill would have required companies to recapture or “claw back” compensation if it had been awarded on the basis of bogus financial statements or if the officer had not met job performance measures.

H.R. 4291’s increased disclosure requirements were also dropped, in response to the Securities and Exchange Commission’s more stringent reporting rules announced on July 26, 2006. However, some expected Rep. Frank to address amendments to those rules (announced on the Friday before Christmas 2006), which changed the way corporations are required to report options grants in the highlighted “summary compensation” table of their proxy statements. Under the old rule, companies had to reveal a total value for the stock options they awarded top executives in the year they made the award. The amended rule lets corporations report options grants bit by bit over the years the option awards are vesting.

These summary tables are supposed to provide full and clear disclosure of just how much in compensation a company’s five highest-paid executives are annually collecting. The SEC considers the December change in the disclosure regulations a “technicality.” Critics, including Rep. Frank, say the change will understate the actual cost of executive pay packages.

In February, AFLAC became the first U.S. company voluntarily to adopt the say-on-pay vote, while more than 50 companies have received shareholder proposals demanding advisory votes on compensation.[36]

2. Limits on Tax-Free Deferred Compensation (Small Business and Work Opportunity Act of 2007, S.349)

In February 2007, the Senate Finance adopted a package of tax measures intended to increase revenues to offset tax breaks for businesses impacted by an increase in the minimum wage. One of these measures would, if enacted, limit how much compensation an individual can have deferred to $1 million annually. This provision, Senate staff estimate, would generate an additional $806 million in tax revenues over 10 years. The House version of the minimum wage increase did not include this proposal, and, at this writing, the fate of the Senate cap remains unclear.

Deferral cap critics say the bill will unfairly burden mid-level employees since the deferral limit kicks in, according to the bill, "when earnings in a plan exceed the five-year average of an employee's annual taxable pay, or $1 million, whichever is less." In fact, only people making far more than the pay of mid-level American employees would be in any way impacted by the legislation. Americans, through 401(k)s and other "qualified" pay deferral plans, can already have set aside, tax-free, enough money to guarantee a secure retirement. The legislation approved by the Senate Finance Committee speaks only to "nonqualified" deferral plans. These plans give selected high-income individuals, not a company's entire workforce, the opportunity to shield unlimited amounts of their pay from taxes.

Other critics charge that executives would respond to any cap on tax-deferred compensation by simply demanding more pay in other forms, through larger bonuses, for example. Executives certainly might demand — and even expect — more overall pay if a deferral cap became law. But a deferred-income cap would be significant nonetheless. With a cap in place, America's most lavishly paid executives would no longer be able to avoid taxes on lush annual income packages.

3. Eliminating Tax Subsidies for Excessive Pay

Shareholders and workers have an obvious stake in reducing runaway executive pay, but so do taxpayers. Corporations deduct their bloated pay packages as "business expenses." This effectively reduces the corporation's tax and further shifts the tax burden onto everyone else.

Tax payers should not be forced to subsidize corporate greed. One policy change would be to cap the deductibility of any form of compensation that exceeds $1 million. A similar law passed in 1993 with a provision that exempted "pay for performance." This loophole rendered the law useless – as boards routinely certified their compensation packages as "performance based." A revised law should simply cap the deductible level, regardless of performance.

A variation on this proposal would tie the amount a corporation is permitted to deduct to wage levels within a company. Instead of the tax code subsidizing excessive pay, this would provide a tax incentive to companies that reduce wage disparities within a firm. It would essentially say, "If you want to raise the top, then raise the floor." A company that is doing well should share its gains with all employees, not just a few top managers.

A version of this law was introduced in the past by retired Minnesota Congressman Martin Sabo. His proposed legislation, entitled the "Income Equity Act" (H.R. 3260), capped the tax deductibility of executive pay to twenty-five times the lowest-paid worker in a firm. Congressional leaders plan to introduce a new version of this law in the 110th Congress.

Enacted Legislation

4. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Section 331

Two years ago, on the initiative of Senator Edward Kennedy (D-Mass.), the Senate and then the House included in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 a little-noticed provision that sets a significant legislative precedent in the debate over excessive corporate executive pay.

