

Is Public Concern Over Growing Executive Compensation Justified? A Study of Income And Wealth Inequality

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Abstract: This paper will scrutinize income inequality trends over the past quarter century, focusing on the relatively disparate growth of corporate executive compensation relative to income and wealth of subordinate wage-earners. In this area of comparative incomes, special attention will be given to stock options—a new hybrid that is often taxed as *income*, yet at other times as *capital gains*—which are a *major builder of wealth* and the ensuing backdating scandals. Possible improvements in corporate governance as well as other remedies are explored.

Introduction

Economic inequality has always been a core concern in England. Underlying the Magna Carta of 1215 and the Bill of Rights in 1689, it was again inequality between high food prices set by wealthy landlords and low-income working classes that led Parliament in 1846 to repeal the Corn Law tariffs and open the country to cheaper food imports from abroad. The issue appeared once again in Britain’s historic General Strike of 1926.

America’s distaste for economic inequality is a clear reflection of its English heritage. Although the 1776 Declaration of Independence announced that “*all men are created equal*,” this ideal proved to be even more elusive and evanescent than it was in the United Kingdom. Abraham Lincoln made this “equality” phrase the keynote of his famous debates over slavery. Yet it was only after civil war and loss of more than a half-million lives that slaves were able to gain the same freedom as other Americans.

Alarmed by the rise of wealthy industrial “robber barons” in oil, steel, automobile, and other major industries, Americans voted in 1910 to amend the Constitution to permit income taxes. Nine years later, after decades of bitter struggle, America’s Constitution was again amended to guarantee women *equal* voting rights with men. Another landmark in the struggle against income inequality came in the midst of a crippling depression that left a fourth of America’s workforce unemployed. In 1935, The National Labor Relations Act¹ was passed to establish *equality of bargaining power*.² The Act guaranteed workers the right to form unions, mandating that employers recognize and *bargain* with them over wages and working conditions. A further giant leap toward *equality in employment* was ushered in with the Civil Rights Act of

1. 29 U.S. Code 151.

2. D. Reitzel, G. Severance, et al, *Contemporary Business Law*, N.Y., McGraw-Hill, 1994, 1075.

1964.³ It prohibited an employer from discriminating (with respect to wages and working conditions) against any employee on account of his or her race, color, religion, sex, or national origin.

Despite the steady gains toward the equality ideal, it has continued to be elusive.

Income inequality has increased significantly in the past 25 years. However, the *extent* of that increase and its *secondary effects* in areas such as education⁴ and upward mobility of workers has been the subject of ongoing economic and political debate. Daily news headlines continued their sensational stories of disparate income and wealth: “Top 10 % hold 85 % of world’s wealth!”⁵ “Goldman-Sachs Group to distribute \$16.5 *billion* in year-end bonus money, an *average* of \$623,000 for each of the bank’s employees.”⁶ The Internet likewise has been flooded with comments on income-wealth inequality.⁷ “Occidental Petroleum Corp. boss took home \$400 million in 2006, netting one of the biggest paychecks in corporate history—mostly from stock options.”⁸ Such anecdotal data not only swept Democrats into majority control of Congress in America’s 2006 election,⁹ but it also fueled a plethora of professional studies of income and wealth disparities. A study by Harvard professor Lucian Bebchuk showed that the top five officers of all of America’s public corporations between 1993 and 2002 received compensation of about \$250 billion—nearly 10 % of aggregate profits during the period.¹⁰ Federal Reserve Chairman Ben Bernanke stated early in 2007 “the degree of inequality has increased for at least three decades.”¹¹

3. Title VII of the Act prohibits discrimination in employment: 42 USC 2000(e).

4. For a well-documented study of the difficulty low income-earners have in sending their children to college to improve skills and upward mobility, see: Tamara Draut, “The Growing College Gap,” *Inequality Matters* (James Lardner & David Smith, eds.) N. Y., New Press, 2005, (89-101).

5. *Houston Chronicle*, 17 December 2006, E-1, quoting from *New York Times*.

6. At Goldman’s, current market capitalization of \$85.3 billion, each of the company’s 26,467 employees “is worth, on average, about \$3.2 million. Google Inc.’s 5,600 employees are each worth on average \$25.8 million in market value.” *Wall Street Journal*, 12/16/06, p. B-3. The Bear Sterns and Merrill Lynch CEOs were expected to “approach or exceed” \$50 million. *Ibid.*, 15 December 2006, C-1.

7. On-line search (accessed 18 Dec. 2006) found 10 income/wealth inequality blogs, some by experts.

8. Occidental’s CEO Ray Irani in 2006 received \$270.2 million from exercised options, \$93.3 million from a deferred stock program that the company abandoned for all employees, a salary of \$1.3 million, cash bonus of \$1.4 million plus other benefits which raised annual compensation to \$55.6 million for 2006; a total of \$419.1 million. Accessed at: <http://money.cnn.com/2007/04/09/newsmakers/occidental.reut/index.htm?cnn=yes>.

9. Nancy Pelosi, the new Democratic Speaker of the House of Representatives, before the election (Nov.’06), promised that if Democrats came to power, their first action would increase the minimum wage (it became law 5/25/2007) and income taxes in the higher brackets.

