UNIT 7

Employee Compensation

Unit Background

Everyone would like to make more money, and organizations operate in a world of limited resources. How can a company fairly allocate salaries and wages?

Module 38

CEO Compensation. [Are American CEOs paid too much? How much is too much? Under what circumstances should large compensation packages be considered?]

Module 39

Taxes and Salaries: Egalitarian and Libertarian Policies. [When allocating scarce resources, should people be treated equally, or should they be rewarded according to the wealth that they generate?]

Module 40

Rawls's Veil of Ignorance and Fair Compensation Systems. [Noted thinker John Rawls proposed the idea of a "veil of ignorance" as a justification for egalitarian policies. Is his point of view reasonable?]

Employee Compensation

Americans are keenly interested in how much money they are paid relative to others. Newspaper articles about salaries are a constant because people find them interesting.

Companies have limited resources, and they are never in a position to give every worker every dollar he or she would like to have. Salary trade-offs are a constant struggle for many businesses.

American CEOs earn tidy sums. In many nations, a typical CEO earns 20 times what an entry-level employee makes. In the United States, the multiplier is several hundred. Boards of directors justify large pay packages by pointing to the tremendous difference in revenue between well-led and poorly led organizations. But many politicians, reporters, and workers remain unconvinced. The first module examines extreme CEO compensation and whether it is justified for all leaders, only for successful leaders, or for no leaders at all.

The remaining modules look at pay for "regular" workers. Libertarian and egalitarian thinkers have different points of view on compensation policies, and the two philosophies are contracted. John Rawls's "veil of ignorance" is one of the more useful tools for thinking through these issues, and it is presented in the unit's final module.

MODULE 38

CEO Compensation

BACKGROUND

It pays to be at the very top. Bestselling author Stephen King brings home $50,000,000 per year. David Beckham earns about the same. And large numbers of CEOs earn sums north of seven figures.

Chief executive officer (CEO) compensation has long been a hotly debated issue, and critics have become more vocal during the current economic downturn. As "regular" workers are laid off, and wages of most workers who stay employed remain stagnant, many in the press have sharp words for executives with large compensation packages.

Corporate compensation committees seem to be paying attention. In 2009, total pay for the leaders of America's 500 largest companies fell 11 percent. But the average CEO of a top-500 company, even with the reduction, still pocketed an average of $11.4 million. Critics continue to call for consumer boycotts and new government regulation.

CEOs seldom defend themselves in on-the-record interviews, but when they do, they argue that their strategic decisions can make the difference between a company that thrives and one that files for bankruptcy. CEOs are paid handsomely, but their compensation totals less than 3 percent of a typical company's profits. If a CEO's vision helps a company earn extra billions, the argument goes, then why shouldn't he or she be able to earn millions?

Later in this unit, we will look at trade-offs between concentrating raises among top earners and spreading them out more evenly among all workers. This module, however, focuses only on the level of CEO pay itself.

CEO Pay and Average Salaries

Until 1994, ice cream maker Ben & Jerry's had a well-known rule that the CEO could earn no more than 5 times the wages of the company's lowest-paid worker. Today, Whole Foods Market has an internal policy that caps CEO pay at 19 times the pay of the average employee. Although a handful of other companies set similar voluntary limits, most do not.

Around the world, there is wide variation in the relationship between executive compensation and the pay of average workers. In Japan, a typical CEO is well paid, but he or she earns only 11 times what the company's average worker earns. So if an average worker at a company earns $40,000, the typical Japanese CEO pockets a very nice but nonshocking sum of $440,000. In the United Kingdom, the multiplier is 22, and a typical executive might earn almost, but not quite, $1 million.

In the United States, the multiplier is substantially higher. A generation ago, it was already 40 times the average worker's salary. Currently, it is 150–200 times higher. Critics argue that this is a harmful disconnect and that CEO pay is unconscionably out of step with an average worker's pay. Critics say that workers are less motivated and that they feel less part of a team when such salary disparities exist.

Others argue that there is no substitute in an organization for excellence among top leaders and that CEOs are extremely well paid because they are irreplaceable.

The Beginnings of Broad Regulation? The Troubled Asset Relief Program

To date, the government has declined to pass laws that place broad limits on CEO pay. However, there has been recent regulation of the pay of the leaders of some companies that have received a new kind of government assistance.

When the housing market collapsed and sparked the current recession, Congress threw several hundred billion dollars at the problem in the form of the **Troubled Asset Relief Program (TARP)**. The essential problem addressed was this: Large numbers of borrowers ("subprime" and otherwise) became unable to pay their mortgages. Banks and others faced tremendous losses as the value of their mortgages and the mortgage-backed securities they held plummeted.

