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Wage Inequalities and Execs Compensation Packages—Quo Vadis

This paper discusses the growing income gap between CEOs and workers and places emphasis on the exorbitant compensation packages for executives. The observed wage differential is much bigger in the U.S. than in any European country or Japan. Various surveys state that CEO's earn 475 times as much as their workers!¹ And there are good reasons why this excess has happened: enormous compensation packages, stock options, bonuses, and grants. After looking at each of these aspects, their influence, and the possible consequences, the discussion focuses on how compensation packages should be designed to align with the interests of the managers, the stockholders, and other stakeholder groups.

It is no secret that men have typically earned more money in the workplace than women. However, a report by the General Accounting Office, the investigative arm of Congress, may surprise some people. The conducted study shows that the gap, far from narrowing, has actually grown considerably.

The study looked at full-time managers in the entertainment, communications, finance, insurance and retailing industries, and found that between 1995 and 2000, the gap grew by 21 cents for each dollar earned. Moreover, the report shows that while women make up nearly half the workforce, only 12 percent make it to the rank of corporate officer.²

Another study conducted by Goldin and Katz³ shows that economic inequality is higher today than at any time in the past sixty years, measured by both the wage structure and wealth inequality. But the comparison between 1939 and 1999 is largely made out of necessity, since the 1940 U.S. population census was the first to inquire of wage and salary income and education.

¹ CEO GO, the Insights and Ideas Group at Burson-Marsteller.

² Alcorn.

³ Goldin and Katz (1999).

In addition, the AFL-CIO⁴ has rising concerns about the widening gap between CEO and workers' pay. At the same time workers' retirement savings have suffered through the worst stock market decline since the Great Depression, hundreds of millions of dollars are being doled out in special retirement plan deals to execs, whose pay continues to be out of line with company performance.

Economists have put forward four main explanations for the increase in wage inequality: technological change; increased imports from low-wage developing economies; higher immigration of low-skilled workers; and the waning power of trade unions. All four have probably played a role, but most economists reckon that new technology is by far the most important factor. Trade by itself is simply not large enough to be the major culprit, and the timing is wrong. America's trade with developing economies grew much faster in the 1990s than in the 1980s⁵, yet most of the rise in wage inequality dates from the 1980s. But how do these factors influence the widening gap between CEOs' and workers' pay?

In 2002, the average CEO compensation package equaled \$10.83 million according to *The New York Times*. While pay cuts for the most richly rewarded CEOs reduced the size of the average compensation package, most CEOs actually got pay raises. Median CEO pay increased by 6 percent in 2002—more than twice the growth of workers' paychecks. And while shareholders—including workers who depend on the stock market for their retirement savings and pensions—have lost \$7 trillion since the stock market peak, today's CEO pay packages are roughly equal to their pre-bear market levels.⁶ Many CEOs attempt to justify this disconnect between CEO pay and performance by pointing to the bad state of the economy or other factors. Of course, they are equally quick to claim credit for their companies' performance in good times.

Stock-option grants promise executives all of the gain of share price increases with none of the risk of share price declines. As a result, they can encourage excessive risk taking by

⁴ American Federation of Labor and Congress of Industrial Organizations.

⁵ Spero and Hart (2003).

⁶ Executive PayWatch.

executives and can prompt executives to pursue corporate strategies designed to promote short-term stock price to the detriment of long-term corporate value.

Stock options are a significant cost for shareholders. According to the Investor Responsibility Research Center, the average potential dilution (meaning the percent of a company's shares that have been promised as stock options) reached a record 15.7 percent in 2002.⁷ And many companies still do not account for these stock options as a compensation expense.

Executives also are asking for and getting other compensation benefits that are risk free. For example, The Corporate Library estimates that the average departing CEO receives a severance package of \$16.5 million.⁸ These golden parachutes can reward underperformance leading up to a CEO's departure and are not justified given already high levels of executive pay. Moreover, these executive severance packages are intended to insure officers against financial loss if their employment is terminated without cause. But according to figures from Board Analyst⁹, nearly half of companies in the S&P 500 pay three years' worth of base salary, target annual bonus and benefit provision, and allow immediate vesting of all long-term awards.

