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Effects of Excessive CEO Pay on U.S. Society

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Abstract

There is a growing trend in the United States to recruit and retain corporate CEOs by offering extravagant pay packages. Excessive pay, defined as compensation that is 20% or greater than the national average CEO salary, has changed the relationship between CEOs and stakeholders. While the free market society can present valid reasons for the escalation in wages, the overwhelming majority of data concludes that the impact on society is detrimental. Contemporary American author David Callahan has coined the phrase "cheating culture" to describe the current decay of ethical behavior in the U.S. and how it contributes to CEO corruption and unethical behavior by stakeholders. This paper will provide supporting evidence to validate the negative impact excessive CEO wage gaps have on society.

Introduction

In his book *The Cheating Culture*, David Callahan (2004) exposes the recent exponential growth of CEO salary and bonus plans in the United States. Callahan makes the claim that CEO wage greed contributes to the growth of the cheating culture in America. Daily news articles found in *The Wall Street*

Journal, as well as other media sources, criticize CEO wage escalation and call for corporate reform.

The Corporate Library, a think tank in Maine, defines excessive pay as compensation that is 20% above the mean wage for similar job functions (Brush, 2005). While it is easy for employees to criticize the large pay gap between their wage and that of the CEO, history is full of unequal wealth distribution, from kings to the Pope. If the compensation is legal and approved, why are so many people upset?

Capitalism, the foundation of American society, rewards individual achievement. The American dream, the potential for financial success that inspires immigration to the U.S., is envied worldwide. The Christian religion also encourages tolerance and acceptance of unequal wealth distribution. The parable of the workers in the vineyard teaches that an individual should not be concerned with the wages of other workers if it does not impact the wage the individual accepted (*The NIV Study Bible*, Matt. 20:1-16).

Thus Callahan and current media articles seem to be in conflict with traditional American and Christian views. Callahan gives the impression that wage inequity forces the automatic response for subordinates to renounce personal ethics to "get even" by any means possible. Legal executive compensation is criticized and blamed as the cause of recent corporate scandals. This leads to the following research question:

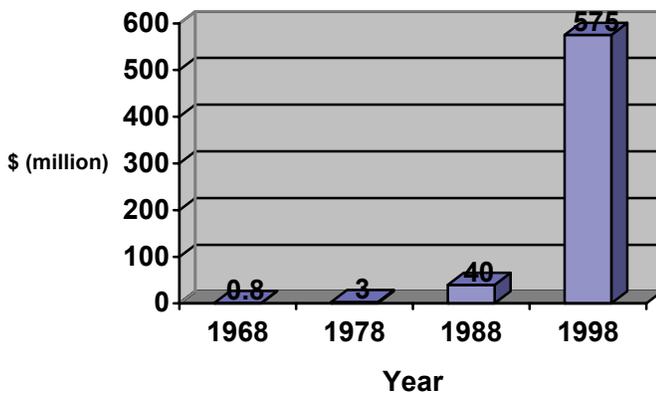
What effect does the current trend in large CEO compensation packages have on society?

To answer this question, all stakeholders, from coworkers to the general population, will be reviewed to present evidence that supports or refutes a link to increased cheating and compromised ethical behavior in society, resulting from the increasing wage gap between CEOs and the public. Pros and cons to this topic will be evaluated to determine the net impact on society.

Trends in CEO Pay

Callahan (2004) describes the widening gap in CEO pay compared to subordinates' wages along a time line starting in the 1940s and extending to the early 2000s. From the 1940s through 1970, the wage gap was constant at approximately a 30-to-one ratio. Although the numbers Callahan uses are very dramatic and get the reader's attention, his information is based on the highest paid CEO in the year discussed, not the average CEO compensation, which may not present a realistic view. Figure 1, "Top CEO Wage by Year," reflects Callahan's research (2004, pp. 45-46).

Figure 1
Top CEO Wage by Year



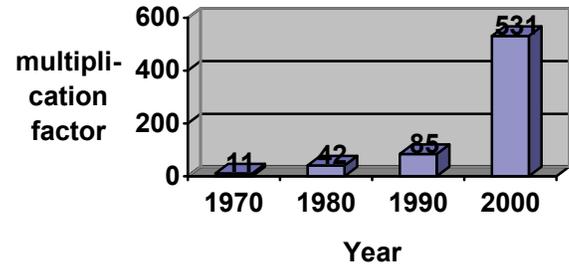
Source: Calahan, 2004

The media also report dramatic numbers. For example, in the article "CEO Pay Still on Steroids," author Holly Sklar calculated that the highest paid CEO in 2004 made over \$230.6 million. Put in perspective, that's over \$4.6 million per week (Sklar, 2005)!