10. ON TWO, *Houston Chronicle* 10 February 2007, D2.

11. Politics and Economics, *Wall Street Journal*, 7 February 2007, A6.

Income Inequality Trends

The long-term trend since 1970 has been toward growing income inequality. According to the U.S. Census Bureau, between 1970 and 1997, the share of aggregate household income controlled by the *lowest* income quintile *decreased* from 4.1% in 1970 to 3.6% in 1997, while the share of household income received by the *highest* quintile *increased* from 43% to 49.4%. Even more remarkably, the share of national income controlled by the *top 5% of households* rose from 16.6% in 1970 to 21.7% in 1997.¹²

Over the same period, the Census Bureau also calculated the Gini index, another measure often used to reflect dispersion of income shares across an *entire income distribution*. The Gini index ranges from zero indicating perfect equality (where everyone receives an *equal share*) to one (1), which also represents perfect inequality (where *all of the income* is received by only *one recipient*). In the same period (1970-1997), the Gini index zoomed from 0.374 in 1970 to its 1997 level of 0.459. Commenting on the trend toward disparate income over this recent 18-year period, the U.S. Census Bureau stated, “The wage distribution has become considerably more unequal with workers at the top experiencing real wage gains and those at the bottom real wage losses.”¹³

The secular trend of the *top five percent of households* progressively receiving a growing percentage of aggregate national income is shown in Table 1.

Looking at column “X” of Table 1, we see that in 1984, the top 5% of households in the United States received 17.1 % of aggregate household income. By 2005, that same top 5% of households received 22.2%. Thus, over that 22-year period, there was a *30% increase* in the share of national household income held by the top 5% of households. But if we look at the far left column, we see that the lowest fifth of households held 4% of the nation’s aggregate household income in 1984 which dropped to 3.4% in 2005, a *decrease of 15%* in the lowest quintile’s share of the nation’s aggregate household income. Stated another way, in 1984 the top 5% of households received only 4.25 times as much income as the lowest fifth (quintile); but by 2005 the top 5% of households were receiving 6.5 times as much as the lowest fifth of the nation’s households.

12. The Census Bureau regularly uses the “top 5 percent of households” category to track from year to year the percentage share of income controlled by the top 5 percent of households.

13. U.S. Census Bureau, at <http://www.census.gov/hhes/www/income/midclass/widelsan.html>. (13 May 2007). The “shares approach,” to measure income inequality, ranks households from lowest to highest (by income); then divides them into equal population groups, e.g., quintiles.

As Table 1 shows, top-salary incomes began to accelerate in the 1980s, gained speed in the 1990s, hesitated briefly in 2001 (when the two-year recession started), and then continued to surge upward. A recent study by Picketty and Saez, based on data from federal income tax returns, found a remarkable income concentration in the wealthiest 1% of households (the rich), which was skewed strongly in favor of the *top 0.1 percent* (the extremely rich). Indeed, they report that the top one-tenth of one percent of households had a meteoric rise in income from 1995 to 2000.¹⁴ This small fraction (0.1%) of *wage income earners* in the United States that received about a one percent share of national wage income in 1972 were receiving 5.4% of national wage income by the year 2000. Thus from 1988 to 2004, the income share of the richest 1% rose from 15.58% to 19.75%, and the *top 0.1% rose from 2.88% to 4.34 %*.¹⁵ Professor Saez' study also found that in 2005 the 300,000 Americans receiving the highest reported income actually enjoyed almost as much income as the 150 million at the bottom of the economic ladder.¹⁶

Clearly, the incomes of the top 1%, 0.1%, and 0.01 % income shares are the driving force in a widening inequality among America's income earners. As shown in Table 1, during this same 1988 – 2004 period, the lowest four quintiles essentially representing the middle-income working classes (constituting 80% of the income earning households in America), failed to show any increase in their share of national household income, but rather steadily lost income share, while only the fifth quintile realized an increase in income share.¹⁷

The above findings, based on U.S. Census statistical surveys, and Treasury income tax data establish that there has been an ongoing trend in recent years toward greater income inequality. Although there is always a time lag, sometimes for months, before release of reliable

14. Emmanuel Saez, "Income and Wealth Concentration in a Historical and International Perspective," *Public Policy and Income Distribution*, eds. Alan J. Auerbach, David Card, and John Quigley. New York, Russell Sage Foundation, 2006, 246. See also: Thomas Picketty and Emmanuel Saez, "Income Inequalities in the United States, 1913-2002," at: <http://elsa.berkeley.edu/~saez/answer-WSJreynolds.pdf>. (Accessed 18 June 2007); and Thomas Picketty and Emmanuel Saez, "Income Inequality in the United States," 1913-1998, *Quarterly Journal of Economics* 118(1), 2003.1-39; Thomas Picketty and Emmanuel Saez, "The Evolution of Top Income" <http://emlab.berkeley.edu/users/saez/piketty-saezAEAPP06.pdf>. For a summary of Dr. Saez' data through 2004, see Center on Budget and Policy Priorities, available at <http://elsa.berkeley.edu/~saez/jep-results-standalone.xls>. (Accessed 18 June 2007).

15. Ibid.

16. D.C. Johnston, "U.S. Income gap growing wider," *Houston Chronicle*, 28 March 2007, A3.

17. Ibid.

data, quick surveys of limited scope are regularly being published.¹⁸ Many such surveys, together with anecdotal evidence, suggest that in 2006 and the first half of 2007 income inequality was accelerating rapidly enough to fuel political debate.