Furthermore, in the face of shareholder discontent, rather than lower compensation grants to reflect poor performance, boards tend to raise them, arguing the need to retain the executive. Option grants do work as a retention device: a Towers Perrin survey found that American employees ranked stock options as the top reason to stay at a job. But grants' value as a performance incentive is less clear. 200 executives from 40 countries surveyed at a conference in 1997 freely admitted that they rarely thought about their shares while making day-to-day decisions—unless it was to underestimate performance targets and qualify for larger options grants.

Brian Hall, a professor at Harvard Business School who has published a number of articles on options, has found otherwise. In the 1970s, he notes, bonuses were usually flat and pay based

⁷ Soulé (2003).

⁸ Hodgson (2003).

⁹ Governance Intelligence from The Corporate Library.

solely on brute growth¹⁰; now, compensation packages are much more flexible. His research with Jeffrey Liebman, a public policy professor at Harvard, found that among similar companies in 2000, pay was ten times more likely to reflect performance than it did in 1980.¹¹ Similarly, Tod Perry of Arizona State University and Marc Zenner of the University of North Carolina found that once CEO compensation had been altered, with salary a smaller percentage of the total package, pay for performance sensitivity increased.¹²

Nor, points out Mr. Hall, are options risk-free. As Mr. Jobs knows, an underwater option¹³ is worth far less than cash or stock. Even in a bull market, an executive has no guarantees of receiving valuable options: Mr. Hall's research found that fully one-third of options held in 1998 were underwater. An executive sitting on a large option grant might be further motivated to increase the company stock price. He could also be tempted to lobby for repricing, which is why Mr. Hall thinks the ideal form of compensation is a mixture of options and outright stock grants.

A reasonable and just compensation system for both executives and workers is fundamental to the creation of long-term corporate value. However, the past two decades have seen an unprecedented growth in compensation only for top executives and a dramatic increase in the ratio between the compensation of executives and rank-and-file workers.

By any standard, many of today's executive compensation packages are excessive. Too often directors have awarded compensation packages that go well beyond what is required to attract and retain executives and have rewarded even poorly performing CEOs. These executive pay excesses come at the expense of shareholders as well as the company and its employees.

Executive compensation packages generally are composed of annual salary, annual incentive awards, long-term incentive awards, stock options and other forms of equity compensation. The structure of a CEO's compensation package influences whether the CEO focuses on boosting the corporation's day-to-day share price or concentrates on building long-term corporate value.

¹⁰ Hall and Murphy (2001).

¹¹ Hall and Liebman (1998).

¹² Perry (2001).

¹³ Out-of-the money option; indicates the option has no intrinsic value, all of its value consists of time value.

In conclusion, the question should be asked how to set up a well-designed executive compensation plan that aligns the interests of senior management with the long-term interests of the company and its shareholders. Pay-for-performance means rewarding executives for meeting explicit and demanding performance criteria and penalizing executives for failures to meet these goals as determined by the board of directors. A Company's board of directors needs to do more than evaluate CEO performance on the short-term stock price. The answer may lie in creating a compensation program geared to the longer-term, as well as emphasizing leadership development, given that 86 percent of CEOs typically come from the inside of the company.¹⁴

Regulators and other watch dog groups should further limit conflicts by requiring companies to have a written charter that specifies the compensation committee's purpose and duties and responsibilities. Furthermore, the International Accounting Standards Board (IASB) has already announced plans to issue a proposal that would require companies using IASB standards to expense the value of options beginning in 2004. In addition, the Sarbanes-Oxley Act addresses issues such as auditor independence, corporate responsibility, enhanced financial disclosures, conflicts of interest and corporate accountability to further influence and limit the design of compensation plans for executives. Warren Buffet, when asked by executives in his companies how they should manage their business and compensation plans, said: "Look at the business you run as if it were the only asset of your family, one that must be operated for the next 50 years and can never be sold." Whether Buffet's advice can help to reduce the income gap between CEOs and workers remains to be seen.

¹⁴ Reilly, Enright, Cumpston and Audi (2003).

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