

Center for American Progress



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How CEO Pay Took Off While
America's Middle Class Struggled**

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The American dream is one of upward mobility. We believe that if you work hard and play by the rules, you should be able to provide for your family and ensure that your children have greater opportunity than you were afforded. But today, the dream of true upward mobility has been limited to a select class of corporate executives while the dreams of middle-class families have been deferred. Corporate CEOs have enjoyed record levels of compensation and corporations have seen record profits, as more and more middle-class Americans are experiencing stagnant wages and vanishing benefits. This expanding inequality is not the American dream.

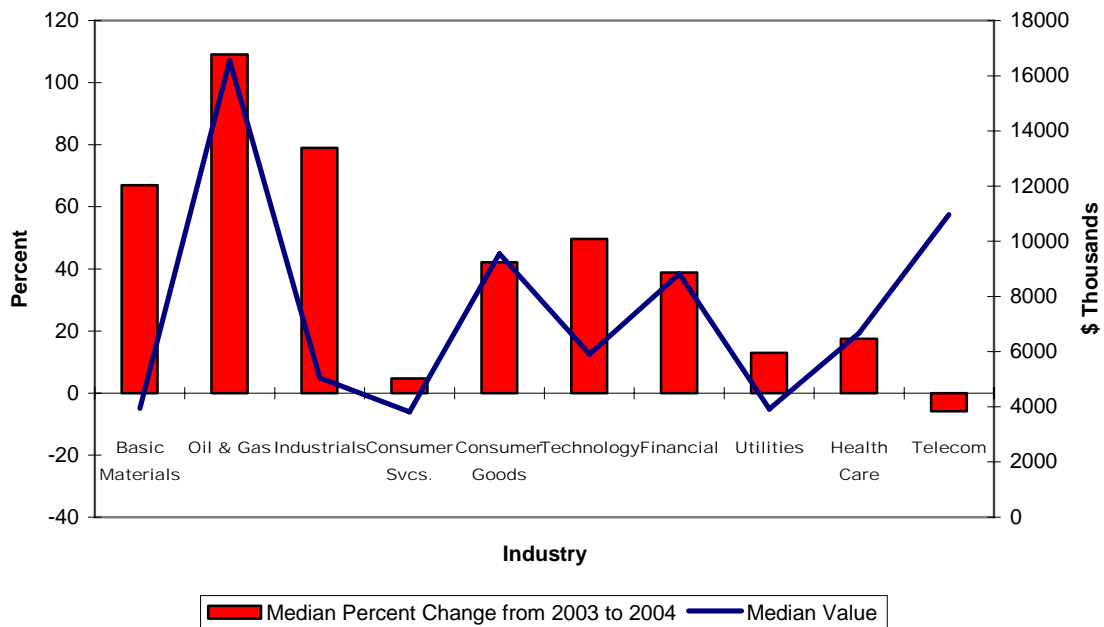
- CEO compensation is out of orbit: At the 350 largest public companies, the average CEO compensation is **\$9.2 million**. Compensation for oil and gas execs increased by **109 percent** between 2003 and 2004.
- In 2004, the average CEO **received 240 times more** than the compensation earned by the average worker. In 2002, the ratio was 145 to 1.
- These levels of CEO compensation are **not the norm for the industrialized world**. Typically, CEO pay in other industrialized countries is only about one-third of what American CEOs make.
- Highly-compensated CEOs are not being rewarded for performance with the interests of shareholders in mind, the “textbook” explanation of CEO compensation, according to an extensive body of research and reporting.
- After-tax profits are booming and corporate America can easily afford to offer fair wages and benefits to rank and file employees. Unfortunately, while CEOs have enriched themselves, **middle-class families have taken hard hits** to their paychecks, their health coverage, and their pension plans.

The Rise of the CEO

In 2004, the average CEO compensation was over \$9 million, as reported in *The Wall Street Journal's* annual analysis of the 350 largest public companies (WSJ, 2005). This is a whopping 14.5 percent increase over average CEO compensation in 2003. The big gains in 2004 were not the exception to the rule. Adjusted for inflation, CEO pay skyrocketed 480 percent between 1980 and 2003. Between 1989 and 2004, CEO compensation grew by 276 percent in inflation-adjusted terms (EPI, 2005; WSJ, 2005).

Median compensation for CEOs ranged from \$3.8 million in the consumer services industry to \$17 million for CEOs in the oil and gas industry (figure 1). The CEOs of oil and gas corporations—awash in earnings, these days—saw their compensation increase by more than 100 percent.