The subject of income inequality is so politically controversial that, as soon as studies are published, the critics attack. Alan Reynolds challenged Picketty and Saez' findings, saying: (a) income tax returns are a poor measure of income since government welfare payments to the poor are not included, (b) changes in tax laws in the 1980s led businesses to file under the personal (not corporate) income tax system, causing *profit to be wrongly shown as personal income*, and (c) large sums are paid by employers into retirement plans (e.g., 401-k) which do not show as income.¹⁹

Wealth Inequality Trends

The trend of growing inequality in income is accompanied by an equally disturbing trend in wealth inequality. Wealth is generally defined as the value of all assets less liabilities. As income becomes more concentrated in the hands of the few, it enhances the ability to generate greater wealth. The growing disparity in wealth is even more troubling than income disparity because wealth accumulation enhances the ability to exert undue political influence despite efforts to curb this practice.²⁰

Measurements of wealth accumulation in the past have been either lacking or poorly designed. Surveys tend to under-represent the small percentage of top wealth-owners, and those at the top are sometimes reluctant to give out that information. One comprehensive study by Lisa Keister took several sources of data and produced a simulation model that closely follows data that is known. Using the Survey of Financial Characteristics of Consumers for 1962, she

18. For example, John Morton, Director of Pew Charitable Trust's "Economic Mobility Project" reported the study showed: more workers are earning less compared with the earnings of top earners; men in their 30s earned less than their fathers' generation at same age, upsetting longtime assumptions that each successive generation will be better off than its predecessor. Generation income gaps raised a question about what could result if a rising percentage of workers believe the American dream is "off limits to them." Molly Selvin, "Men in Their 30s Making Less than Dads Did" *Houston Chronicle*, May 26, 2007. Cf. Ip Greg, "Men in Their 30s Lag Behind ... Fathers in Pay," *Wall Street Journal*, May 25, 2007, A-2. Another study by Prof. Carola Frydman (MIT) and Raven Saks of the Federal Reserve Board found that in the 1970s CEOs of largest companies received 80% more than the #3 executive; the gap in 2007 is 260%. I. M. Stelzer, "Future of Two Americas," *Weekly Standard* available: <http://www.theweeklystandard.com/Content/Public/Articles/000/000/013/758ewiiq.asp>

19. For critiques of Picketty and Saez, see: Alan Reynolds, "The 1% Problem: On Inequality the Politically Correct is Factually Incorrect," *Wall Street Journal*, 14 Dec. 2006, A-20; A. Reynolds *Income and Wealth*. London, Greenwood Press, 2006.

20. Lisa A Keister, *Wealth in America: Trends in Wealth Inequality*. Cambridge, NY: Cambridge University Press, 2000.

estimated that wealth per household has grown from \$115,995 in 1962 (adjusted to 1990 dollars) to \$176,485 in 1995 (using the Survey of Consumer Finances).²¹ Keister's simulation model estimated that the top 1% of wealth owners has increased its percentage of total wealth from 34.3% in 1962 to 39.1% in 1995. Meanwhile the bottom 40% of wealth owners has seen a decline from 0.2% to a *negative* 0.2% for the same period. Keister estimated a Gini coefficient²² for wealth at 0.80 in 1962 and 0.87 in 1995, which indicates a clear measure of growing inequality in wealth.

Arthur Kennickell, Senior Economist and Project Director with the Federal Reserve Board, found a continuing trend towards wealth inequality from 1989 to 2004.²³ Exploring sources of changes in wealth, he stated that one large contributor is capital gains. The population as a whole held 11.2% of their gross assets as *unrealized capital gains*, while the top one percent of households held 31.2 % of gross assets as capital stock at the median. He stated, "Thus, variations in the ownership of assets subject to capital gains appear to be very important over time as a determinant of wealth."²⁴

James Smith examined possible sources of growth in wealth arising from (1) inheritance from previous generations, (2) differentials in savings rates related to the growing income inequality, or (3) actual rates of return from capital gains. He found that for many families, especially at lower incomes, the majority of increases in wealth came from inheritances which are used primarily for consumption. He estimated that only 13% of wealth values from 1984 to 1994 are due to inheritances. When savings rates were examined, though it is common to assume that rising income inequality leads to greater savings rates, such rates actually *declined* as incomes increased for households in the top 50% of income brackets. These data support the conclusion that increased *savings rates* do not explain growing disparity of wealth at higher income levels. However, overall the portion of wealth held in stocks and bonds increased three-fold from 1984 to 1994 while other components had more modest increases.

Using data from the Health and Retirement Survey which followed the same cohorts ages 51 to 61 in two-year increments, Smith found that equity prices doubled again from 1992 to

21. Ibid.

22 Changes in the Gini coefficient over time indicate changes towards more equality of wealth as the coefficient moves towards zero, or more inequality as it moves towards one.

23. However, Kennickell found the estimates for 1998 and 2001 weren't significantly different from 2004, probably due to the recession of 2001.

24. Arthur B. Kennickell, "Currents and Undercurrents: Changes in the Distribution of Wealth, 1989-2004," At <http://www.federalreserve.gov/pubs/oss/oss2/papers/concentration.2004.5.pdf> . (Accessed 3 June 2007).

1996. Over two-thirds of the mean increase in wealth represented by stocks in that period was due to capital gains, not new investments. When capital gains were eliminated, asset values for the top income decile actually fell.²⁵ *Thus, the driving force behind growing wealth inequality is unrealized capital gains.*

Income & Wealth Inequality Emerge As A Political Issue

The data presented show that since 1980, income *and* wealth inequality in America have been increasing at an accelerating rate. To be sure, when truth seekers look behind the numbers, flaws are to be found—failure to include important data,²⁶ or overlooking an external event that caused error.²⁷ However any such flaws or error only minimally affect the magnitude of the inequality or the rate of its acceleration. Consequently, there has been growing political pressure to address the rising inequality. Early in 2007, President Bush noted the widening gap between the rich and the middle class and said, “I know some of our citizens worry about the fact that our dynamic economy is leaving working people behind. ...Income inequality is real.”²⁸ A recent *Los Angeles Times* poll found that 75% of Americans believed income inequality was a major issue. This belief was shared by large majorities in every income group and political party.²⁹

Candidates campaign on issues they perceive to be in the public eye and they must appeal to their constituents’ notions of fairness and social justice. No single economic issue has been so incessantly vilified by the press, argued in economic debates, excoriated by social critics, and cursed by the man in the street as the subject of excessive compensation of corporate executives.

