Executive Excess 2008

How Average Taxpayers Subsidize Runaway Pay
15th Annual CEO Compensation Survey

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Key Findings

CEO-WORKER DIVIDE: CEOs in the United States, despite our current hard economic times, continue to pocket outlandishly large pay packages. S&P 500 CEOs last year averaged $10.5 million, 344 times the pay of typical American workers. Compensation levels for private investment fund managers soared even further out into the pay stratosphere. Last year, the top 50 hedge and private equity fund managers averaged $588 million each, more than 19,000 times as much as typical U.S. workers earned.

TAXPAYER SUBSIDIES FOR EXECUTIVE PAY: Average U.S. taxpayers subsidize excessive executive compensation — by more than $20 billion per year — via a variety of tax and accounting loopholes. That $20 billion for America's most powerful is more than double what the federal government spent last year on educating America's most vulnerable — children with disabilities.

INDIRECT TAXPAYER SUPPORT FOR RUNAWAY PAY: Many billions more taxpayer dollars indirectly encourage excessive executive pay, through everything from government contracts for goods and services to corporate bailouts. More than 85 percent of the public companies on the federal government's top 100 contractors list paid their CEOs over 100 times the pay of average U.S. workers.

REFORM ROADBLOCKS: Legislation that would plug executive-friendly tax loopholes is already pending in Congress. But this legislation has stalled — and will likely remain stalled unless the November 2008 elections change current Congressional voting dynamics.

WHERE THE CANDIDATES STAND: Senator John McCain and Senator Barack Obama differ significantly on the executive pay reforms now before Congress, but neither candidate has yet endorsed all the major reforms needed to start addressing — and ending — over-the-top executive compensation.

IF CURRENT TRENDS CONTINUE: The divide between CEO and worker pay appears likely to grow even wider, since industries projected to show the largest employment growth over the next decade sport pay gaps far wider than industries that are losing the most jobs.

EXECUTIVE PAY AND WORKER RIGHTS: Excessive executive pay and the tax code loopholes that enable this excess reflect the absence of checks and balances on America's economic landscape. Historically, trade unions have operated as the most important of these checks and balances. They could play that role again if lawmakers passed the pending Employee Free Choice Act, legislation that would help workers realize their right to organize into unions and bargain collectively with their employers.

Introduction

Every year, on Labor Day, American society stops to celebrate the dignity of working people and honor their struggle for a "fair day's pay for a fair day's work."

Every other day of the year, unfortunately, the realities of contemporary American economic life subvert this celebration. Average Americans today work longer, harder, and smarter than they labored a generation ago. Yet they take home, after adjusting for inflation, less in wages than they did in the early 1970s.

Some Americans, to be sure, are earning more these days than they did back then. Much more. In 2007, CEOs in the United States took home an average of $10.5 million, 344 times the take-home for typical American workers (see box for details). Thirty years ago, chief executives averaged only 30 to 40 times the average American worker paycheck.

This Executive Excess series has, over the years, documented the specific outrages behind these numbers. We have shown, for instance, how CEOs who downsize jobs, profiteer off government defense contracts, and squeeze consumers at the gas pump regularly collect significantly more in compensation than executives elsewhere in the world of big business and high finance.

But we have not — until this year's report — focused on what may be the biggest CEO pay outrage of them all: Average Americans are subsidizing executive pay excess. The federal government, through the tax code, is actually rewarding companies that overpay their top executives.

Indeed, the more that corporations shell out for executive pay, the more they pocket in profit at the expense of average taxpayers.

No one, of course, has ever asked average Americans if they want their government — and their tax dollars — helping the country's top business executives become phenomenally wealthy. No one has ever asked lawmakers either. Congress has never taken an explicit, up-or-down floor vote on any of the major tax code loopholes that enrich our current captains of industry and finance.

These loopholes, instead, owe their provenance to obscure bureaucratic rulings that lavishly paid corporate lawyers and lobbyists have stretched and distorted far beyond their original rationale.

How much do these loopholes cost taxpayers? We place the total at over $20 billion a year. But this figure, we believe, understates the true extent of the current taxpayer subsidy for executive excess. We have included in our executive pay subsidy calculations only those loopholes that speak directly to executive pay. We have not considered here the many more taxpayer supports — everything from economic development grants to accelerated depreciation allowances — that inflate corporate quarterly bottom lines and share prices and, in the process, generate windfall rewards for executives who have their pay pegged to the "performance" of their companies.

Worker Pay versus Executive Pay

Last year, average CEO pay rose 2.6 percent to $10,544,470, according to an Associated Press survey of S&P 500 firms.[1] That's 344 times the pay of an average American worker.[2] The gap between CEOs and minimum wage workers runs even wider. In 2007, CEOs averaged 866 times as much as minimum wage employees.

Private investment managers continue to push U.S. business leader paychecks off the charts. Last year, the top 50 hedge and private equity fund managers earned an average of $588 million, according to *Alpha* magazine.[3] That's more than 19,000 times as much as average worker pay.