Figure 1: CEO Total Direct Compensation Trends, 2004



Source: Wall Street Journal, CEO Compensation Survey, April 11, 2005.

In recent years, some executives received well over \$100 million in annual compensation. Between 1998 and 2003, Michael Eisner of the Walt Disney Company saw his compensation average \$121.1 million a year. Lawrence Ellison of Oracle received a mind-boggling \$781.4 million in compensation between 2000 and 2002. In 2003, Reuben Mark of Colgate-Palmolive received compensation totaling \$141.1 million (Lavelle et al., 2003; Sklar, 2004).

Unfortunately, CEO compensation packages are often designed with tax avoidance in mind. By being compensated in ways other than direct salary payments, CEOs can take advantage of ever lower taxes on capital income compared to income from work. Additionally, CEOs who pay themselves very low salaries avoid certain forms of taxation, such as payroll taxes for Social Security or Medicare, altogether—collecting practically all of their compensation in tax-advantaged forms.

The ten CEOs with the largest compensation packages received total direct compensation between \$44 million and \$88 million (table 1). Their salaries constitute, at most, a mere 3.1 percent of their total compensation packages. Additionally, these figures for “total direct compensation” do not take into account various deferred stock options, insurance plans, and other perks that constitute a substantial percentage of the long-term compensation ultimately received by many CEOs.

Table 1
Top 10 CEOs with Largest Direct Compensation

Name (company)	Salary (millions of dollars)	Total direct compensation (millions of dollars)	Salary as percentage of total direct compensation
George David (United Technologies)	1.2	88.3	1.4 %
Ray R. Irani (Occidental)	1.3	66.4	2.0%
Richard D. Fairbank (Capital One)	0.0	56.5	0.0%
Richard M. Kovacevich (Wells Fargo)	1.0	51.4	1.9%
Bruce Karatz (KB Home)	1.0	50.0	2.0%
Jeffrey L. Bleustein (Harley-Davidson)	0.9	46.7	1.9%
Lawrence Ellison (Oracle)	0.7	45.8	1.5%
William E. Greehey (Valero Energy)	1.4	44.8	3.1%
Irwin Mark Jacobs (Qualcomm)	1.1	44.1	2.5%
Robert I. Toll (Toll Brothers)	1.3	44.0	3.0%

Source: Wall Street Journal, CEO Compensation Survey, April 11, 2005.

International Comparison

The shifting composition of CEO compensation in America makes international comparisons difficult. An international comparison of CEO pay—rather than total compensation—necessarily understates the full size of American compensation packages by excluding bonuses and other non-cash forms of compensation. But even this low-ball estimate of American CEO pay shows a wide gap between American CEOs and their counterparts in 13 leading industrialized nations (table 2).

Table 2
International Comparison of CEO Pay

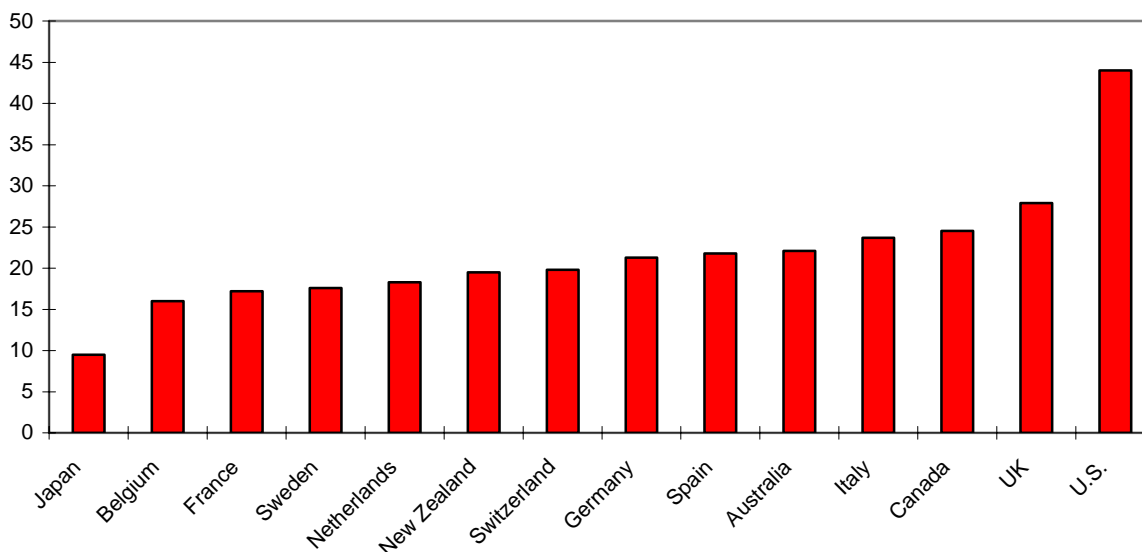
Country	Average CEO pay		Percent change 1988 to 2003	Foreign CEO pay relative to U.S. (U.S.=100)
	1988	2003		
Japan	\$473,655	\$456,937	-4%	20%
Belgium	\$361,591	\$697,030	93	31
France	\$381,015	\$735,363	93	33
Sweden	\$221,138	\$700,290	217	31
Netherlands	\$373,545	\$675,062	81	30
New Zealand		\$449,414		20
Switzerland	\$481,125	\$1,190,567	147	53
Germany	\$388,486	\$954,726	146	42
Spain	\$331,708	\$620,080	87	28
Australia	\$170,336	\$694,638	308	31
Italy	\$322,743	\$841,520	161	37
Canada	\$398,946	\$889,898	123	40
United Kingdom	\$427,335	\$830,223	94	37
United States	\$759,043	\$2,249,080	196	100
Non-U.S. average	\$360,969	\$748,904	129	33