The American public has been bombarded with an accelerating crescendo of surveys, news releases, and pronouncements of prominent leaders—all condemning the astronomical heights to which incomes of corporate executives have ascended. Bebchuk and Fried report that from 1992 to 2000 the average real pay of S&P 500 firms’ Chief Executive Officers (CEOs) increased by a multiple of four, from 3.5 million dollars to 14.7 million dollars, fueled primarily by stock options. In 1991, the average CEO³⁰ received salary compared to that of an average

25. James P. Smith, “Why is Wealth Inequality Rising?” in *The Causes and Consequences of Increasing Inequality*, ed. Finis Welch (Chicago: The University of Chicago Press, 2001).

26. e.g., transfer payments from welfare, Social Security, to those in the lowest quintile increase their income significantly, but are frequently excluded from income inequality studies.

27. e.g., Alan Reynolds, *Income and Wealth*, London, Greenwood Press, 2006, is a conservative scholarly critique of the Picketty-Saez studies.

28. The Outlook, *Wall Street Journal*, 26 March 2007, A-2.

29. “Income Gap,” *Houston Chronicle*, 11 February 2007, E2.

30. Throughout this paper, wherever the context so requires, the term “CEO” is deemed to include the next 4 executives below the CEO, thus comprising the top 5 executive officers of the firm.

worker on a ratio of 140:1. By 2003 that ratio had increased to 500:1.³¹ By 2005, average compensation for a CEO of companies with global sales of \$500 million was \$2.2 million.³² In 2006, Exxon Mobil, a big oil producer, paid its CEO a total of \$22.4 million for his first year of service.³³

For 2006, the first year of Walt Disney's CEO Bob Iger, both earnings and stock price surged. Iger received a \$2 million salary, a \$15 million cash bonus, long-term incentive pay of \$4.3 million, 411,000 stock options with an estimated value of \$2.9 million, and \$666,000 to cover costs (security, personal air travel, and car). Additionally, he exercised \$7.96 million of expiring stock options. For the same year, media giant, News Corp. paid its CEO an \$8.1 million salary and \$21.2 million bonus, a total of \$29.3 million.³⁴

To the increasing disgust of shareholders, a number of corporations have paid excessive compensation to a CEO who has presided over a general decline in the corporation's stock price. At the end of 2006, Home Depot's stock price had dropped from its 1999 peak of \$69 to \$40. Displeased with the stock's decline, the directors terminated the CEO and paid him \$200 million in severance pay—a part of the executive compensation which he had negotiated at the time he was hired in 2000. Nevertheless, the stockholders, general public, and even the House of Representatives' Financial Services Chairman commented that the CEO's chief contribution to raising Home Depot's stock value consists of quitting and receiving hundreds of million dollars to do so.³⁵

Since 2003 an increasing number of employees and their unions have been incensed to discover that during the same time their income had remained stationary, the CEO and top executives were receiving excessive income which bore no relation to increased profitability. In 2003, the United Auto Workers Union was outraged to learn that the CEO of General Motors received \$2.8 million in restricted stock and the vice chairman received \$1.8 million although the stock had depreciated 40% in value during their tenure in office. This provocative action

31. Lucian Bebchuk and Jesse Fried, *Pay Without Performance*, (Cambridge, MA: Harvard University Press, 2004)

32. E. Taylor, "CEO... Backlash Over Executive Pay," *Wall Street Journal*, 26 May 2007, A-2.

33. N. Brulliard, "Exxon Paid \$22.4 Million to CEO in '06," *Wall Street Journal*, 12 April 2007.

34. M. Mark, "Disney CEO Iger's Bonus, Salary: \$17 Million," *Wall Street Journal*, 1 Jan.'07.

35. Editorial, *Wall Street Journal*, 5 January 2007, A12.

seriously complicated labor negotiations in which the company was seeking to reduce workers' income by cutting health insurance costs.³⁶

In still other cases, exorbitant executive pay was granted even as the CEO was leading the corporation into bankruptcy. K-Mart, America's second-largest retailer, "loaned" \$5 million to its CEO and \$1.75 million to its CFO, neither of which was ever repaid. During bankruptcy, the CEO's \$1.5 million salary was paid to him and in addition a "severance" bonus of \$500,000.³⁷

Stock Options, Engine Of Income And Wealth Inequality

In 2006, 500 CEOs in America's largest corporations received an average of \$15.2 million each. This compensation resulted from an average pay raise of 38% over that of the previous year. The chief component of CEO compensation in 2006 was *exercised stock options*, which accounted for 48% of total CEO pay and resulted in an average capital gain of \$7.3 million.³⁸

In the corporate world, the stock option that is typically part of a CEO pay package is called an *incentive stock option* (ISO). It is a contractual right granted by resolution of a corporate board of directors to certain named employees, conferring on them the right to purchase within a stated time period a specified number of shares of the corporation's stock at a stated price (called the "*strike price*" or "*grant price*"). The strike price is usually the fair market value of the stock as of the date of the board's resolution granting the option, notwithstanding that the stock's value may increase significantly after the date when the option was granted. An ISO is also sometimes referred to as a qualified or statutory stock option. Employees with stock options buy at the strike price within a specific time period. After exercising the option and buying the stock, they typically cannot resell all of the option stock, but only that portion of the total shares that has *vested* each year.³⁹ The staggered vesting period restrains key personnel from defecting to a competitor.

