Why CEO Pay Will Keep Rising to Even More Insanely Unjustified Levels While Ordinary Workers Get Squeezed

Naked Capitalism
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October 14, 2013

Even casual scrutiny will tell you that the current ridiculous levels of CEO pay bear no relationship to anything other than their highly developed rent extraction skills.

Bloomberg reported earlier this year that the ratio of CEO pay to worker pay has increased 1000% since 1950. Fortune 500 companies pay their chieftans 204 times the level of average worker pay, versus a mere 20 times in 1950 and 42 times in 1980. Is it really five times harder to run a big company now than in 1980? It's one thing if CEOs were the ones that had built important businesses and taken entrepreneurial risk. But the Bill Gates and Sergey Brins of this world got really rich on their shareholdings. CEOs, by contrast, inherit businesses with established franchises. And the idea that paying more buys you more talent is spurious. If you were to say that paying more for a house makes it a better house, you'd see how this rationalization is a form of magical thinking. Studies have found no correlation between CEO pay and results. Quite a few studies have found the correlation to be negative (here, here and here, for instance). And forget about the myth of the superstar CEO. Lucian Bebchuk, Martijn Cremers, and Urs Peyer analyzed what they called the CEO pay slice, which is the proportion the CEO took of the total pay of the top five execs that went to the CEO. The more the CEO took relative to the rest of the top team, the worse the company did. But CEO pay is strongly correlated with one metric: how many people they fire.

Things have gotten so bad that even the lapdog SEC has tried to tamp things down a bit by launching a new rule requiring companies to disclose their ratio of top pay to average worker compensation. But as James Surowiecki describes in a new article in the New Yorker, this measure is not only likely to be ineffective, it may well be counterproductive. It does nothing to change the perverse norm for setting CEO pay, that of benchmarking. Benchmarking sounds perfectly sensible and objective until you understand how it really works in this arena. As we wrote in 2008:

> One practice that I have seen get perilous little mention is where the pay targets are set. Based on their belief of what constitutes good modern practice (influenced in no small degree by the pay consultants) most boards set general target ranges for how they would like the CEO to be paid relative to peers. The comp consultant then helps define and survey the peer group's pay ranges, setting a benchmark for how the CEO in question is to be paid.
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> That all sounds fine, right? Well, except just as all the children at Lake Woebegone are above average, no board likes setting a target below peer group norms. I have heard of numerous examples of targets being set somewhere in the top half (66th percentile, top quarter, top 20%), hardly any at the mean, and none I know of below average…. If readers know of any examples of companies (other than those with substantially owned by insiders) where the target for CEO pay is below the median of comparable companies, please let me know.

> So with this mechanism in place, any CEO who has fallen below median pay who is targeted to be in a higher group will have his pay ratcheted up, independent of performance, merely to keep up with his peers, This increase raises the average and creates new laggards. The comp consultants have institutionalized a leapfrogging process that keeps them busy surveying competitor reward levels and keeps top-level pay rising relentlessly.

Surowiecki cited a paper by Charles Elson and Craig Ferrere that not only confirms what we had inferred in 2008, that no board sets out to pay less than 50th percentile, and most set pay levels above that, assuring a constant ratcheting up of CEO pay levels. Even worse, a study by Ron Laschever found that some boards often used a peer group that was really a stretch in terms of size and complexity of the company, again serving to justify higher levels of compensation (note this was not just to help the CEO; it would also presumably justify higher directors' fees as well).

Now the SEC's assumption appears to have been that the disinfectant of sunlight, as in better disclosure, would curb these excesses. But shareholders are disenfranchised. Even large holders don't have a big enough stake to have any real clout. Passive investors like index funds and ETFs accounted for 22% of the market in 2010. All they care about is index replication and minimizing expense ratios; they could care less who is running a company. It makes much more sense for an unhappy shareholder to sell rather than put up a fight. But investor sell stock for lots of reasons: technical signals or their more modern cousin, algos, portfolio rebalancing, missing earnings targets, a change in industry fundamentals, that any sales out of unhappiness with CEO pay or performance are lost in the noise of other trades.