2007 Compensation of the Top Five Highest-Paid Private Investment Fund Managers and CEOs

Private Investment Fund Managers		Public Company CEOs	
John Paulson, Paulson & Co.	$3.7 billion	John Thain, Merrill Lynch	$83 million
George Soros, Soros Fund Management	$2.9 billion	Leslie Moonves, CBS	$68 million
James Simons, Renaissance Technologies	$2.8 billion	Richard Adkerson, Freeport-McMoran	$65 million
Philip Falcone, Harbinger Partners	$1.7 billion	Bob Simpson, XTO Energy	$57 million
Kenneth Griffin, Citadel Investment Group	$1.5 billion	Lloyd Blankfein, Goldman Sachs	$54 million

Sources: Private investment funds: *Alpha* magazine. CEOs: Associated Press.

The tax loopholes we examine in this year's Executive Excess have, in some cases, sat lodged in our tax code for many years. But the exploiting of these loopholes — for executive personal aggrandizement — is a much more recent phenomenon, a development that has intensified only since the early 1980s.

What has changed on the American economic scene, over the last three decades, to make these loopholes so exploitable? Economic power, to put the matter most simply, has concentrated in America's executive suites. The mid 20th century checks and balances of our economic system — the building blocks of post-World War II American middle class prosperity — have been swept away.

The most important of these checks and balances: a vital trade union presence in the private sector. A half-century ago, over one-third of American private sector workers belonged to unions. Bargaining between these workers and their employers set wage patterns throughout the U.S. economy, in both organized and unorganized workplaces, and served to restrain executive rewards at the top of the corporate ladder.

Today, according to the latest Bureau of Labor Statistics survey data, only 7.4 percent of private-sector workers belong to unions. Top executives, at the vast majority of America's workplaces, face no institutional challenge from their workers. The absence of that challenge leaves executives free to pocket rewards at levels that would have seemed recklessly greedy only a generation ago.

Recent academic research has demonstrated the executive pay difference that a union presence can make. In one survey, released last year, researchers found that CEOs at nonunion companies take home nearly 20 percent more than their fellow executives in unionized firms.[4] Workers in union companies, meanwhile, make $200 more a week than their counterparts in nonunion firms, $863 a week for union employees, only $663 weekly for their nonunion counterparts.[5]

These figures, if current trends continue, point to a continuing — and even grander — income gap between top executives and average Americans.

What could reverse these current trends? We note in this year's Executive Excess, our 15th annual, a series of legislative actions that could begin to turn the tide. Most of these are already pending before Congress — and already familiar to reformers who do battle against top-heavy corporate pay systems. But we have added into the mix this year a pending legislative action that never mentions the phrase "executive compensation," the Employee Free Choice Act, a bill designed to help workers exercise their lawful right to organize and bargain collectively with their employers.

Corporate executives today regularly maneuver to prevent workers from exercising this right. They have a powerful incentive to do so: the awesome windfalls that Corporate America and Wall Street bestow upon America's most "successful" executives. The enormity of these windfalls encourages executives to take risks and run roughshod over any employees who might stand in their way.

Americans lose from this dynamic as workers. And we also lose, as this edition of Executive Excess explains, as taxpayers.

Tax Subsidies for Executive Excess

The U.S. tax code currently is riddled with loopholes that allow top corporate and financial leaders to avoid paying their fair share of taxes. Still other loopholes allow corporations to claim unwarranted deductions for exorbitant executive pay. Ordinary taxpayers wind up picking up the bill. That's why this report defines such loopholes as "subsidies for executive excess."

This section focuses on five such subsidies. For each one, analysts have been able to calculate an estimated annual cost to taxpayers. The first three of these subsidies put money directly into executive pockets. The final two give employers an incentive for doling out excessive executive rewards. All five have become targets for legislative reform action.

Estimated Annual Cost to Taxpayers of the Five Most Direct Tax Subsidies for Excessive Executive Pay	
1. Preferential capital gains treatment of carried interest	$2,661,000,000
2. Unlimited deferred compensation	$80,600,000
3. Offshore deferred compensation	$2,086,000,000
4. Unlimited tax deductibility of executive pay	$5,249,475,000
5. Stock option accounting double standard	$10,000,000,000
Total	**$20,077,075,000**

Subsidy #1

Preferential capital-gains treatment of carried interest
Annual cost: $2,661,000,000

The top 50 highest-paid private equity and hedge fund managers last year made $558 million on average, according to the business trade journal *Alpha*.[6] The top five each collected over $1 billion. These private investment fund magnates hardly seem to need taxpayer assistance. Yet they get it — in massive amounts. Our current tax code allows top private investment fund managers to pay taxes, as investor Warren Buffett has repeatedly noted, at lower rates than their office receptionists.[7]

This tax loophole plays off the peculiarities of pay practices in the investment fund industry. In a publicly-traded corporation, a CEO pay package typically includes salary, bonus, perks, and stock awards of various sorts. Private investment fund managers take their rewards through two distinctly different revenue streams. They first collect annual management fees, usually set at 2 percent of the capital they oversee. But these managers also collect a share of the profits realized when they sell fund assets. Within the financial industry, this share goes by the label of "carried interest." Private investment fund managers usually claim, for themselves, a 20 percent "carried interest" share.