36. J. Stoll and E. Welsch, "GM Bonuses May Complicate Labor Talks," *Wall Street Journal*, 23 March 2007, A2.

37. At: http://findarticles.com/p/articles/mi_m0FNP/is_9_41/ai_85591896. (Accessed 18 June '07)

38. Forbes.com "Special Report on CEO Compensation (May 3, 2007) accessed June 8, 2007. http://www.forbes.com/2007/05/03/highest-paid-ceos-lead-07ceo-cz_sd_0503ceo_land.html See also Managing, *Wall Street Journal*, 30 April 2007, B3.

39. For example, the terms of the option grant might provide: "The 100 option shares you have purchased may only be sold on or after the date of vesting, which is printed on each share." The printed shares would then contain vesting dates so that only 10 shares could be sold each year.

Corporations find that the advantages of using ISOs are: (a) they give the executive an interest in the company as a *shareholder*; (b) they are tax deductible to the company since they're treated as salary; and (c) their tax advantages appeal to employees. If, after exercising a vested option by purchasing the stock, the employee holds it for two years before selling it, the profit is taxed at the lower capital gains rate (15%) instead of at the much higher income tax rates.

But ISOs also have their disadvantages. Whenever a corporation issues more ISOs or any other kinds of stock, earnings per share (EPS) are diluted. ISOs also require the executive to make an investment in the company, and if the stock *depreciates* in value after the option has been exercised, he or she may be embittered against the company. Dishonest executives with large holdings of ISOs often are tempted to engage in illegal short-term price manipulation.

Corporate boards often give the CEOs and other top executive's *restricted stock*. In contrast to option stock which the *employee must buy* at the grant price, restricted stock is deemed to have been earned; but to protect the public its resale is *restricted* by Securities and Exchange Rule 144.⁴⁰ Upon receiving a restricted stock grant, the recipients have a choice of declaring the shares as ordinary income at their market value, or waiting until they are permitted to sell the shares and declare proceeds as ordinary income at that time.⁴¹ One disadvantage of issuing restricted stock is that it immediately *dilutes* the corporation's earnings-per-share by the total amount of restricted shares distributed.

ISOs are of recent vintage and have particularly come into vogue with larger corporations in the past fifteen years. In the late 1980s and throughout the 1990s as the computer revolution gathered speed, scores of start-up corporations were formed. Most of these prospered and matured into companies whose names were unheard of 40 years ago—e.g., Microsoft, Apple, Intel, Cisco, and Google. Each of these companies—and scores of others—were started by two or three skilled engineers or technicians who thought of a new way to supply the growing demand of the computer and Internet revolution. At the inception, many of these start-up

40. Also called “the 2-year and dribble” rule, it mandates that the CEO recipient must (a) not resell for 2 years, and (b) even then it must be sold in small lots (not exceeding 1% of outstanding shares or average weekly trading volume for 4 weeks, whichever is greater) through a broker, and with notice to the SEC. *Contemporary Business Law*, loc.cit., 1027.

41. The second option is beneficial to the shareholder when the market stock price has fallen.

companies had very limited capital.⁴² Often, to lure and retain mid-level employees to work for below-market salaries, companies would supplement their salaries by issuing ISOs. Likewise, top executives, key engineers, technicians, and directors who wagered *all their assets* on a high-risk venture, typically allocated ISOs to themselves—just in case the venture succeeded.

Indeed, the ventures did succeed! In the exploding “information age,” profits realized through exercised stock options and sales of the stock in the market created *hundreds of billionaires*⁴³ and *thousands of millionaires* overnight in the most remarkable stockpiling of wealth in the history of capitalism.⁴⁴ Even vaster sums of wealth were accumulated through the increase in the value of stock not sold, but held by investors and executives in the form of *unrealized capital gains*. The technology revolution, firmly grounded on the marriage between ingenuity and stock options, even reached out to hand its blessings to academia.⁴⁵

Ironically, a major factor accounting for the flood of stock options after 1993 was legislation adopted by the Democratic Congress in a concerted effort to *limit and restrict CEO compensation*. Concerned about income inequality, the U.S. Senate Finance Committee held hearings to review the growing disparity between workers’ and CEO pay. The hearings revealed that a decade earlier, average CEO pay was \$624,996—*42 times the pay* of the average factory worker. By 1990, average executive pay, not including stock options had increased to \$1,214,090—*85 times the earnings* of the average factory worker. The Committee concluded that excessive compensation could be eliminated by amending tax law to prohibit corporate *tax deduction of executive compensation over \$1 million per year (excluding performance-based*

42. Bill Hewlett and Dave Packard started Hewlett-Packard, the world’s largest computer manufacturer out of their garage. Google Corp. also had its beginning in a garage.

43. Microsoft employees exercising options, buying and holding their stock created 4 billionaires, and an estimated 12,000 millionaires. J. Bick, “The Microsoft Millionaires Come of Age,” *New York Times*, 29 May 2005, A1.

44. After leaving Stanford Graduate school at age 25, Larry Page and Sergey Brin founded Google in 1998; their stock value in 2006 (in billions): Page \$16.6, Brin \$7.1, CEO Schmidt \$2.7. See http://www.forbes.com/lists/2007/10/07billionaires_Larry-Page_XFXI.html (accessed 9 June 2007)

45. Dr. J. Hennessy, engineer and Stanford President, from 2001-2006 received \$43 million of stock option (paper) profits, restricted stock, director fees from Atheros Communications, Cisco, and Google, which dwarfed his university salary (\$616,000). J. Hechinger and R. Buckman, “The Golden Touch of Stanford’s President,” *Wall Street Journal*, 24 January 2007, A-1.

based compensation). Congress then enacted the Revenue Reconciliation Act of 1993 (RRA),⁴⁶ including an amendment limiting the stock option exception.⁴⁷

Corporate lawyers quickly saw that the new limit on salary deductibility did not apply to stock options. As a result from 1994 forward, the great majority of American corporations rarely paid salaries to CEO's in excess of \$1 million per year, but often granted ISOs that in value periodically proved to be worth over a \$1 billion, and quite often turned out to be worth tens of millions of dollars. Thus stock options increasingly became the preferred method of compensation, but at the same time a Pandora's box filled with temptations and legal pitfalls.