Source: Economic Policy Institute, State of Working America 2004/2005, Ithaca, NY: Cornell University Press.

While ranked third in percentage growth of pay, CEOs in the U.S. are paid well beyond their peers in other industrialized countries. Typically, CEO pay in other industrialized countries is only about one-third of that of U.S. CEOs (table 2). Switzerland was the only nation surveyed in which CEOs made at least half of what American CEOs take in. In all other industrialized countries surveyed, CEOs fell much further behind the American CEOs.

The ratio of CEO to worker pay is far more extreme in the U.S. than in any of the other industrialized countries surveyed (figure 2). And this is an underestimation. Taking a broader definition of compensation into account—instead of simply “pay”—in 2004, the ratio between CEO and worker pay in the America was 240 to 1 (Weller and Burton, 2005).

Figure 2: International Comparison of CEO to Worker Pay



Source: Economic Policy Institute, *State of Working America 2004/2005*, Ithaca, NY: Cornell University Press.

How Do We Explain This?

The textbook explanation is that this level of executive compensation is necessary in order to maximize shareholder value, and that compensation committees are rewarding executives for their performance. These days, even conservatives are calling this theory into question. Reflecting on recent levels of CEO pay, William F. Buckley, Jr., a prominent conservative and editor-at-large of the *National Review*, writes:

That money was taken, directly, from company shareholders. But the loss, viewed on a larger scale, is a loss to the community of people who believe in the capitalist free-market system. Because extortions of that size tell us, really, that the market system is not working—in respect of executive remuneration. What is going on is phony. It is shoddy, it is contemptible, and it is philosophically blasphemous. (Buckley, 2005)

An extensive body of academic work has searched for an answer that can accurately explain the phenomenon of CEO compensation. One explanation that makes a lot of sense is that of “managerial power”: The fact that managers have considerable power to shape their own pay arrangements helps to explain why the pay arrangements set by the boards of directors fail to maximize shareholder value (Bebchuk et al., 2002; Bebchuk and Grinstein, 2005).

The academic argument, based on the data, is borne out by the anecdotal record. Compensation consultant James Reda puts it bluntly: “There’s no rule that a CEO can’t be present when directors discuss his pay. And if you ask 10 consultants to evaluate

performance, there are no standards. It's an area ripe for misjudgment" (Strauss and Hansen, 2005).

Managerial power is not the only factor contributing to excessive compensation. Studies have established that there is a negative correlation between executive compensation and unionization, and that a loss of union members (due to decertification elections) is associated with higher CEO pay (DiNardo et al., 1997). Additionally, there is a strong correlation between the fraction of shares held by large institutional investors and the fraction of executive pay in the form of stock options, introducing yet another factor into the equation (Hall, 2000).

Looking at the big picture, there are two major problems. First, the composition of executive compensation is too complex. Each additional detail makes it difficult for outsiders to assess the true level of compensation. Something too difficult to understand will rarely be believed as a fair structure—especially if it is the CEO's compensation package. The various forms of compensations create constituencies outside of the firm that may have an interest in certain forms of compensation being used as opposed to others.