TARP money was used to buy these "toxic assets" and to help keep financial institutions afloat. In return, the government took an ownership stake in bailed-out businesses. In addition, TARP recipients had to accept new regulations.

In June of 2009, President Obama appointed Kenneth Feinberg the TARP program's Special Master for Executive Compensation. The press sometimes refers to Feinberg as the "pay czar." He has broad authority to regulate the pay of the top 5 executives and the next 20 most highly compensated employees of companies that have received TARP funds. CEO pay is not strictly limited to any defined level, but Feinberg can and often has rejected proposed compensation packages.

Some members of Congress have argued that TARP program restrictions on CEO pay should be significantly expanded to cover all publicly traded companies.

In the following scenarios, several people have taken in the same amount in the past year. The questions that follow will ask you to approve of or condemn their large paydays.

SCENARIOS

Consider the following companies. Assume that all CEOs described took home total compensation of $50,000,000 last year.

Company 1

CEO Jane Smith leads the most profitable pharmaceutical company in the world. When she took over five years ago, its performance was average. She made a series of bold moves and assembled a team of researchers who lead the industry in patents. Her marketing department and network of sales representatives are also considered second-to-none. Her pay is a total of less than 1 percent of the company's annual profit.

Company 2

Javier Vazquez is CEO of a bank that was in deep trouble when he took the helm four years ago. At that time, the bank was near bankruptcy. Foreseeing the mortgage collapse, he instituted a strict policy of making no loans to applicants with low credit scores and set about reshaping the bank's image. Today, the bank has become very profitable again. Vasquez recently received an offer to take over a larger competitor at a salary of $65 million. When the board of his current employer offered him a new package worth $50 million, he decided to stay. His new compensation amounts to 5 percent of the bank's total profit from last year.

Company 3

Jerome Smith is CEO of an oil company. It has held steady for several years as the nation's fifth largest oil company. He has brought the company through a difficult strike among refinery workers and a significant drop-off in crude oil prices. His pay is about 1 percent of the company's annual profit.

Company 4

Randy Roberts is CEO of a struggling software company. When he took over seven years ago, the company was thriving and was a leader in creating and selling business applications. Today, the company is substantially less profitable than in its heyday; 15 percent of its workforce has been laid off. Roberts has argued repeatedly to the board of directors that "it could be worse" and that his leadership has prevented the company from collapsing altogether in a changing market. His pay is about 6 percent of the company's total profit.

Consider also these non-CEOs.

Al

Al Harris was badly hurt in an auto accident when his car's steering malfunctioned. He is partially disabled from the accident and probably always will be. He is able to care for himself, but he will never again be able to resume his job as a construction worker. He sued the maker of his car and won $50 million.

Jan

Jan Linus is a genius day trader. Over the last 15 years, she has built an initial stake of $200,000 into $100 million. She had a particularly good year last year, snapping up undervalued assets and increased her net worth by $50 million.

Franklin

Franklin J. Moneypenny inherited $50 million from his grandfather.

Betty

Betty Goodfortune won $50 million in the Powerball lottery.

DISCUSSION QUESTIONS

1. How justifiable are the large compensation packages for the CEOs discussed above?

	Completely Unreasonable ⟷ Completely Reasonable						
Pharmaceuticals	1 ---	2 ---	3 ---	4 ---	5 ---	6 ---	7
Bank	1 ---	2 ---	3 ---	4 ---	5 ---	6 ---	7
Oil	1 ---	2 ---	3 ---	4 ---	5 ---	6 ---	7
Software	1 ---	2 ---	3 ---	4 ---	5 ---	6 ---	7

2. Is it reasonable for the government to regulate companies that have received TARP money? If so, should the government go further and regulate the CEOs of all corporations? If not, should the government never set legal maximums for salaries?

3. Do you give any weight to the criticism that CEO salaries are too many multiples of the salaries of average workers? Is Japan more reasonable with a multiplier of 11, for example, than the United States is with a typical multiplier of 150–200? What should the multiplier be? Or is this a nonsensical comparison?

4. This module opened with Stephen King and David Beckham. Compare their $50 million to the $50 million the CEOs in the scenario earned. On a gut level, do you find it any better or worse when a celebrity or entertainer makes a large amount of money than when a CEO does the same?

5. Now consider the $50 million that the non-CEOs received. If you were the king or queen and had total authority, who would you allow to keep all of the $50 million, less regular income taxes that everyone pays? Circle everyone who you think should be able to keep the entire $50 million, and leave blank anyone on whom you would impose a "special extra tax."

Al Harris (lawsuit)	Jan Linus (stock market)
Franklin J. Moneypenny (inheritance)	Betty Goodfortune (lottery)