The Stock Option Backdating Scandal

In May 2005, a university finance professor published a study finding that in a number of corporations there was a suspicious coincidence between corporate stock-option grant dates and the stock's lowest market price.⁴⁸ A Securities and Exchange Commission (SEC) investigation was started which confirmed that about a dozen companies were improperly backdating employee stock options (ESOs) to provide insiders with a compensation windfall. In November 2005, directors of Mercury Interactive Corp. appointed a committee to investigate stock-option grants and found 49 cases of backdating. The CEO and two top executives resigned. Upon the news, the stock price fell 25%. Delays in restating earnings to reflect additional expense and tax liability forced delisting of the firm's shares.⁴⁹

During 2006, the scandal accelerated, as dozens, then scores of companies began firing top executives, taking charges against earnings amounting to billions of dollars, paying fines and civil damages and sending written confessions to the outside shareholders admitting that they

46. "Executive Compensation and the Revenue Reconciliation Act of 1993," *CPA Journal Online*, 2 Feb. 1995; at: <http://www.nyscpa.org/cpajournal/old/16641858.htm>. Accessed 18 June 2007.

47. IRC §162(m), effective 1 Jan.1994, denied deductibility of CEO pay over \$1 million per year. Directives required the board's compensation committee (with at least 2 outside directors) to (1) develop a written incentive plan with a preestablished goal; (2) make the option grant to the employee (for approval by the directors); and (3) provide that the total amount recovered by the employee's sale of stock be based solely on an increase in value of the stock after the grant date. It also declared that options with an exercise price less than the fair market value as of the grant date are not nondeductible and the terms of the option should be disclosed to the stockholders, including, the number of option shares granted, the option price, the option-exercise period, and any other restrictions.

48. Erik Lie. <http://www.biz.uiowa.edu/faculty/elie/backdating.htm>. Accessed 20 May 2007.

49. M. Maremont, "Authorities Probe Improper Backdating of Options," *Wall Street Journal*, 11 November '05, A1.Cf. ff; accessed 9 June '07: <http://www.forbes.com/2006/07/24/leadership-brocade-backdating-Mercury-Interactive-Corp.-was-a-Silicon-Valley-software-company>.

had misrepresented exactly how and when the “grant dates” were fixed by the board in its annual proxy statement.⁵⁰

In January 2007, Internal Revenue Service (IRS) announced a compliance program that permitted companies to pay the additional taxes due from employees who had received windfalls from the backdating, but who were not a part of the insiders’ backdating scheme.⁵¹ The result was that many companies quickly assumed the tax liability of executives who were not insiders; and where such executives’ potential profit decreased because the option date was changed to the date actually issued by the directors, many corporations paid them the difference in cash, listing them as bonuses in their reports to the SEC. Such practices only further exacerbated public anger over inequality of executive compensation.⁵² As the federal investigations expanded, major corporations were brought into the widening circle of insider abuse of ISOs. In January 2007, the SEC started an investigation of Apple, Inc. Its CEO Steve Jobs was found to have been awarded a grant of 7.5 million stock options that carried a false 2001 date. Since the option gave its holder up to 10 years to exercise his right to buy stock at the grant price, backdating the grant to an earlier date when the market price was lower, guaranteed the holder a profit the moment he received the option.

In March 2002, Apple’s directors had told shareholders—incorrectly—that the 2001 grant to Mr. Jobs was made at fair-market value on the date of grant. In August, Jobs also signed a statement to the SEC bearing the false price and false date of October 19, 2001. Apple’s internal investigation report was sent to the SEC. It cleared Mr. Jobs of any misconduct, but found that 6,428 backdated options had been granted between 1997 and 2002. All firms’ backdated options incur option expenses that must be booked, thus lowering net profit. SEC and tax penalties would lower profit further. Apple’s restatement reflected an \$84 million charge for the period between 1998 and 2006, which included \$20 million for Mr. Jobs grant. At the time SEC investigated Apple, 66 top corporate officials lost their jobs because of illegal backdating, and the Justice Department had already commenced criminal fraud investigations against various firms.⁵³

50. C.Forelle, “Executives Get Bonuses as Firms Reprice Options,” *Wall Street Journal*, 1 Jan.’07, A1.

51. The compliance plan only applied to 2006. IRS Announcement 2007-18, and IRC § 409A.

52. At least one penitent CEO took the high moral road. CEO Sehat Sutardja of microchip Marvell Technology Group Ltd. reimbursed his company \$5,355,001 for wrongly dated stock options he had already cashed in. *Wall Street Journal*, supra.

53. “Leading the News,” *Wall Street Journal*, 12 January 2007, A3.

By 2007, the multiplicity of corporate stock option abuses had triggered a crescendo of criminal prosecutions and fines, civil penalties, and forced resignations of key corporate executives. The net effect on hundreds of corporations was reduced profits,⁵⁴ depreciated stock value, and declining public confidence in the honesty of corporate management. There arose a clamor of angry shareholder complaints about the lack of transparency of board actions and the self-serving decisions of key executives. Responding to these protests, U.S. Congress, the Securities & Exchange Commission (SEC), and the Internal Revenue Service (IRS) began a push for regulatory control.