Second, members of the elite sub-culture of executives and directors are often unable to objectively assess the individual performance of their fellow elites. Indeed, this is not a fair transparent market where *supply meets demand*—this is a culture with its own norms, hierarchies, and behaviors (Garvey, 2003)—behaviors that are very expensive for the rest of us. Pat McGurn of Institutional Shareholder Services argues that “there's still a culture that says any sort of positive performance has to be met with a significant increase in pay. It's become an executive entitlement system.” (Strauss and Hansen, 2005)

As CEOs get richer, more families fall into poverty

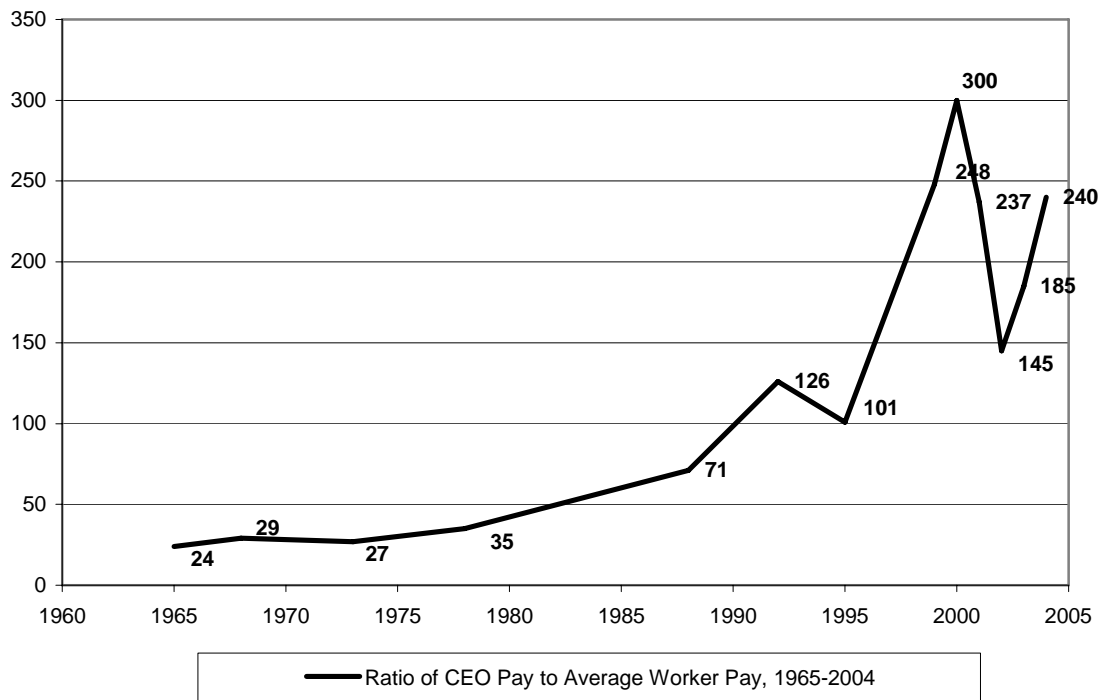
“If CEO and worker pay had increased at the pace of worker productivity, CEOs would have made [only] \$2.3 million in 2003 and workers \$51,148,” according to one estimate. (Sklar, 2004) But this is not what happened. Median income declined by about \$600 in inflation-adjusted dollars, or 1.2 percent between 2001 and 2003, according to Census data. In fact, from the end of 2003 through March 2005, inflation-adjusted weekly earnings for the “production non-supervisory worker” (this includes 80 percent of the American workforce) actually declined by 0.9 percent (Bureau of Labor Statistics, 2005).

As corporations are enjoying strong gains in after-tax profits, CEOs are reaping the benefits through greater compensation. We are in a period of high productivity growth yet not enough of these gains have trickled down to the middle class. “We're in for a long period where inflation-adjusted wages will be under pressure,” says Stephen S. Roach of Morgan Stanley, quoted in *The New York Times*. “That's a most unusual development in a period of high productivity growth. Normally, real wages track productivity” (Greenhouse, 2005).

As incomes slide and the income inequality between CEOs and workers grows larger, the risk of poverty for workers looms larger. The number of people in poverty increased by 0.8 percentage points from 11.7 percent of the total American population in 2001 to 12.5 percent in 2003 (Census, 2004). The statistics are bad for those who are employed and even worse for those that aren't. Average monthly employment growth from March 2001 to March 2005 was less than 0.1 percent—the lowest level in any business cycle since World War II, according to the Bureau of Labor Statistics (Bureau of Labor Statistics, 2005).

