Gap in CEO-Worker Pay Widens

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The difference between the compensation of corporate chief executive officers (CEOs) and the pay of factory workers is gaping and growing steadily in the United States. In 2001, executives of surveyed corporations in the United States made more than $11 million—some 350 times as much as the average factory worker.[1] (See Table 1.) And this earnings differential grew more than fivefold between 1990 and 2001.[2]

Today, the U.S. gap is at least 10 times greater than the differential in other industrial nations, where tax laws and cultural norms have prevented huge increases in executive pay. But as U.S. executive compensation practices—which rely heavily on stock, rather than cash, as the primary form of CEO compensation—are adopted elsewhere, the earnings gap in other countries could increase as well.

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The average executive compensation of $11 million in the United States compares with the average pay of factory workers of $31,260.[3] Because earnings of manufacturing workers increased only 42 percent between 1990 and 2001, the bulk of the fivefold increase in the pay gap clearly came from sharp increases in executive pay. The pay for manufacturing workers in other industrial countries grew on average 39 percent, roughly similar to that of workers in the United States.[4]

Growing pay discrepancies in the United States emerge largely from a compensation system skewed in favor of the CEO. In the past two decades, the shift to compensation based on stock options gave CEOs the right to buy company stock in the future at a price set today. The assumption was that tying executive compensation to company stock would give CEOs a strong incentive to ensure that a company is financially successful.

In the rapidly rising stock market of the 1990s, executives often held on to their options, allowing the value of the stocks to rise, then purchased the stock at the low price they had locked in. This led to huge accumulations in wealth. In the year 2001 alone, the average value of stock options received by CEOs in 370 surveyed U.S. companies was at least $8 million, more than triple the average level of CEO salary and bonuses ($2.3 million).[5] In the 1990s, the generous grants of options quickly skyrocketed in value. In an extreme example, Oracle CEO Larry Ellison cashed in $706 million in long-held options in 2001, making his take-home pay that year more than 17,000 times greater than the pay of the average manufacturing worker.[6]

With the fall of the stock market in 2001, executives saw an average decline of 43 percent in pay-related wealth (the sum of pay, bonuses, and accumulated stock options).[7] But two things cushioned this decline and give lie to the claim that compensation is closely pegged to company performance. First, pay packages are typically determined by committees of other CEOs, making the setting of compensation levels a political rather than an economic process—and a process that CEOs often influence.[8] Second, when stock prices fall, many compensation committees simply give the CEO more stock options, or they trade deflated stocks for newer and more valuable options.[9] Thus Ellison's $706-million record bonanza in 2001, for example, came even as his other stock holdings lost more than $2 billion in value.[10]

The use of stock options outside the United States, though less common, is on the rise as well. In the mid-1990s, stock option plans were allowed in only 10 of 26 nations surveyed.[11] By 2000, 19 of them had such schemes.[12] In Japan, where options have been allowed only since 1997, the number of firms using them grew by 7 percent between 1999 and 2000.[13] The trend appears to be one of the consequences of a globalization of the executive labor force, as corporations compete across borders for managerial talent. This can lead to odd situations in which branch executives working in the United States make substantially more than their bosses at headquarters in Europe or Asia.

In the United States, options are attractive not only to CEOs but to corporations as well, because they open an accounting loophole that saves companies money. U.S. accounting rules do not treat options as expenses, so millions of dollars in executive compensation do not show up on corporate balance sheets. Indeed, the difference between the income that corporations report to shareholders and what they report to the Internal Revenue Service grew by 70 percent just in the late 1990s, as more corporations took advantage of this loophole.[14] It is as though companies found a way to pay their executives at no cost to the corporation.[15] This accounting trick artificially inflates stock values—by 5–8 percent, in U.S. companies, according to a study by the U.S. Federal Reserve.[16]

Indeed, because options are profitable to CEOs and corporations alike, they now account for about 80 percent of executive compensation packages in the United States.[17] Elsewhere the figure is lower, but growing: in Australia, options and other long-term incentives made up 35 percent of CEO compensation in 1998, up from 13 percent in 1990.[18] Options are so liberally dispensed in the United States that they now account for about 15 percent of all stocks outstanding in the country.[19]

Such a system of compensation puts CEOs at odds with workers, both directly and indirectly. A 2002 study by the Institute for Policy Studies shows that many of the companies under investigation for accounting irregularities saw their CEOs claim lavish salaries—in part because of options—even as workers were laid off by the thousands.[20] U.S.-style compensation packages put jobs in jeopardy because they encourage executives to take excessive risks that will inflate stock values and because aggressive accounting methods overstate company earnings, a charade that cannot continue indefinitely.[21]