Regulatory Responses

The SEC was one of the first regulatory agencies to attack the secrecy with which corporate executives and boards issued exorbitant stock options to themselves. In July, 2006, the SEC modified its rule that specified what facts public corporations must include in their annual proxy statement.⁵⁵ The revised rule required that corporate directors and managers should describe in detail (a) how they determined compensation of the CEO and other top officials, (b) stock option awards made and a summary of options that *vest each year*, rather than the total value of the options granted; and (c) changes in the value of a pension if the executive retires. Such rules improve corporate governance by making key facts about options available to the media, the public, and *most importantly the shareholders*. Once they have access to facts adversely affecting their interests, shareholders will protest, and if in sufficient numbers, directors will listen and take remedial action.

Another regulatory response to stock options came in 2006 when the Financial Accounting Standards Board moved to clarify confusion over the tax status of options, an issue that had been debated and litigated for many years.⁵⁶ Rule FAS 123R⁵⁷ required corporations to

54. Landry's Restaurants, to review its stock option problems, delayed its 2006 report until 8/10/07 showing a \$10.9 million charge for years 1993 to 2005. The delay caused bondholders to call \$400 million of notes. To pay them, the firm borrowed \$515 million at 10.4 %. The CEO's 2006 pay and perks was \$15.3 million. "Jump Page," *Houston Chronicle*, 11 August, 2007, D1.

55. http://securities.stanford.edu/news-archive/2006/20061215_Headline102239_OHara.html (accessed 20 June 2007).

56. The Financial Accounting Standards Board (FASB) is a private, non-profit organization whose chief purpose is to create and publish generally accepted accounting principles (GAAP) in the public's interest. The SEC, using its statutory authority under the Securities Exchange Act of 1934, has designated FASB to set accounting standards for public companies in the U.S. The SEC sees FASB rules as being in the public interest.

subtract the *total value of stock option grants (both vested and unvested)* to executives from corporate earnings for that year. Prior to the rule, options were *not counted as a corporate expense*. However, the SEC using its power of review issued a superseding rule on January 3, 2007.⁵⁸ The new rule required corporate directors to set the value of options based on their “fair value” at the time of the grant, and to disclose that “fair value” number as compensation *as the options vested*, notwithstanding that they could be worth much more or much less than their original “fair value.” The new SEC rule also stated that only the value of options that *vested in the tax year*, rather than the total value of all options granted, should be reported. Thus, a decade of debate was settled by a rule holding that a vested option (a grant given to an employee who has a right to immediately resell it) is *income to the employee* and is an *expense to the corporation*, just like any other form of compensation. The Internal Revenue Service enforced the rule by levying income taxes on these immediately saleable options.⁵⁹ However, the IRS overlooked a huge windfall tax deduction for the appreciated value of options that employees held and sold later. Upon discovering the oversight, members of the U.S. Congress recently announced they would eliminate the loophole.⁶⁰

The new amended SEC regulation required all public corporations to include a plethora of important information in the annual statements mailed to shareholders at the time their proxies are being requested.⁶¹ Thus, all elements of key officers’ pay must be shown, including *salary, cash bonuses, deferred compensation, and various perks as well as vested stock options*.

Do Stock Options Increase Performance?

57. FAS Statement of Financial Accounting Standards No.123R, Share-Based Payment, Dec. 2004. For firms with December fiscal year, the rules would affect the first-quarter results in 3/31/06.

58. SEC Amendment to Item 402, Regulation S-K and S-B. The purpose was to provide investors with “more complete and useful disclosure.” The revised rule exceeds 450 pages. <http://www.sec.gov/rules/final/2006/33-8765.pdf> (accessed July 27, 2007).

59. Grants of options that can be sold immediately are often called “in-the-money” options.

60. Legislators recently revealed plans to enact law eliminating an accounting quirk whereby large corporations that issue option stock, and restricted stock, have been able to accrue a tax return “expense” benefit from options exercised by employees which the companies never actually pay, e.g., in 2006, Google’s stock price generated a \$611 million tax benefit from restricted stock that vested, reducing their tax rate from 23% down to 8%. “Tech Companies’ Tax Obligation is Clouded by Options,” *Wall Street Journal*, 16 April 2007, C-2/. Senior Senate Democrat Carl Levin recently stated he planned legislation to plug this loophole. He noted that elimination of this deduction would add billions to Treasury’s revenue. K. Scannell & S. Lueck, “Lawmaker to Push Options-Tax Overhaul,” *Wall Street Journal*, June 5, 2007, A-2.

61. A management proxy is a shareholder’s written authorization that the directors, or their nominee, may vote his or her shares at the corporation’s annual shareholders’ meeting.

While the rules adopted by FASB, SEC, and IRS have clarified accounting procedures, simplified taxation of incentive stock options, and increased the transparency of CEO-board actions concerning options, neither the U.S. Congress, the federal regulatory agencies, nor corporate America has come to grips with the jugular question concerning *incentive stock options: Is the stock option program accomplishing its purported objective of paying the CEO and key executives for performance?* The answer to this question is, with narrowly drawn exceptions, “no.” As shown below, the CEO’s motivation or activities are largely unrelated to the vast majority of increases in the market price of corporate stock. For this reason, except in certain industries where a CEO’s technical knowledge drives development of new marketable products or directly increases profitability (e.g., as engineer or inventor),⁶² there is little correlation between a contractual pay package that includes stock options and CEO motivation to increase productivity that directly causes a rise in stock.

Since 1993 many—if not most—corporate boards used stock options to circumvent the tax law limit of \$1 million on CEO salaries. Though stock options gave CEOs little or no zeal to boost profits, issuing them gave more than a few boards a convenient excuse to avoid the directors’ moral (and often legal) duty to observe rules of corporate governance.