This Kennedy provision limits pay for top executives, for the first time ever, to a fixed multiple of the pay that goes to a company's average workers. No company in bankruptcy, under the new bankruptcy act, can bestow upon its executives any "retention" bonus or severance pay that runs over ten times the average bonus or severance awarded to regular employees in the previous year.

This legislation does not cover "performance-based pay," and news reports indicate that companies in bankruptcy, to avoid the Section 331 pay limits, are defining their executive bonuses as "performance-based."

5. Air Transportation Safety and System Stabilization Act of 2001

In the aftermath of the September 11 tragedy, Congress set an important precedent for ensuring that corporate executives would not be able to profit personally from the country's troubles. Congress, shortly after the terrorist attack, authorized a $15 billion bailout for the nation's airlines. This bailout legislation prohibited airlines from handing any raise, over the following two years, to any executive who made over $300,000 in the year 2000. The legislation also limited severance to double an executive's final annual compensation.

The principle behind this bailout law could be applied more broadly. During wartime, for example, Congress could insist that the pay levels for executives of all companies receiving war-related contracts be frozen at their peace-time level.

Under Discussion

6. Defining "reasonable" compensation

On September 6, 2006, the Senate Finance Committee held a hearing on the stock option backdating scandal that focused considerable attention on the 1993 change to Section 162(m) of the federal tax code. The 1993 reform limited the tax deductibility of certain top executive compensation to $1 million, but allowed corporations to deduct unlimited sums above that cap, so long as these additional rewards were based on performance.

At the hearing, Senator Jeff Bingaman (D-N.M.) noted that the tax code currently stipulates that compensation must be "reasonable" to qualify as a business expense.[37] He asked if the IRS had ever considered challenging the deductibility of an executive's compensation on the grounds the compensation was not a "reasonable" allowance. The answer: no. A useful reform, Senator Bingaman's exchange suggests, might be to set a standard for reasonability.

7. Linking special tax considerations to executive pay

In the mid 1990s, at both the federal and state levels, various lawmakers suggested creating a new tax-favored category of corporation, with the tax breaks from that category flowing to those corporations that meet a series of "good behavior" benchmarks.

In 1996, as part of a "Senate High Wage Jobs Task Force," Senators Bingaman and Tom Daschle (D-S.D.) floated the notion of an "R" corporation. Corporations could only qualify for tax-advantaged "R" status — the "R" stood for "responsible" — if they contributed 3 percent of payroll to portable pensions, devoted 2 percent to employee training, paid half their employee health care costs, encouraged profit sharing or employee ownership, and held the pay of executives to no more than 50 times the pay of their lowest-paid employees.

8. Linking government procurement to executive pay

Current federal law links government procurement to selected equity standards. Companies that discriminate against women or members of minority groups in their employment practices cannot receive government contracts.

Government contracting could make an equally significant contribution to greater equity in American life, some analysts have observed, by tying procurement to internal compensation practices. Under this approach, companies that compensated their executives at over 25 or 50 times what their lowest-paid workers receive would not be eligible to win federal contracts.

Federal procurement law already limits the amount of pay that a company with a government contract can bill the government for executive compensation.[38] This sum, set annually, has never neared as much as $1 million, or less than 10 percent the current average compensation for major corporate chief executives. But this "cap" only applies to direct federal dollars. A corporation whose profits or share price soar after receiving a federal contract remains free to pay its top executives whatever the company's board pleases.

9. Enabling a broader right to bring suit against offending corporations

In 2002, California Senate majority whip Richard Alarcon, a Democrat from the San Fernando Valley, introduced a "Code for Corporate Responsibility" to prohibit the directors of any corporation from performing their duties "at the expense of the environment, human rights, the public health and safety, the communities in which the corporation operates, or the dignity of the corporation's employees."

Alarcon's bill, if enacted, would have given average Californians the right to sue offending corporations — and their directors — if damaged by any violation of these prohibitions. If his bill ever became law, corporate directors who handed lavish option windfalls to executives while these executives were handing pink slips to employees could be held personally liable, under the code, for subjecting employees to indignity.