Surowiecki tells us why the SEC might have made matters worse. The visibility of pay makes the benchmarking easier (as in it helps the comp consultants goose pay higher) and likely has the effect of anchoring. A $10 million pay package is seen as justified because we read out them often. But Surowiecki reports that price transparency has had perverse effects elsewhere, often where the value of the service is hard to determine and price is thus seen as a proxy for quality. Surowiecki adds other possible causes:

> Some boards, in the face of much evidence to the contrary, remain convinced of what Elson calls "superstar theory": they think that C.E.O.s can work their magic anywhere, and must be overpaid to stay. In addition, Elson said, "if you pay below average, it makes it look as if you'd hired a below-average C.E.O., and what board wants that?"…
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> In a host of recent cases, public disclosure of the prices that hospitals charge for various procedures has ended up driving prices up rather than down. And the psychological causes in both situations seem similar. We tend to be uneasy about bargaining in situations where the stakes are very high: do you want the guy doing your neurosurgery, or running your company, to be offering discounts? Better, in the event that something goes wrong, to be able to tell yourself that you spent all you could. And overspending is always easier when you're spending someone else's money. Corporate board members are disbursing shareholder funds; most patients have insurance to foot the bill….
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> [T]here's something naïve about the new S.E.C. rule, which presumes that full disclosure will embarrass companies enough to restrain executive pay. As Elson told me, "People who can ask to be paid a hundred million dollars are beyond embarrassment."

And that leapfrogging effect? It's being used with great effectiveness against ordinary workers. Again as we wrote in 2008:

> One meme I have noticed surfacing in the debate over the automaker bailout is that UAW employees are paid more than average workers.
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> Now in and of itself, that statement is meaningless. You need to have an idea of worker productivity to see whether that it out of whack (and for some odd reason, the bloated and highly paid management cohort almost never gets mentioned in these discussions, nor do the massive state level subsidies to the foreign transplants). Perhaps I missed it, but I do not recall seeing any longitudinal work on labor costs (that sort of analysis would help bring some badly needed facts to the table).
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> But why is framing the discussion around averages alone dangerous? Let's say we collectively want to bring car worker pay down to some sort of average. ***That has the effect of lowering the average***. You will have groups that were formerly at the average that are now above it. And if you accept the implicit logic "above average pay is bad" (fill in the blank as to why), you have a race to the bottom due to pressure on the relatively better paid to take less which puts pressure on aggregate pay.

And look at how the anti-worker effort has targeted various well-paid cohorts. The first target was members of unions at major manufacturers. Those blue-collar wages helped provide a reference point for the wages of college-educated white collar workers (as in the presumption was they should get at least comparable compensation, if not better). And you can't attribute the wage squeezes to solely to cheap Chinese labor; for instance, middle level and senior corporate manager are often doing what would have been one and one half to two jobs fifteen years ago, and often at lower inflation-adjusted levels of pay. Similarly, retailers are squeezing down even more on workers by turning full-time jobs into part-time positions to stop providing benefits and to push pay even lower (workers who are desperate to get more hours will also accept reduced wages, working off the clock, and abusive work conditions). Remember, retailers are insulated from international wage competition. Yet this sort of wage-cutting is taking place even in high end stores that would presumably benefit from increasing income disparity.

So now you can see how the assault on public sector workers fits in. When I was young, teachers and government employees were modestly paid, but they did have job security and decent pensions. Now that the wages of well and even merely adequately paid private sector workers have been beaten down, suddenly these not all that terrific compensation levels arouse jealousy among the newly disenfranchised, who now demand that public sector workers join them in the race to the bottom. Once this sort of beggar thy neighbor attitude is institutionalized, and it has been in many circles, it's hard to reverse. But if we are going to restore the standing of the middle class, it's time to reject the notion of competitive pay levels which can be used to justify class warfare, and return to the older, successful model of sharing the benefits of productivity gains between workers and management, rather than having it all go to the rentiers.