Fund managers report this carried interest as a capital gain, not ordinary income. This categorization, critics note, distorts marketplace reality. Carried interest, they point out, clearly represents payment for the delivery of a professional service, the managing of other people's

KKR: Tax Break Bonanza

Corporate buyout king Henry Kravis (right) earned $450 million as the head of the KKR private equity fund in 2006, *Forbes* reports.[8] A labor group, using public documents, has estimated that Kravis saved somewhere between $58.6 million and $96 million in taxes on that income, thanks to the carried interest loophole.[9] *Forbes* currently ranks Kravis as the 178th wealthiest individual in the world, with a net worth of $5.5 billion.[10]

KKR has launched a vigorous lobbying campaign to "defend" the carried interest loophole — and preferential tax treatment for Henry Kravis. In 2007, the fund paid more than $2 million to advance its interests in Congress. Kravis himself went to Capitol Hill to lobby Senators in July 2007, a job he has traditionally left to those further down the totem pole.[11]

KKR is also a key player in an industry lobby group formed principally to protect tax preferences for investment fund managers. The Private Equity Council opened up shop in early 2007 and spent over $2 million on lobbying before the year ended. The Council's member firms, including the high-profile Blackstone and Carlyle investment funds, spent an additional $7.9 million.[12] In the year's first six months alone, Blackstone shelled out what *The Washington Post* subsequently called the "heftiest six-month payment to any lobbyist ever reported."[13]

money. Such professional fees, everywhere else in the economy, face the same tax rate as ordinary wage and salary income, up to 35 percent for income in the highest tax bracket.

The capital gains tax rate, by contrast, now sits at only 15 percent. On every $1 million pocketed in "carried interest," in other words, an investment fund manager saves about $200,000 in taxes.

Pending reform: Subject carried interest to the same tax rate as ordinary income.

Last November, the U.S. House of Representatives passed a tax reform bill that would have closed the carried interest loophole.[14] But an aggressive lobbying campaign by deep-pocketed investment fund industry movers and shakers — current and potential major campaign donors all — halted the initiative in the Senate.[15]

If the reform had been adopted, the Joint Committee on Taxation estimates, the federal government would have garnered an additional $2,661,000,000 in 2008.[16]

Subsidy #2

Unlimited deferred compensation

Annual cost: $80,600,000

The vast majority of CEOs at large companies now legally shield unlimited amounts of compensation from taxes through special deferred accounts set up by their employers.

According to researchers at Equilar, a compensation analytics firm, 83.4 percent of S&P 500 companies offered such accounts for their top brass in 2007.[17] Equilar found that deferred compensation plan balances increased by 54.3 percent last year, to a median value of $4,517,488.

By contrast, ordinary taxpayers face strict limits on how much income they can defer from taxes via 401(k) plans — $15,500 max per year for most workers.

What makes special deferred pay accounts such a desirable perk for top executives? These accounts offer, of course, the standard economic advantage of pre-tax compounding. Dollars stashed in deferred-pay pots grow and grow, untaxed, until executives start withdrawing from them. Down the road, at that withdrawal time, the executives might just face a lower tax rate than they do now. Today's top executives, after all, have watched top federal marginal tax rates fall sharply since their careers began. These rates, they have reason to hope, could sink even lower.

Executive deferred pay accounts boast another appealing feature. Many corporations guarantee executives an above-market rate of return on the dollars in their deferred pay accounts. American Express CEO Kenneth I. Chenault, the Associated Press notes, collected $1.55 million in above-market returns on his deferred compensation in 2007.[18] Average corporate employees, by contrast, enjoy no guarantees on the dollars in their deferred-pay 401(k)s. The funds in 401(k)s grow and compound tax-free. But if an employee's investment choices go sour, the funds may not grow at all.

Over recent decades, by forcing workers out of traditional "defined-benefit" pension plans into "defined-contribution" plans like 401(k)s, corporations in the United States have shifted the risk of retirement funding onto workers. Increasingly, in our new American economy, only executives rate retirement security.

Tax Benefits of Deferring Compensation

A hypothetical based on two taxpayers in the top income tax bracket:

Taxpayer who *can* defer compensation	Taxpayer who *cannot* defer compensation
1. Receives compensation in the amount of $100	1. Receives compensation in the amount of $100
2. Defers compensation for 5 years, earning 10% return on investment each year, for a total of $161.05	2. Pays a tax of $35, leaving only $65 to invest
3. Amount the taxpayer can pocket after paying a one-time tax of 35%: **$104.68**	3. Amount available to the taxpayer after earning an after-tax return of 6.5% per year (10% return – 35% tax on earnings per year) for five years: **$89.06**

Source: Based on analysis by the Joint Committee on Taxation.[19]

Target's Treasure Chest

Before retiring in January 2008, Target CEO Robert Ulrich (right) amassed a treasure chest of $140,791,549 in deferred compensation — all of this over and beyond the dollars in his regular pension and 401(k). Last year alone Ulrich contributed $9,511,070 to his pay-deferral pot.

Ulrich can clearly afford to set aside millions in his deferred-pay stash and still easily maintain the style of life to which he has become accustomed. Last year he cashed in $93,497,000 in stock options.[20]

Pending reform: Cap the amount of pay executives can have deferred.

In 2007, Senate Finance Committee chairman Max Baucus (D-Montana) and the panel's ranking minority member, Senator Charles Grassley (R-Iowa), pushed all the way to a House-Senate conference committee legislation that would have limited annual executive pay deferrals to $1 million.[21] This extremely modest cap, if enacted, would have generated an estimated $806 million over 10 years.[22] Attacked fiercely by corporate interests, this proposal did not survive the conference committee deliberations, but Senator Baucus has pledged to revisit it.

Subsidy #3

Offshore deferred compensation
Annual cost: $2,086,000,000

U.S.-based corporations do incur a tax cost when they allow their executives to stash massive sums in deferred accounts. Until executives begin to withdraw from the accounts, the company cannot claim a tax deduction for the executive compensation deferred.