Appendix: Business Roundtable Members' Pay

Methodology: Includes all members of the Business Roundtable that appear in the April 9, 2007 Wall Street Journal CEO Compensation Survey. All data are from that survey, which was conducted by Mercer Human Resource Consulting and includes 350 U.S. public firms with revenues in excess of $1 billion.

Details on the numbers:
Total direct compensation: salary, annual incentives (bonus/incentives earned in 2006, stock option grants (fair market value at grant date), restricted stock grants, performance-based grants (cash or equity), and any restricted cash not disclosed elsewhere. Does not include perquisites, severance packages, or increased pension value. Total Realized Long-Term Incentives: stock options gains, restricted stock value and long-term incentive payouts.

Company	CEO in 2006	2006 Total direct comp (000)	% change from 2005	2006 total realized LTI (000)
Abbott Laboratories	Miles D. White	14,704.4	21.3	8,312.9
ADP	Arthur F. Weinbach	7,910.8	46.1	7,833.4
Aetna	Ronald A. Williams	17,927.9	n.a.	6,120.0
Air Products and Chemicals	John P. Jones III	8,437.0	-4.1	2,712.1
Alcoa	Alain J.P. Belda	10,111.1	17.5	0.0
Allstate Insurance Co.	Edward M. Liddy	11,193.9	45.1	18,076.0
American Electric Power Co.	Michael G. Morris	8,407.2	-3.5	8,970.7
American Express Co.	Kenneth I. Chenault	18,831.1	-16.9	13,374.3
Ameriprise Financial	James Cracchiolo	17,557.5	51.0	1,412.7
Anadarko Petroleum	James T.Hackett	11,464.1	78.1	5,842.4
Applera Corp.	Tony L. White	5,456.0	6.3	4,783.4
Archer Daniels Midland	Patricia Woertz	7,998.7	n.a.	6,877.5
ArvinMeritor Inc.	Charles G. McClure	4,886.5	10.8	450.0
Avery Dennison Corp.	Dean A. Scarborough	4,316.8	21.1	1,706.8
Boeing Company	W. James McNerney Jr.	16,514.7	n.a.	6,627.1
Brink's Company	Michael T. Dan	4,865.3	-5.7	1,341.0
Bristol-Myers Squibb Co.	James M. Cornelius	379.8	n.a.	0.0
Burlington Northern corp.	Matthew K. Rose	11,502.5	15.3	9,354.4
Chevron Corp.	David O'Reily	13,275.6	3.2	17,125.0
Chubb Corp.	John D. Finnegan	19,782.3	78.3	36,013.4
CIGNA corp.	H. Edward Hanway	14,764.4	-8.6	34,622.2
Citigroup Inc.	Charles Prince	24,833.3	9.6	5,210.7
Coca-Cola Co.	E. Neville Isdell	20,732.1	18.9	0.0
ConocoPhillips	James J. Mulva	14,092.5	-18.1	30,271.4
Con-Way	Douglas Sotlar	3,336.4	95.8	1,216.6
Corning	Wendell P. Weeks	8,602.1	10.1	13,329.4
Crane	Eric C. Fast	6,728.2	33.5	9,503.5
CSX Corp.	Michael J. Ward	12,109.6	335.6	19,116.9
Deere & Co.	Robert W. Lane	12,039.0	-6.1	15,860.4
Dow Chemical Co.	Andrew N. Liveris	12,229.9	-1.4	2,785.2
DuPont	Charles O. Holliday Jr.	9,863.7	15.2	0.0
Eastman Chemical Co.	J. Brian Ferguson	6,567.5	-16.4	6,079.4
Eaton corp.	Alexander M. Cutler	7,449.7	-18.0	11,344.0
Electronic Data Systems	Michael H. Jordan	13,555.7	1.2	4,568.3