As taxpayers, workers are also hit.[22] While companies do not report stock options on the balance sheets in their annual reports, they do report options in their tax returns, as this reduces their tax liability—and increases the tax burden of the rest of society. And to the degree that workers hold stock, they are also hit, because liberal grants of stock options dilute the value of stock for other shareholders.[23]

Table 1: CEO-Worker Disparity in Pay, Selected Countries, 2001

Country	Average Annual Pay: Chief Executive Officers	Average Annual Pay: Manufacturing Workers	Ratio
	(dollars)		
United States			
With stock options	10,926,000	31,260	350
Without options	1,932,580	31,260	41
Mexico	866,833	3,720	233
Brazil	530,220	4,840	110
Italy	600,319	19,880	30
Canada	787,060	27,040	29
Spain	429,725	16,140	27
France	519,060	21,500	24
United Kingdom	668,526	27,720	24
Australia	546,914	23,460	23
Netherlands	604,854	29,000	21
New Zealand	287,345	15,300	19
South Korea	214,836	11,940	18
Sweden	413,860	28,960	14
Japan	508,106	36,960	14
Germany	454,974	34,760	13
Switzerland	404,580	35,180	12

Source: Towers Perrin, *Business Week*, and Bureau of Labor Statistics.

In response to recent options-related American corporate scandals, reform of options packages are being considered, even on Wall Street.[24] Many major corporations are now expensing their grants of stock options, and others are looking to tie stock grants more directly to company performance. At the same time, there are efforts to limit the gap between the pay of workers and that of executives, or at least to end government support for huge gaps. A bill before the U.S. Congress, the Income Equity Act, would change the U.S. tax code to cap the deduction for executive pay at 25 times that of the lowest paid worker in the company.[25]

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1. Total compensation, with stock options, from Louis Lavelle, Frederick F. Jesperson, and Michael Arndt, "Executive Pay," *Business Week Online*, 15 April 2002; 350 times is a Worldwatch calculation based on executive pay from Towers Perrin, "Total Remuneration—Chief Executive Officer," at <www.towers.com/TOWERS/services_products/TowersPerrin/wwtr01/im…/exhibit1.gif>, and on worker pay from "Hourly Direct Pay in U.S. Dollars for Production Workers in Manufacturing, 30 Countries or Areas, 1975–2001," in Bureau of Labor Statistics (BLS), "International Comparisons of Hourly Compensation Costs for Production Workers in Manufacturing, 1975–2001," Supplementary Tables for BLS News Release, 27 September 2002.
2. Fivefold is from Scott Klinger et al., *Executive Excess 2002: CEOs Cook the Books, Skewer the Rest of Us*, Ninth Annual CEO Compensation Survey (Washington, DC: Institute for Policy Studies and United for a Fair Economy, August 2002).
3. Lavelle, Jesperson, and Arndt, op. cit. note 1; "Hourly Direct Pay in U.S. Dollars for Production Workers," op. cit. note 1. Worldwatch conversion of hourly pay to annual pay assumes a work year of 2,000 hours.
4. "Hourly Direct Pay in U.S. Dollars for Production Workers," op. cit. note 1.
5. "Executive Compensation Scoreboard," *Business Week*, 15 April 2002.
6. Lavelle, Jesperson, and Arndt, op. cit. note 1; gap with workers is a Worldwatch calculation based on CEO data in ibid. and on manufacturing worker data from "Hourly Direct Pay in U.S. Dollars for Production Workers," op. cit. note 1.
7. Lavelle, Jesperson, and Arndt, op. cit. note 1.
8. Lucian Arye Bebchuk, Jesse M. Fried, and David I. Walker, "Managerial Power and Rent Extraction in the Design of Executive Compensation," Discussion Paper 366, Harvard John M. Olin Discussion Paper Series (Cambridge, MA: Harvard University, June 2002).
9. Lavelle, Jesperson, and Arndt, op. cit. note 1.
10. Ibid.
11. Eric Wahlgren, "Spreading the Yankee Way of Pay," *Business Week Online*, 18 April 2001.
12. Ibid.
13. Ibid.
14. Klinger et al., op. cit. note 2, p. 7.
15. Lavelle, Jesperson, and Arndt, op. cit. note 1.
16. Klinger et al., op. cit. note 2.
17. Lavelle, Jesperson, and Arndt, op. cit. note 1.
18. Wahlgren, op. cit. note 11.
19. Lavelle, Jesperson, and Arndt, op. cit. note 1.
20. Klinger et al., op. cit. note 2, p. 3.
21. Ibid.
22. Ibid.
23. Lavelle, Jesperson, and Arndt, op. cit. note 1.
24. "Powerful Voices Join the Chorus of Pay Critics," *Charlotte Observer*, 25 August 2002.
25. Representative Martin Slav Sabo, at <www.house.gov/sabo/ie.htm>.