Businesses registered in offshore tax havens, on the other hand, have little or nothing to lose by allowing their employees to accumulate boatloads of compensation in deferred accounts, since registering in such havens allows them to sidestep the U.S. tax liabilities they would otherwise face.

Offshore maneuvering creates particularly lucrative tax-avoidance opportunities for hedge funds, since most of them have already created offshore subsidiaries. Hedge Fund Research, a Chicago-based analyst firm, estimates that of the total $1.86 trillion invested in hedge funds, $1.25 trillion is kept in funds registered offshore.[23] According to the Joint Committee on Taxation on Capitol Hill, 92 percent of offshore hedge funds have situated themselves in the notorious tax havens of the Cayman Islands, the British Virgin Islands, Bermuda, and the Bahamas.[24]

Deferring pay in offshore accounts represents only one way that the wealthy use tax havens to avoid paying their fair share of taxes. The practice of stashing funds in offshore banks, one Senate investigation has found, costs U.S. taxpayers an estimated $100 billion dollars each year.[25] The data so far available do not reveal how many of these billions benefit business executives, the focus of this report, as opposed to other rich tax-dodgers.

Citadel: Protecting Pay from Taxes

Kenneth Griffin (right), the head of Citadel Investment Group, made $1.5 billion in 2007, up from $1.2 billion in 2006.[26] Citadel's largest fund, the Bermuda-registered Citadel Kensington Ltd.,[27] manages about $10 billion in assets and has reported over 20 percent annual gains for the past nine years.[28] Information on Griffin's tax-deferred offshore accounts is not publicly available, and the investment kingpin lustily defends the tax breaks he enjoys.

"I am proud to be an American," he told the *New York Times* last year. "But if the tax became too high, as a matter of principle, I would not be working this hard."[29]

To help maintain Griffin's work ethic, Citadel has spent more than $1.1 million since the beginning of 2007 lobbying to preserve tax loopholes for private investment managers. Griffin is also hedging his political bets. He has hosted fund-raisers for both Senators Obama and McCain and acted as a "bundler" to collect more than $50,000 for each candidate.[30]

Pending reform: Prevent executives from using offshore tax-deferred compensation accounts.

The Joint Committee on Taxation estimates that American hedge fund managers have amassed so much wealth in offshore deferred accounts that if this tax-dodging scheme had been eliminated this year, the federal government would have received an additional $2,086,000,000 in revenue.[31] A bill that would have closed this loophole passed this year in the House, but stalled in the Senate.[32]

Subsidy #4

Unlimited tax deductibility of executive pay
Annual cost: $5,249,475,000

Tax law allows corporations to deduct the cost of executive compensation from their income taxes, as a business expense, so long as this compensation remains "reasonable." But what's reasonable? The IRS has no clear definition.

In 1993, the Clinton Administration sought to provide some guidance here by promoting legislation designed to cap executive pay deductions at $1 million. But this attempt to define executive pay reasonableness has proved wholly ineffective because the legislation, as enacted, allows an exception for "performance-based" pay. Most companies simply limit top executive salaries to $1 million or so and then add on to that total various assortments of "perform-

Wal-Mart: "We Deduct for More"

In 2007, Wal-Mart CEO H. Lee Scott, Jr. (right) made $29,682,000 — 1,314 times as much as the company's average full-time workers. The discount giant refuses to disclose pay levels for its thousands of part-time workers, but reports that full-time workers make an average of $10.86 per hour.

If Wal-Mart had been required to pay corporate income taxes on the portion of Scott's compensation that exceeded 25 times the value of the firm's average full-time compensation, the company's tax bill would have increased by $10,191,069 in 2007.[33]

This seems a small price to pay, given that taxpayers have provided billions of dollars in subsidies to Wal-Mart over the years in the form of public assistance for the retailer's poorly compensated employees.[34]

ance-based" bonuses, stock awards, and other long-term compensation that increases overall executive pay about an average ten times over.

This tax loophole operates as a powerful subsidy for excessive compensation. The more corporations pay out in executive compensation, the less they owe in taxes. And average taxpayers wind up paying the bill.

Pending reform: Deny corporations deductions on any executive pay that runs over 25 times the pay of a company's lowest-paid worker.

This legislation, the Income Equity Act, has been pending before Congress since the early 1990s, introduced first by the now retired Martin Sabo (D-Minn.) and currently by Barbara Lee (D-Calif.).[35]

The Income Equity Act would not set a ceiling on, or dictate in any way, how much corporations can pay their executives. The legislation would instead place a cap on the amount of pay that corporations can deduct off their taxes. Corporations could still freely pay their executives outlandishly large sums. But the federal government – and America's average taxpayers – would no longer reward them for their excessive generosity.

The bill could have an important impact on lower-level workers as well. By tying pay at the top of the corporate ladder to pay at the bottom, the Income Equity Act would encourage corporations to raise pay at the bottom, since the greater the pay for a company's lowest-paid worker, the higher the tax-deductible pay for the company's highest-paid executives.

The Income Equity Act would, if enacted, also require corporations to annually reveal the pay gap between their highest- and lowest-paid workers. American taxpayers and consumers currently have no way of knowing exactly how much companies squeeze their least powerful workers to create windfalls for executives at the top.