To find out if Calahan's information presents an accurate view on pay gaps, Figure 2, "Gap Between Average CEO Compensation and Average Hourly Worker Wage" depicts information from F. John Reh, in his article "CEOs are Overpaid." In this graph, average

CEO wages are compared to average hourly worker wages (Reh 2005).

Figure 2
Gap Between Average CEO Compensation and Average Hourly Worker Wage



Source: Reh, 2005

Figure 2 shows that in 1970, the average CEO compensation was 11 times the average hourly worker wages. In 1980 the gap was 42 times, and in 1990 CEO compensation was 85 times greater than average hourly wages. CEO compensation in 2000 demonstrates a pay gap of over 531 times the average hourly worker wage. The two graphs show similar direction and magnitude, confirming the exponential growth trend.

This trend originated in the US and is not a result of global influence, as the 2004 statistics for foreign CEOs show a five to ten times wage advantage compared to average workers, far lower than for U.S. corporations (O'Toole, 2005).

This increase in pay for CEOs has not been in proportion to company profits. Bebucuk and Ginstein found that "pay for the top five company executives rose from 4.8 percent of aggregate net company income during 1993-1995 to 10.3 percent of aggregate net income during 2001-2003" (as cited in Sklar, 2005). This means that executives are now taking a larger percentage of the overall corporate income.

Examples of CEOs making huge profits during years of massive corporate loss are recorded weekly in *The Wall Street Journal*. For example, in 2004 Merck had to pull Vioxx off the market due to concern linking Vioxx to increased risk of heart attack or stroke. This quickly led Merck stock to decrease by 28 percent. That same year the CEO of Merck, Ray Gilmartin, received not only his base salary but performance-based bonuses worth over \$37.8 million (Sklar, 2005).

According to Derek Bok, "there are only two decades since World War I when executive compensation went up much more rapidly than blue-collar wages. That was the 1920s and 1980s" (as cited in Vogl, 1994). Bok felt this was due to a culture where

money was celebrated and business leaders were considered role models. Both decades of excess were followed by economic downturns and public dissent, which led to legislative activity regulating corporate accounting.

Michael Brush puts excessive CEO pay in perspective with his article “Extravagant CEO Pay Is Back.” In this article Brush highlights George David, the CEO of United Technologies, one of the highest paid executives in 2004. David collected \$88.7 million in 2004. Brush articulates the magnitude of George David’s salary in the following passage:

What kind of fire power can you buy with \$88.7 million these days in the market for CEOs? Here is one way to think about it. David pocketed just a little less than the \$89.1 million that we pay all the top executives running the three branches of our federal government. In other words, for around the same amount United Technologies shareholders paid for their CEO last year, taxpayers got: one president, a vice president, 535 lawmakers on Capitol Hill, and nine Supreme Court justices. David’s pay includes a base salary of \$1.2 million, an annual bonus of \$3.5 million and gains of \$83.6 million from cashing options. Was David worth the pay he received? While David led United Technologies to produce stock gains three times the returns of the S&P 500 for the same time period, his compensation was nineteen times the median CEO pay package (Brush, 2005).

Brush puts CEO compensation in a practical, real world, perspective.

The trends in CEO wage escalation having been discussed, all the relevant stakeholders will be analyzed to determine if stakeholders suffer negative consequences and whether this influences their ethical behavior.

Boards of Directors

How can CEOs get away with such a large salary, plus stock options, perks, and bonus packages? The answer is that boards of directors set base pay, bonus packages, use of corporate resources and severance pay. What reasons do boards give for large CEO incentives?

- The Great Person Theory of Shareholder Value proposes that large compensation packages are used to attract the best person to run the company. The market and availability of qualified experienced candidates set the rate. This theory does have merit. When Boeing appointed James McNerney to run the company in 2005,

Boeing stock went up \$4 per share. Boeing, on that one day, generated a paper profit of over \$3 billion. This easily offset the six-year \$62 million salary McNerney accepted (Murray, 2005). In this example, the board of directors received positive feedback from the public market that confirmed its decision to pay a high wage.

- The second reason a board of directors may use to justify large CEO salaries is that it can be used to indicate how well the company is performing. Hiring a CEO is newsworthy and gives the company an opportunity to advertise its new goals and business strategy. High wages give the company the perception of profitability and may contribute to new investor interest.