The vast majority of America's private sector workforce—more than 80 percent—can be classified as “production non-supervisory workers.” In 2004, the average compensation for these workers was about 0.4 percent of the average compensation of a CEO. Shockingly, that's not a typo. In 2003, CEO compensation was 185 times the average compensation of the typical worker—a shockingly high number, yes, but much lower than the 240 ratio recorded in 2004 (figure 3). Is this an accurate reflection of the value of the American workforce? Most would argue otherwise.

Figure 3: Ratio of CEO Pay to Average Worker Pay, 1965-2004

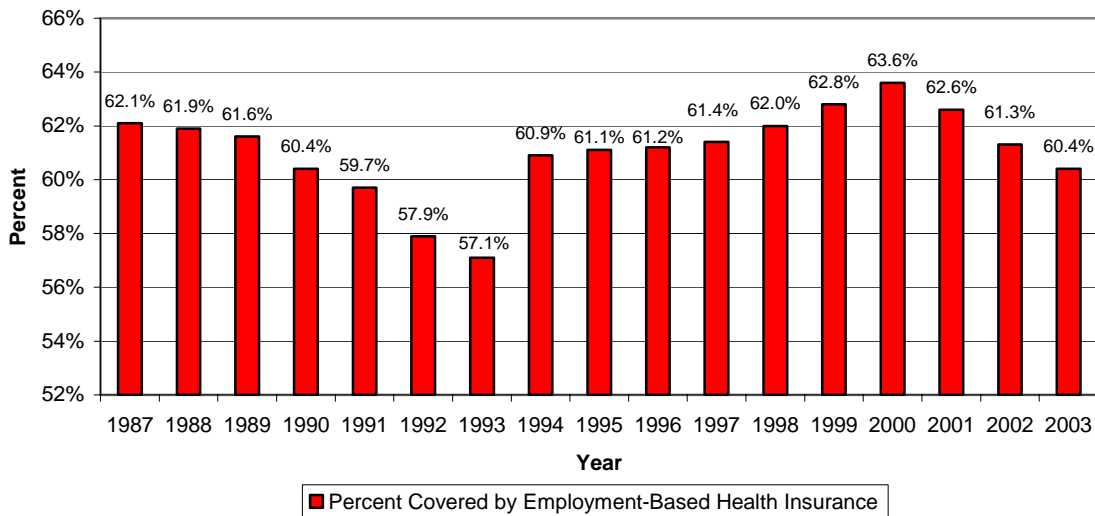


Notes: Average worker compensation is calculated by multiplying the average hourly earnings of production non-supervisory workers times 2,080 and then multiplying this figure by the ratio of compensation to wages for 2003 – the last year for which data are available – for private industries. Data prior to 2004 are taken from L. Mishel, J. Bernstein, and S. Allegretto, *The State of Working America 2004/2005*, Ithaca, NY: Cornell University Press. Data for 2004 are from the Wall Street Journal, CEO Compensation Survey, April, 11, 2005, and from the Bureau of Labor Statistics, Average Hourly Earnings of Production Non-Supervisory Workers, Washington, D.C.: BLS, www.bls.gov.

While corporations enjoy record profits and enrich their CEOs with perks and benefits, they are scaling back health benefits for their rank and file employees. By 2003, the share of people with employer-sponsored health insurance was at its lowest level since 1994 (figure 4). Between 2000 and 2003, the share of the population without health insurance increased from 14.2 percent in 2000, to 15.6 percent of the population in 2003—an additional 5.2 million Americans uninsured, according to Census estimates. Between 2000 and 2003, the number of people covered by employment-based health insurance fell from 178 million (63.6 percent) to 174 million (60.4 percent).

One quarter of those experiencing health care cost increases say they have reduced retirement savings contributions because of growing medical bills, and nearly one-half report reducing other savings, according to the 2004 Health Confidence Survey of individuals released by the Employee Benefit Research Institute (EBRI, 2004).

Figure 4: Percent Covered by Employment-Based Health Insurance (1987-2003)



Source: U.S. Census Bureau, Income, Poverty, and Health Insurance Status of the Population, 2003, Washington, D.C.: Census.

Conclusion

As fair-minded people, Americans believe that there should be a correlation between the job well done and the reward. The trend in excessive CEO compensation reflects a culture of greed and a growing inequality that poses a threat to the viability of the American dream for many middle-class families. As a nation, we must move forward with a progressive vision that restores our values of hard work and fair play and insures that the promise of economic opportunity is extended to all.

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