Company	CEO in 2006	2006 Total direct comp (000)	% change from 2005	2006 total realized LTI (000)
EMC Corp.	Joseph M. Tucci	2,440.0	-91.2	3,104.4
FedEx Corp.	Frederick W. Smith	13,002.8	-11.4	3,375.0
Fluor Corp.	Alan L. Boeckmann	8,491.9	86.4	11,993.5
FMC Corp.	William G. Walter	4,243.8	-5.6	3,175.4
General Electric Co.	Jeffery R. Immelt	29,037.6	80.3	3,238.8
General Mills Inc.	Stephen W. Sanger	10,261.8	28.2	7416.8
Goldman Sachs	Lloyd C. Blankfein	54,812.4	n.a.	15,679.6
Goodrich Corp.	Marshall O. Larsen	4,743.9	-12.1	3,420.5
Honeywell International	David M. Cote	11,723.7	-31.3	20,389.6
Humana Inc.	Michael B. McCallister	5,447.2	1.1	25,878.8
IBM Corp.	Samuel J. Palmisano	17,808.7	-3.5	9,925.7
Johnson Controls Inc.	John M. Barth	18,678.3	60.4	22589.7
JP Morgan Chase & Co.	James Dimon	26,973.1	n.a.	42,681.8
Kodak	Antonio M. Perez	6,862.2	29.3	2487.2
Lilly (Eli)	Sidney Taurel	10,938.7	9.6	4,775.1
Marsh & McLennan Co.	Michael G. Cherkasky	8,609.8	-14.9	0.0
McGraw-Hill Co.	Harold McGraw III	7,119.3	-1.2	15,061.7
MeadWestvaco Corp.	John A. Luke Jr.	6,033.8	n.a.	737.5
Merck	Richard T. Clark	8,003.2	167.3	0.0
Merrill Lynch & Co.	E. Stanley O'Neal	48,986.0	27.2	16,666.6
MetLife Inc.	C. Robert Henrikson	8,222.8	n.a.	1,792.1
Morgan Stanley	John Mack	40,233.5	n.a.	36,206.8
Motorola Inc.	Edward J. Zander	14,995.0	-13.5	7,420.0
Norfolk Southern	Charles W. Moorman IV	8,963.5	40.4	2,623.7
Nucor Corp.	Daniel R. DiMicco	4,772.9	42.8	4,579.7
Pfizer Inc.	Jeffrey B. Kindler	7,223.7	n.a.	2,319.2
PPG industries Inc.	Charles E. Bunch	7,478.9	34.0	755.8
Praxair Inc.	Dennis H. Reilley	9,517.0	22.7	16,474.5
Procter & Gamble	Alan G. Lafley	26,025.0	16.4	13,921.2
Prudential Financial	Arthur F. Ryan	14,981.1	10.6	8,730.2
Realogy	Henry R. Silverman	0.0	n.a.	0.0
Rockwell Automation Inc.	Keith D. Nosbusch	6,884.3	15.0	631.2
Ryder System Inc.	Gregory T. Swienton	4,803.7	-16.7	10,265.6
Sara Lee Corp.	Brenda C. Barnes	6,803.5	56.7	1,669.9
Solectron Corp.	Michael R. Cannon	4,337.5	173.9	2,737.5
Sun Microsystems	Jonathan Schwartz	4,921.5	n.a.	9,010.4
Texas Instruments Inc.	Richard K. Templeton	12,857.4	25.0	18,594.0
Textron Inc.	Lewis B. Campbell	10,728.7	9.1	25,839.1
Travelers Co.	Jay S. Fishman	12,759.7	4.9	773.7
Tyco International Ltd.	Edward D. Breen Jr.	14,734.0	-24.0	4,060.0
Tyson Foods Inc.	Richard L. Bond	3,712.9	n.a.	342.0
Union Pacific Corp.	James R. Young	11,660.8	n.a.	4,517.8
Unisys Corp.	Joseph W. McGrath	3,083.7	15.8	0.0
United Technologies Corp.	George David	17,225.5	18.0	31,337.1
Verizon Communications	Ivan G. Seidenberg	21,837.4	42.5	4,869.1
Weyerhaeuser Co.	Steven R. Rogel	4,768.5	-0.6	0.0
Whirpool Corp.	Jeff M. Fettig	7,565.7	-38.7	1,108.8
Wyeth Corp.	Robert A. Essner	17,268.3	-2.9	24,808.7
YRC Worldwide Inc.	William D. Zollars	4,187.5	-4.1	3,034.3
median		9,863.7	10.6	

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