Tax Plutocrats to Restrain Their Pay

An easy solution to the excessive compensation of CEOs, hedge fund managers and professional athletes

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There has been a great deal of talk lately about the compensation of executives of publicly owned companies in the United States, including how to control the size of executive salaries and termination payments. It is surprising that amidst all this hoopla about excessive CEO salaries (as well as overpaid hedge fund managers, professional athletes, actors, rappers and rock stars) there has not been any serious discussion of the tried-and-true remedy of yesteryear.

Those of us who have been around since the 1930s and '40s remember the Eisenhower years, when the top marginal rate of federal income taxation for married couples was 91 percent, and it kicked in at taxable income of $2.7 million in 2006 dollars. Under these circumstances it is not surprising that most employers weren't willing to pay executives or anyone else great sums of money that just went to swell the federal government's tax coffers. Most employees didn't see much point in it, either. As a result, the income spread back then between the top "earners" and the rest of mankind was not nearly as wide as it is today.

The accompanying chart illustrates the top marginal rates in effect from the inception of the federal income tax in 1913 to the present, and at what level of taxable income (adjusted for inflation) they went into effect.

The federal income tax went into effect in 1913 with a top marginal rate for married couples of 7 percent on taxable income in excess of $500,000 (the equivalent in today's dollars of about $10,187,000). Under the pressure of paying for America's participation in World War I, the TMR was raised to 77 percent in 1918 on taxable income in excess of $1 million (the equivalent of $13.36 million in 2006 dollars).

During the next 20 years (1919 to 1939), the top marginal rate declined to 25 percent in 1925 (kicking in at $1.15 million in 2006 dollars) and stayed there until it jumped to 63 percent in 1932 when it was applied to taxable income in excess of $1 million ($15.52 million in 2006 dollars). In 1941, on the eve of American participation in World War II, the TMR was 81 percent on taxable income in excess of $5 million (the equivalent of $68.61 million today).

Taxes were higher during wars

During the war years, the top marginal rate ranged from 88 percent to 94 percent on taxable income in excess of $200,000 (the equivalent of $2,241,000 in 2006). The TMR declined to a range of 87 percent to 84 percent in the years after World War II, but returned to the 91 percent level for the Korean War and remained at that level through 1963.

The American people recognized that World War I, World War II and the Korean War were critical to our future as a nation, and that everyone needed to make some financial sacrifices to sustain our war efforts, especially those who had received the largest financial rewards from living in the U.S.

From 1951 through 1963, the top marginal rate was 91 percent on taxable income in excess of $400,000 (the equivalent of about $2.64 million in 2006 dollars). Today, many folks would look on a 91 percent TMR as extremely high, but top executives in 1962 were considered to be very well-paid, although they received relatively modest sums compared to majority of their 2006 counterparts.

In 1971, the top marginal rate was reduced from 71 percent to 60 percent on taxable income in excess of $996,000 in today’s dollars, and it dropped to 50 percent and remained there until 1987. The TMR was lowered again in 1988, this time to approximately 30 percent. These large reductions of the top marginal rate during the 1970s and 1980s were an open invitation to astonishing increases in executive compensation, and the invitation was widely accepted.

A study by Carola Frydman and Raven Saks of Harvard University published in 2004 notes the remarkable stability of executive compensation from 1936 to 1969. During this 33-year period, the average 1.3 percent annual increases in executive pay were less than the wage gains made by the average American worker. The inflation-adjusted value of executive pay in 1969 had just barely returned to its pre-World War II level.

Frydman and Saks also noted that between 1969 and 1992, average total executive compensation increased by 75 percent, and that during the period 1993 to 2002 “executive pay rose at an astounding rate of more than 14 percent per year” so that at the end of the 20th century, “the real value of executive compensation was more than seven times its level prior to World War II.”

A 2005 study by Lucian Bebchuk of the Harvard Law School and Yaniv Grinstein of the Cornell University School of Management found that the aggregate compensation of the top five executives of all of the publicly owned companies in the United States from 2001 to 2003 was $92 billion, and that the ratio of the aggregate top-five compensation to the aggregate earnings of these companies increased from 5 percent of earnings in 1993 to 1995 to 10 percent in 2001 to 2003.

In short, the tremendous increase in executive compensation in recent years has diverted billions of dollars from shareholders’ equity and dividends to the compensation of executives employed to manage America’s publicly owned companies (and probably a lot of privately owned companies as well).

Past tax levels did not harm growth

I’m not an economist and I don’t know what the best top marginal rate is, or at what level of income it should take effect, but it is clear that our TMRs have been much higher for most of the 20th century, during which the United States made enormous economic progress, and that much higher top marginal rates did not harm our general growth and prosperity. It also is clear that higher top marginal rates had a significant moderating effect on compensation levels at the top end of the pay scale.

It’s hard to see why today’s top marginal rate is only 35 percent, and why the TMR is reached at $312,000 rather than at some higher level of taxable income. A good case can be made for having higher marginal rates and having them take effect at levels of taxable income much higher than the level at which the highest rate starts today.

For instance, a new marginal rate of 50 percent could be applied to ordinary taxable income in excess of $3,120,000 (10 times higher than the kick-in level for today’s top rate), with a higher marginal rate of 70 percent applying to taxable income in excess of $7 million, and perhaps an even higher rate of 90 percent applying to taxable income in excess of $14 million.

Such a tax schedule would restrain top-end executive compensation, would reduce the size of severance packages at the top end of the scale, and would eliminate most “gross-up” provisions at the top end as well. It would be high enough to adjust [former Home Depot CEO] Bob Nardelli’s recent, and Michael Vick’s current, take-home pay, without adversely affecting most lawyers, other professionals, mid-range executives, actors, athletes, rappers and rock stars.

I doubt that higher top marginal rates applied at higher levels of taxable income would substantially increase the revenues of the federal government, because the most likely response to higher TMRs, after a short period of adjustment, would be a reduction of today’s highest compensation levels.

So adopting a new tax schedule would be a much faster, easier and more effective way to discourage excessive compensation packages rather than trying to figure out how to change state corporation laws to give public company shareholders the power to approve (or disapprove) the compensation agreements with their executives.

In a future column, I hope to address the issue of the appropriateness and fairness of establishing higher marginal tax rates at higher levels of ordinary taxable income.