- The negative side of boards of directors and CEO salary negotiation is the way many corporations structure the board. In many cases the board is composed of past CEOs and other people with direct ties to the CEO. The article “Six Degrees of Separation” declares that “CEOs who had any ‘back door’ link to someone on the company’s compensation committee received on average \$453,688 more than CEOs who had no such links. The average compensation for CEOs at firms where inside and outside directors were linked in any way was greater by \$612,422” (Six, 2005). A common trend where individuals may sit on several boards is called “overboarding” (Lawrence, Webber & Post, 2005, pp. 295). Overboarding has the potential for creating conflict-of-interest situations as board members from one company may be CEOs of another company. CEOs also have great influence on the compensation of the board of directors. CEOs can recommend board members and often influence the current board members by using corporate networking strategies.

How Excessive CEO Pay Affects Business

Effect on Other CEOs

Extravagant pay packages created by a board of directors have contributed to the “free agent” mentality currently seen in corporate culture. Callahan sums this up by stating “The new freedom of top executives to funnel more profits into their own pockets gave CEOs an immense incentive to worship the leanest and meanest version of the bottom line, since every new ‘efficiency’ translated directly into personal gain” (Callahan, 2004, pp. 45-46).

The article “The Serial CEO,” by Joann Lubin, describes the emergent trend in hiring CEOs away from other companies. While 70% of all CEOs are currently hired from within the company, this number is dropping fast (Vogl, 1994). This also correlates with a reduction of tenure for CEOs. “Among the 300 largest U.S. companies, 19 percent of the CEOs have worked at the

company for less than five years, up from 5 percent in 1980” (Lubin, 2005).

It is understandable that a board of directors would like to hire the best possible CEO; however, many experts believe that enticing individuals with enormous pay packages is detrimental to the integrity of corporate America. Closed door negotiations to persuade a CEO that he/she is underpaid and would have a better future at a different company distract the CEO from his/her duty to focus on company business. Unethical behavior to attract desirable people and the impact of a key person suddenly resigning are also detrimental to a corporation. Companies with revolving door CEOs may never reach efficient organizational behavior, as each CEO brings in a new vision and management style (Six, 2005).

The free agent mentality creates competition between CEOs and a lack of long-term commitment and vision. The free market society rewards the most deserving and in-demand CEOs; however, there has been little proof that the high wages are justified and create more shareholder value. In the article “Vexing Questions,” J. Vogl states that “all of the studies that I’ve read suggest that the correlation between executive pay and performance is very weak” (Vogl, 1994).

Effect on the Company

The majority of compensation for CEOs comes from stock options, which allow the CEO to purchase shares in company stock at a set price that can be significantly lower than market value. The ability to buy stock at a lower price and sell when stock prices are higher may motivate the CEO to find ways to exaggerate the value of company shares. This temptation to “take the money and run” can motivate CEOs to direct subordinates to report false profit statements and undertake unethical accounting methods, creating a false impression of corporate profitability (Levin, 2005).

Before legislation to report stock options as an expense went into effect in 2004, U.S. accounting rules allowed stock option compensation to be kept off a company’s books as an expense, even when taken as a business expense deduction on the company’s tax return (Levin, 2005). Enron, in 2000, paid executives \$750 million in a year when Enron’s net income was \$975 million (Levin, 2005). These payments did not reduce the profits reported in Enron’s financial statement, creating a false impression of profitability. Since the Financial Accounting Standards Board released Statement 123 in 2004, requiring accounting for share-based payment, the use of stock options has declined, but it is still a significant source of income for the CEO (AFL-CIO, 2004).

Stock options create an environment in which unethical behavior can germinate. CEOs can use people, company activities, and deception as a means to an end in obtaining higher short term stock market value. There is a big incentive for CEOs to “cook the books” to report false business levels and hide low corporate growth. Stock options often reward short term decision making, which can be detrimental to a company’s long term success (A Decade of Executive Excess, 1999).

By exercising stock options, CEOs may also be able to purchase a significant percentage of controlling stock. This would shift the ownership stake of the company to a partial owner/employee relationship. It is very easy to see the potential for conflicts of interest and board manipulation when the CEO is a majority stock owner.