Government estimates of the tax revenue implications of this bill are not available. The Institute for Policy Studies has calculated a conservative estimate, based on a limited sample of the top five executives at 1,500 U.S. firms. The current subsidy, by these calculations: $5,249,475,000.[36]

Subsidy #5

Stock option accounting double standard
Annual cost: $10,000,000,000

Stock options – the most lucrative of all executive pay categories – come with a magical accounting and tax double standard that makes them nearly irresistible to both executives and the corporations that employ them.

Current *accounting* rules value stock options on their grant date. The current *tax code* values stock options on the day that executives decide to cash them in. The two numbers rarely match, and in recent years, the actual "in-the-pocket" value has been significantly higher than the grant date estimate. As a result, companies can lower their tax bill by claiming deductions for options-related costs that are much higher than what they report in their financial statements.

At the same time, by reporting a low expense for stock options on financial statements, corporations can show higher quarterly net earnings. That keeps Wall Street investors happy, share prices high, and executive rewards flowing at ever more ample levels.

Internal Revenue Service research shows that corporations claimed 2005 stock option tax deductions that were collectively $61 billion larger than the expenses shown on company books.[37]

"By eliminating this outdated and overly generous corporate tax deduction," notes Sen. Carl Levin (D-Michigan), "we would eliminate a tax incentive that encourages corporate boards to hand out huge executive stock option pay which, in turn, fuels the growing chasm between executive pay and the earnings of rank and file workers."[38]

UnitedHealth's Stock-Option Sleight of Hand

Between 2002 and 2006, a Congressional inquiry has found, UnitedHealth Group, one of the nation's largest health insurance companies, claimed a tax deduction of $317.7 million on 9 million stock options exercised by CEO William McGuire (right).

In its financial statement, UnitedHealth recorded zero expenses related to those options.[39]

The stock option accounting double standard offers all corporations, not just UnitedHealth, an incentive to dole out generous helpings of executive stock options. At UnitedHealth, corporate board members took this doling out to the extreme.

In 2006, the company became one of the top culprits in a rash of stock option backdating scandals after news reports revealed that McGuire and other high-level executives had been allowed to pick the grant dates for their options to maximize payouts.

"Backdating" itself does not break the law, but improper reporting does. Government investigators nailed UnitedHealth for improperly reporting the real cost of its executive options. As a result, McGuire had to forfeit about $618 million worth of options to help settle shareholder and federal government claims and paid a record $7 million fine to the SEC.[40]

In July 2008, the company announced it was settling one shareholder suit for $895 million and cutting costs by laying off 4,000 employees.[41] McGuire technically "lost" his job, too, but he still retired into the sunset with hundreds of millions in dubiously-acquired compensation.

Pending reform: Mandate a single standard for reporting stock options.[42]

Neither the Joint Committee on Taxation nor the Congressional Budget Office has analyzed the revenue implications of this reform. In 2007, Senator Levin cited an estimate of $5 billion to $10 billion in additional revenues that could be generated by eliminating what he calls "unwarranted and excess stock option deductions."

Levin chairs the Senate's Permanent Subcommittee on Investigations, the panel that has led the examination of the stock option accounting double standard. Levin based his estimate on partial-year numbers for 2004 that were considerably lower than the IRS findings for 2005. This report uses the high-end estimate.[43]

Additional Subsidies for Executive Excess

The tax and accounting loopholes noted above actually deliver a relatively small piece of the taxpayer largesse that every year plops into corporate coffers. The federal government also encourages and supports excessive executive pay indirectly, through a variety of supports that range from procurement contracts to handouts that go by the label of "corporate welfare." A recent report revealed that two-thirds of U.S. companies paid no federal income taxes between 1998 and 2005, in part because of tax credits.[44] How much of this taxpayer money winds up in the pockets of top executives? No researchers have yet calculated a specific figure. But the sum likely dwarfs the executive pay subsidies that flow through tax loopholes.

Nearly every major corporation in the United States owes a significant chunk of its profitability to interactions with federal, state, and local governing bodies. Executives regularly claim credit — and huge rewards — for their corporate "performance." Without taxpayer dollars, executives would "perform" nowhere near as well.

That reality creates an opportunity that executive pay reformers have seldom appreciated. Government policies today encourage executive excess. But governments at all levels, if they so chose, could leverage the power of the public purse to discourage such excess and encourage instead the more equitable pay differentials that nurture effective and efficient enterprises and healthy economies.

We describe here a small sampling of today's indirect subsidies for executive excess and the opportunities that ending these subsidies would create for real executive pay reform.

1. Government Procurement and Executive Excess

By law, the U.S. government denies contracts to companies that discriminate, in their employment practices, by race or gender. Our tax dollars, Americans agree, should not subsidize racial or gender inequality. But billions of taxpayer dollars flow annually to companies that increase *economic* inequality — by paying CEOs hundreds of times more than their workers.

In theory, existing law prevents government contractors from pouring tax dollars, at excessive levels, into executive pockets. Every year, the Office of Management and Budget establishes a maximum benchmark for contractor compensation, $612,196 in FY 2008. But this benchmark only limits the executive pay a company can directly bill the government for reimbursement. The benchmark in no way curbs windfalls that contracts generate for companies and their top executives.

One bill before Congress, the Patriot Corporations Act, would discourage these windfalls.[45] This legislation offers a preference in the evaluation of bids or proposals for federal contracts to companies that meet a series of benchmarks for good corporate citizenship. Among the benchmarks: paying executives no more than 100 times the pay of their lowest-paid employee.

Most top contractors do not currently meet this standard.

Lockheed Martin CEO: Getting Rich on the Dole

Perennial top-ranking defense contractor Lockheed Martin took in $32.1 billion from the federal government in 2006, most of it from the Pentagon. These taxpayer dollars made up more than 80 percent of the aerospace giant's total revenues.

In 2007, Lockheed Martin CEO Robert Stevens (right) took home more than $24 million — 787 times the annual pay of a typical U.S. worker ($30,617). That placed the company far over the 100-to-1 standard for good corporate citizenship the pending Patriot Corporations Act proposes.

To make matters worse, at the same time CEO Stevens and his fellow executives were lining his pockets with taxpayer dollars, government auditors were accusing the aerospace firm of more than $8 billion in cost overruns on weapons development projects.[46]

The Institute for Policy Studies has analyzed the data available for the top 100 U.S. federal government contractors in 2006. Together, these contractors received over $226 billion in taxpayer-funded contracts.[47] Of these 100 contractors, 47 operate as publicly traded U.S. corporations, a distinction that requires these companies to report the annual earnings of their top five executives. In 2006, 40 of the 47 (85 percent) paid their CEOs more than 100 times the pay of a typical U.S. worker.[48]

The privately held U.S. companies on this list have not been required to report their executive pay to the SEC. At an October 2007 hearing, members of Congress pushed the CEO of one of these private contactors, Blackwater's Erik Prince, to disclose his personal compensation. Blackwater has received over $1 billion to provide security services in Iraq and Afghanistan, but Prince refused to give a specific figure for his own compensation, defiantly noting that he collected "more than $1 million."[49]

Congress recently passed legislation, the Government Contractor Accountability Act, which will now require executive pay disclosure of all major contractors that receive more than 80 percent of their revenues from federal contracts.[50]

2. Bailouts and Executive Excess

Shortly after the 9/11 attacks, lawmakers in Congress established an important precedent to limit windfall profit-taking in industries that receive substantial government assistance. The $15 billion airline industry bailout Congress okayed in 2001 required that airline companies accepting bailout dollars ban raises and limit severance for all executives who had taken home over $300,000 the previous year.

Unfortunately, lawmakers have not applied strict limits on executive pay in other bailout situations.

This year, the Federal Reserve Board has taken aggressive action to prop up the troubled U.S. financial sector, injecting hundreds of billions of dollars of liquidity into the system — with no restrictions whatsoever on pay for the executives who had reaped massive personal gains while engaging in behaviors that created the credit crisis. The Federal Reserve also agreed to buy up to $29 billion in shaky mortgage bonds to facilitate JPMorgan Chase's purchase of

Fannie and Freddie: Risky for Taxpayers, Not CEOs

In 2007, the heads of Freddie Mac and Fannie Mae both earned far more than the average for large company CEOs – despite their utter failure to recognize the housing bubble or avert the mortgage crisis.[51] At Freddie Mac, chief Richard Syron (far right) took in nearly $19.8 million, while presiding over a 50 percent drop in the company's stock.[52] Fannie Mae head Daniel Mudd (near right) made $13.4 million, 27 percent more than the average for S&P 500 CEOs, according to the Associated Press.[53]

During the debate over a taxpayer bailout for the firms, Senator Bob Casey (D-Pennsylvania) urged the mortgage firms' boards to sue to recover the bonuses that Syron and Mudd pocketed while failing to do their jobs.

beleaguered Bear Stearns, a move that put taxpayers at risk while placing no restrictions on the benefits that executives might reap from the subsidy.[54]

In late July, Congress followed up this Federal Reserve action by passing a rescue package for Fannie Mae and Freddie Mac that contained only loose controls over the executive pay practices of these private sector "government-sponsored enterprises." The bill created a new regulator for the two mortgage firms and gives this regulator the authority to limit or withhold "golden parachutes" and to ensure that executive pay levels are "reasonable." But the legislation does not define "reasonable," a decision that allows regulators considerable latitude.[55]

Executive Pay Subsidies: What's At Stake?

Fiscal Trade-offs

Our ongoing — and deepening — U.S. economic downturn is forcing governments at every level to make painful choices on which problems to address and which to ignore. In this political climate, taxpayer subsidies for executive excess take on an even greater significance.

All subsidies involve trade-offs. Each time we allow executives and their employers to avoid paying taxes they would otherwise owe, we reduce government's capacity to deliver needed services that taxpayers and their families would otherwise receive.

Tax subsidies for excessive executive pay represent a particularly indefensible waste of government resources. At the moment, no serious observer of the American scene is arguing that top business executives, as a group, earn too little in compensation. So why then should government, in any manner, be encouraging corporations and investment firms to pay their executives even more?

Those tax dollars that currently go to encouraging and rewarding corporate America's most advantaged could, if redirected, go a long way toward addressing *real* problems.

Consider, for instance, one of America's weakest and most vulnerable populations: children with disabilities and other special needs. In the 2007 fiscal year, the federal government distributed not quite $10.8 billion in state aid for special education.[56] Top business executives this year will enjoy nearly twice that amount in federal subsidies for excessive executive compensation.

Or consider federal support for risk taking. Ample rewards for business executives, defenders of contemporary American executive pay often argue, serve as an important incentive for the risk taking necessary to keep an economy innovative and growing.