Possibly the most detrimental effect of large CEO incentive packages is the emphasis on short-term profits without regard to long-term strategy. Incentive plans reward short-term goals, reduce the focus on long-term goals, and diminish investment in future products. CEO compensation also reduces the money available for corporate research and development, employee training, and market research (A Decade of Executive Excess, 1999). As already illustrated, many CEOs have taken significant payouts that are a large percentage of company revenue, and some have reaped enormous personal benefit even when the company has suffered a loss.

From the company’s perspective, CEOs fill a critical and needed role in an organization and can have an enormous positive effect on a company. It is the CEO who sets the direction and vision of a corporation. The skills and responsibilities required to run a company are specialized, require total dedication to the company, and are found in only a small percentage of the population. The majority of CEOs are worth the wages they receive and can justify wages many times the base salary of subordinates (Coleman, 2005). However, the current trend in excessive compensation is out of proportion to the value of the CEO (A Decade of Executive Excess, 1999).

Effect on Subordinate Workers

Research has concluded that high CEO pay contributes to higher subordinate turnover, lower job satisfaction, and lower quality products. A 1992 study conducted by David Levine, a business professor at the University of California at Berkeley, found that bigger pay gaps between CEOs and workers had a measurable adverse effect on product quality (as cited in Boisseau, 1996). In the article “Workers Foot Bill for Boost in Bosses Pay,” Margaret Blair, senior fellow in corporate governance for the Bookings Institution, states, “There is

a growing sense—and it’s not totally unwarranted—that since the mid-1980s, the gains to shareholders have come at the expense primarily to employees” (as cited in Boisseau, 1996).

There have been many instances of CEOs making huge fortunes during cost cutting, outsourcing, layoff and wage reduction initiatives. This can only lead to resentment and poor worker morale. Take Albertsons’ CEO Lawrence Johnston, an example of a CEO profiting during unprofitable times. Johnston became CEO of the Boise-based retail grocery chain in 2001. Within three years his salary and bonus package had risen 68 percent. In that same time period the company closed 95 stores, laid off 1,300 workers, and had a fall in stock prices of over 5.4 percent. To make matters worse, the average salary of a grocery worker for Albertsons’ is \$18,000 per year, which means that a grocery worker would need to work 911 years to make the same yearly salary as Johnston (Ouchi & Timmerman, 2005).

Authors Lynne Andersson and Thomas Bateman conducted research to find root causes for cynicism in the workplace. Their paper, “Cynicism in the workplace: Some causes and effects,” published in the *Journal of Organizational Behavior* in 1997, presents the following hypotheses:

- High levels of executive compensation will lead to significantly higher levels of cynicism than modest levels of executive compensation
- Poor organizational performance will lead to significantly higher levels of cynicism than strong organizational performance
- Higher levels of executive compensation will have a greater impact on cynicism when organizational performance is poor than when organizational performance is strong
- High levels of executive compensation will have a greater impact on cynicism when harsh and immediate layoffs are announced than when a less severe and more gradual workforce reduction strategy is announced.

On the other hand, positive effects of CEO salaries on coworkers could also be deduced (Coleman, 2005):

- Motivating subordinates to set goals to obtain upward mobility toward high-paying CEO positions
- Attracting the best candidates to the company, due to the high wage of the CEO
- Using the high salary of the CEO as a reason to justify higher employee compensation. This has the potential to raise the wages of all subordinates in a company.

The positive effects discussed do not appear sufficient to justify or legitimize excessive pay gaps,

however. The overwhelming evidence supports the negative effects on employee morale and turnover.

The idea that a single person in the company can be worth 531 times the average worker salary must be demoralizing to workers. When a company grows and is profitable, not all the praise and reward should be focused on the CEO. While the CEO sets the course for the company, the subordinate workers are ultimately responsible for the profitability of the company. Without an educated and motivated workforce, the company will struggle, regardless of CEO management. High CEO wages can only contribute towards the feeling that the CEO is a superhuman, someone above the norms of society and not in communion with fellow workers.

How Excessive CEO Pay Affects Society

Impact on the Community and Nation

Alan Greenspan, past Chairman of the Board of Governors of the Federal Reserve from 1987 to 2006, has expressed concern over excessive payouts to CEOs contributing to inflation and reducing the corporate focus on long term profitability (Winnick, 2002). This delivers a one – two punch for the economy. First, corporations shift the wealth to individuals who have the means to hide or protect the income from taxation. This also reduces compensation to the vast majority of employees, further reducing tax revenues.