But executives hardly make up the only risk-takers on our economic scene today. Many Americans, every day they walk into work, risk their lives. In 2006, 5,320 private-sector workers died on the job. Nearly half a million more lost workdays to on-the-job falls and back injuries.[57]

What's government doing about this real problem? In 2006, the federal government spent $264 million enforcing workplace safety standards. The government is devoting 75 times more than that $264 million, every year, encouraging higher paychecks for top executives, precious few of whom will ever face real "risk" in the workplace.[58]

Additional Economic Costs of a Pay System out of Control

Subsidies for excessive executive pay don't just involve fiscal trade-offs. These subsidies have deep consequences for the economy as a whole — and the economic well-being of America's families.

The subprime mortgage meltdown over the last year has brought these consequences into unusually sharp relief. Financial industry executives did not rush wildly into risky mortgage lending ventures because sober business analysis showed these ventures to be prudent investments. They rushed into subprimes because doing business with these loans was generating fantastically high rewards.

These rewards blinded top executives to the financial risks involved — and to the fraud committed up and down the subprime lending chain as various lending industry players sought to cash in by any means necessary.

Now these same executives are writing off billions of dollars in bad loans and axing the jobs of tens of thousands of employees who had no part in the decisions that inflated the subprime financial fiasco.

This has all happened before and will all happen again unless lawmakers begin to remove the subsidies that help keep executive rewards so dangerously immense. Bills to make a good start in this direction are already pending in Congress. But these bills are languishing, perhaps in part because they face, should they pass, an almost certain veto from the White House. In 2009, with a new face in the White House, prospects for this legislation could change.

Presidential Candidate Positions

Both Senator Barack Obama and Senator John McCain have attacked excessive executive compensation on the campaign trail. At an event organized by a religious organization, for example, Obama stated that he "would like to see executives recognize that when they're getting as much in one day as their average worker is getting in an entire year, that there is a moral element to that. That that's problematic."[59]

Referring to the mortgage crisis, McCain has noted that "Americans are right to be offended when the extravagant salaries and severance deals of CEOs — in some cases, the very same CEOs who helped to bring on these market troubles — bear no relation to the success of the company or the wishes of shareholders."[60]

On remedies, both candidates have endorsed the notion that shareholders deserve the right to make their feelings known on executive pay packages, the reform thrust widely known as "say on pay." Obama is sponsoring legislation that would mandate a shareholder right to an advisory vote. McCain has suggested he would go even further by giving shareholders veto power over executive pay.[61] But he has declined to clarify whether he would support Obama's or any legislation on this issue.[62]

We certainly do need, as a nation, a more democratic shake for shareholders. But shareholder "say on pay," even if enacted into law, will leave in place all the direct and indirect taxpayer subsidies for executive pay and, as a result, have little impact on executive pay rates overall, as experience with "say on pay" has shown in other nations.

Real executive pay reform demands legislative action that will take the federal government out of the encouraging-excessive-CEO-pay business.

We have noted, in this *Executive Excess* edition, a legislative starter list for these reforms. Of these five pending bills, Senator Obama has so far publicly endorsed one. Obama supports eliminating the preferential capital gains treatment of the "carried interest" that has made private investment fund managers the business world's most lucratively compensated executives. He has not yet indicated a position on the other four.

Candidates' Positions on Pending Reforms Related to the Five Most Direct Tax Subsidies for Excessive Executive Pay

	Obama	McCain
1. Ending preferential capital gains treatment of carried interest	Supports	Opposes
2. Cap on unlimited deferred compensation	No position	No position
3. Ending offshore deferred compensation	No position	No position
4. Cap on tax deductibility of executive pay	No position	No position
5. Ending stock option accounting double standard	No position	No position on current proposal (supported similar bill in 2002)

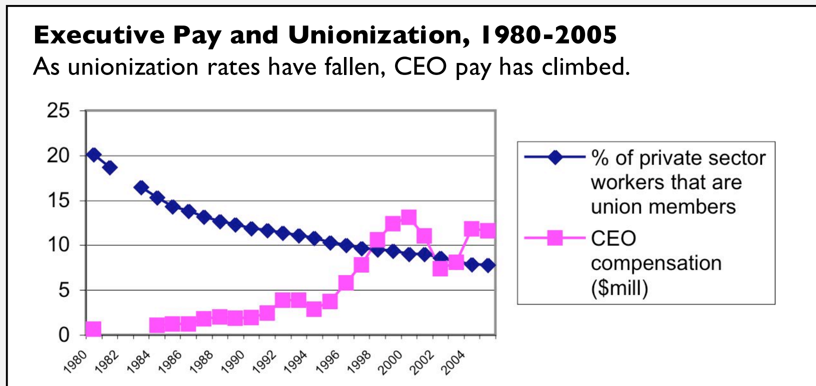
Senator McCain has not yet endorsed any of the five. In 2002, he co-sponsored a bill similar to the pending proposed fix for the stock option accounting double standard. But McCain has declined, according to Senator Levin's office, to take a position on the current bill.[63]

In 2007, both candidates voted in favor of a minimum wage bill that included an amendment to cap executive deferred compensation. But neither has spoken out about this measure specifically, and the proposal is still pending, since a House-Senate Conference Committee stripped the deferred-pay limit from the minimum wage bill.[64]

None of these five reforms will, either individually or as a group, fully correct the power imbalances in the American economy that have tilted rewards so far up the corporate ladder. The first step needed to restore some modicum of balance? That would be passage of the **Employee Free Choice Act,** the legislation now pending in Congress that would expand collective bargaining throughout the American economy. Senator McCain opposes this legislation, Senator Obama supports it.

CEO Pay and Worker Rights: Without Labor Law Reform, CEO-Worker Pay Gap Likely to Grow

The divide between CEO and worker pay is on course to grow even wider, since industries projected to have the largest employment growth in the next decade show pay gaps that are far wider than industries that are losing the most jobs. One reason for the difference: union representation. In the expanding service sectors, only a tiny percentage of workers have the power to bargain collectively for fair compensation.



According to the Labor Department, the top job growth industry, food services, will add over 1 million jobs by 2016. The 9.3 million non-management workers in this sector — only 1.2 percent of whom are union members — earn an average of $18,877 per year.[65] The CEOs of the top 10 firms in this industry — McDonald's, YUM Brands (owner of KFC, Taco Bell, Pizza Hut) and other major employers that set industry-wide pay standards — averaged 354 times that amount in 2007.

In retail, another fast-growing industry with low unionization, the CEO-worker pay gap runs even wider, 453-to-1.

By contrast, in industries like auto parts and pulp and paper, where unionization rates are above 20 percent, CEO-worker pay gaps stand at 173-to-1 and 219-to-1 respectively. These manufacturing workers have used union leverage over the years to bargain for decent compensation. Today, however, "free trade" agreements and other factors are slashing employment in these traditional union strongholds.

Without legislative action to allow more workers the right to organize, the divide between compensation for top executives and the rest of us will only continue to grow.

Chart sources: Unionization: Bureau of National Affairs, Union Membership And Earnings Data Book. CEO pay: Business Week and Wall Street Journal surveys.[66]

Conclusion

Journalists have been writing about rising executive pay since the early 1980s. Over the past quarter-century, poll after poll has shown widespread public opposition to our contemporary CEO pay levels. Almost every high-ranking political leader in the United States has, at one time or another, expressed dismay over pay at America's corporate summit. Surveys have found that even those individuals directly responsible for setting executive pay levels — the members of corporate boards of directors — feel we have a serious executive pay problem.

Yet, year after year, nothing changes. Executive pay continues to rise much faster than compensation elsewhere in the U.S. economy. Does all this mean that rising executive pay reflects some inexorable natural economic phenomenon? Not at all. Public policies, we have detailed in this edition of *Executive Excess*, have fueled the executive pay explosion. We can change public policies.

Historically, troubled economic times in the United States have helped generate long-overdue public policy reforms. We have now entered troubled economic times, likely our worst since executive pay started ballooning in the 1980s. Ballooning executive pay has helped create our current economic woes. Deflating that excess can help end them.

Endnotes

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Past reports on CEO pay from the Institute for Policy Studies and United for a Fair Economy

Available online at **ips-dc.org** or **faireconomy.org**.

Executive Excess 2007: The Staggering Social Cost of U.S. Business Leadership. Compares executive pay to pay for leaders in other sectors of the economy.

Selfish Interest: How Much Business Roundtable CEOs Stand to Lose from Real Reform of Runaway Executive Pay. (April 10, 2007)

Executive Excess 2006: Defense and Oil Executives Cash in on Conflict. Examines CEO compensation at top oil companies and defense contractors.

Executive Excess 2005: Defense Contractors Get More Bucks for the Bang. Examines CEO compensation at top defense contractors and reviews and updates some of the most harmful pay trends of the past decade and a half.

Executive Excess 2004: Campaign Contributions, Outsourcing, Unexpensed Stock Options and Rising CEO Pay. CEOs at the companies outsourcing the most workers were paid more than typical CEOs. The report also looks at the link between high CEO pay and campaign contributions.

Executive Excess 2003: CEOs Win, Workers and Taxpayers Lose. CEOs at companies with the largest layoffs, most underfunded pensions and biggest tax breaks were rewarded with bigger paychecks.

More Bucks for the Bang: CEO Pay at Top Defense Contractors. (April, 2003) CEOs at the nation's largest military contractors rose 79 percent in 2002, compared to a six percent increase for typical CEOs.

Executive Excess 2002: CEOs Cook the Books, Skewer the Rest of Us. CEOs of companies under investigation for accounting irregularities earned 70 percent more from 1999 to 2001 than the average CEO at large companies.

The Working Group on Extreme Inequality (extremeinequality.org) was founded by several dozen organizations concerned about poverty and economic insecurity. We believe that to make significant headway we must both "raise the floor" *and* challenge the concentrated wealth and power at the top of our economic ladder. Based at the Institute for Policy Studies, our work revolves around…

- **Mobilization.** We're engaging labor, religious, civic, and business groups concerned about poverty and unequal opportunity in dialogue about the importance of confronting the dangers that concentrated wealth and power increasingly engender.
- **Education.** We're talking with the wider public about these dangers — and the need for public policies that encourage the dispersal of wealth. Through research, reports, publications, media work, public forums, and popular education workshops, we're reaching broad and diverse audiences.
- **Advocacy.** We're building support for public policies that can address the concentration of wealth and, at the same time, raise badly needed revenue for social investments that foster real economic opportunity. We host legislative forums, provide support for Congressional hearings, and publish fact sheets and other informational materials.