The past practices of deducting CEO pay as a company expense drastically reduced tax revenue at the state and federal level. While new legislation makes this practice illegal, only time will tell if tax revenue and accurate cost accounting will turn around the trend of corporations paying less in taxes every year. A study conducted by the nonprofit organization United for a Fair Economy found CEO pay and perk deductions to be “one of several factors in the dramatic drop in the share of federal taxes paid by corporations. In 1960, corporations paid 23.2 percent of federal taxes; in 1998 they paid only 11.4 percent” (A Decade, 1999).

Society as a whole is also adversely affected. Sky-high CEO pay creates new role models for the next generation. As the media glorify excessive wealth, a shift in values and norms is taking place. Individuals define basic needs and success based on inflated and distorted lifestyles. Authors such as Derek Bok, Chuck Collins and Ralph Estes have all elaborated on the negative effect excessive pay has on society (Callahan, 2004).

Impact on Multinational Companies

As stated previously, U.S. CEOs make on average 531 times the average employee wage, while the

ratio is 13-to-1 in Germany and 11-to-1 in Japan (O'Toole, 2005). Not only does this cause U.S. corporations to be at a competitive disadvantage with foreign companies, but mergers and takeovers involving U.S. and international firms become more complicated. In cultures that are more collectivistic compared to the individualistic U.S., high CEO wages are not common and many cultures consider excessive wage gaps unethical.

However, the effect of U.S. CEO wage escalation has started a trend in raising the compensation packages in foreign corporations. Stock options are becoming more popular in other countries and mergers between U.S. and foreign companies have often elevated foreign CEO salaries. Foreign companies are also starting to witness the migration of top CEOs from existing native homeland corporations to U.S.-based companies. In a very real way, U.S. CEO pay is having an impact on world economics (A Decade, 1999).

Impact on the Future Work Culture

The past decade of CEO compensation escalation has raised the bar on future CEO expectations. Prospective new hires expect higher starting salaries and quick upward mobility, a direct result of media focus using dramatic, front page articles on total compensation estimates for top business executives.

An Australian study conducted in 2000 by Diane Swanson, a professor of business ethics at Kansas State University, found a correlation between ethics and expected wage levels of newly hired workers. "Those who expressed a preference for being paid far beyond what other employees earn were also the ones least concerned with matters of corporate ethics." She recommends that executive applicants be screened based on pay expectations, to weed out employees with low moral inclinations (as cited in MacDonald, 2005).

Callahan argues that the trend in unethical behavior and cheating will increase unless business and governmental programs are instituted to reduce inequality and narrow the income gap. There are already signs of a cultural shift away from materialism toward social advancement that may reduce many of the avenues CEOs have used in the past for wealth accumulation. Voter anger over scandals at Enron and WorldCom has led to several new accounting laws. Recently passed regulations include the following:

- Revenue Reconciliation Act of 1993, which limits the corporate tax deduction for executive compensation to \$1 million per person (Lawrence, Webber & Post, 2005).
- Sarbanes-Oxley Act of 2003, which sets the requirement for independent board oversight on audits,

as well as holding the CEO responsible for accurate financial statements (Lawrence, Webber & Post, 2005)

- Statement 123 Share-Based Payment created by the Financial Accounting Standards Board, which requires financial statements to account for share-based payments to all employees (Securities and Exchange Commission, 2005).

Conclusion

Research supports the assertion that excessive CEO compensation has a negative influence on society. David Callahan is not alone in declaring this era as a time where the cheating culture is growing like never before. Research suggests excessive CEO compensation contributes to the cheating culture in every aspect of society. Each stakeholder--from coworker to the international community--may be negatively influenced by the U.S. system of CEO pay packages. The mentality that earning potential has no limit in a capitalistic society fosters a cheating culture. CEOs have enormous responsibility and should be compensated accordingly; however, 531-to-one wage ratios are not justified. This ratio continues to create an environment where ethics are easily compromised.

There has been a recent uprising in concern and anger by the public regarding excessive CEO pay packages. With the recent legislative enactment of the Sarbanes-Oxley Act and increased Securities and Exchange Commission activity, it is apparent that the U.S. government is taking action to curb this trend. It is possible that the thirty-year period from the 1980's through 2010 will be considered the golden age of CEO wages. It is certain that future boards of directors will have new guidelines and a focus on corporate responsibility for all stakeholders.

The impact of today's excessive CEO compensation on the emerging class of CEOs remains to be seen. The trend of abuse and corruption could continue, or a movement toward higher moral and ethical standards could take place. It is hoped that ethics will prevail.

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