Effective Corporate Governance

The linchpin of corporate governance is diligent board oversight of CEO *productivity*. In the jargon of economics, boards must continuously estimate the CEO’s *marginal productivity*.⁶³ Boards must keep seeking the answer to this question: Does the additional revenue (e.g., *net income*) from the productive effort of the CEO warrant his⁶⁴ total pay? Many American boards have overpaid the CEO simply by overestimating his productivity and his *marginal revenue*, that is, the increase in corporate revenue and net income resulting from the CEO’s activities.⁶⁵ This miscalculation of the CEO’s *marginal productivity* is due largely to the erroneous assumption by boards that *an increase in the market price of a company’s stock will be an accurate measure of the new CEO’s marginal productivity*.

62. Similarly, the prospect of profit from stock options could motivate a CEO with knowledge of mergers, acquisitions and antitrust law (e.g., a corporate lawyer with powers of persuasion) to find a prospect and negotiate a merger to greatly increase efficiencies of scale, and profitability.

63. In economics, a firm’s additional product produced by the last worker hired is called a marginal product; the revenue derived from the sale of the marginal product is called marginal revenue.

64. Throughout this paper, “his” is used as a collective pronoun to mean both “his” and “her”.

65. The additional revenue directly resulting from the CEO’s productivity.

Before we review a variety of sound board governance practices that ensure increased CEO productivity, let us quickly review four most common causes of a rise in stock price—which are all unrelated to CEO activity.

First, where there is a *general increase in demand for all products in the prosperity phase of the business cycle*, the market price of virtually all stocks will rise. In the business cycle upturn from 2003 to 2007, the S & P 500 stock index rose 56%.⁶⁶ Key causes of prosperity were rising employment (from new housing), rising income, and a manufacturing boom for Iraq war materiel. Yet millions of dollars were paid to CEOs in the form of exercised stock options on the theory that each CEO—not the prosperity phase of the business cycle—had caused his corporation's stock to rise. Second, a rise in world demand for a particular industry's products can cause a concomitant increase in the market price of the stock of all corporations in that industry. The current rise in the market price of oil stocks is a case in point. Due to a sharp increase in world demand, oil stock prices increased 50% in the 2-year period between 2005 and 2007,⁶⁷ clearly not a CEO-induced price rise.

Third, when a private-equity buyout firm offers to purchase *all* of a corporation's stock, its price often zooms up overnight—usually 15% or more. The recent offer to purchase all stock of TXU immediately triggered a 20% rise⁶⁸ in stock price to \$65,⁶⁹ again, not caused by any CEO activity.

Fourth, corporate boards often set aside billions for a “buyback” of the firm's shares in the stock market, causing share prices to rise. Again, this is wholly unrelated to the CEO's effort. A stock buyback's effect is that total outstanding shares are reduced and per-share earnings *and stock price* rise.⁷⁰ Ironically, a corporate board often initiates buybacks to reverse falling stock prices caused by the dilution effect of it having issued *reserved stock and stock options to its executives*. Since the above four causes of most rising stock prices do not involve CEO activity,

66. Standard & Poor Index of 500 stock prices of large-cap American corporations for July 16 in 2003 (994) and 2007 (1549.52). <http://www2.standardandpoors.com> (accessed 30 July 2007).

67. e.g., Occidental Petroleum stock in this period rose from 76.93 to \$115.76 (adjusted for split) or 50.6%. Exxon Mobil, Chevron, Royal Dutch Shell, and British Petroleum increased similarly. China and India's middle class purchase of autos has been a major cause of oil shortages.

68. Offer was by KKR-Texas Pacific-GoldmanSachs group. An SEC filing said TXU's CEO (for less than 4 years) would receive a total pay package over \$300 million if the deal closes. http://biz.yahoo.com/ap/070725/apfn_txu_resignation.html?.v=1 (Accessed 31 July 2007).

69. R. Smith, “Pay of TXU Chief Stirs Controversy,” *Wall Street Journal*, 2 May 2007, B-1.

70. S & P 500 companies had a record \$122 billion of stock buybacks in second quarter of 2007. J. Lahart, “Surge in Buybacks,” *Wall Street Journal*, 7 August 2007, C2.

incentive stock options would appear to be issued on the flawed theory that they will motivate executives to increase stock price. Should the stock price later rise, it is erroneously assumed that executive productivity was the cause. However, it must be quickly acknowledged that there are important sectors of the American economy where there can be a direct cause-and-effect relation between executives' productivity and the rising price of their firm's stock.⁷¹

Directors should be cautiously skeptical about using "incentive" stock options as motivators to raise productivity and stock price. Fortunately, this precept rests upon other solid building blocks of corporate governance. Boards can use these governance principles to curb excessive executive compensation, eliminate corporate waste, and tie pay to productive performance.

A number of incisive studies have accurately identified root causes of runaway rewards. Surprisingly, all of these studies found that sky-rocketing CEO pay was linked with inability of corporate directors to understand and pinpoint basic governance principles that could control wasteful excessive compensation. Theoretically boards serve shareholders' interests by devising economic incentives for increasing shareholder value. Yet, many of the reported payoffs to executives have been in spite of poor performance by the company and its stock. Besides misusing stock options as an incentive, what else went wrong?

Bebchuk and Fried reinforced the above conclusion that *it is the flawed process that leads to CEO payoffs disconnected to performance*. They restate the theory behind an effective board: it serves shareholders' interests by "arms length" negotiations with the CEO using the theory of "efficient contracting."⁷² However, instead of pursuing efficient bargaining in the CEO labor market so as to hire at competitive rates, boards compromise good governance principles by letting themselves be unduly influenced by the CEO into above-market stock options, bonuses, and perks. Boards further compromise their fiduciary duty to bargain at arm's length by succumbing to inappropriate CEO tactics calculated to influence individual directors to

71. Certainly, one area where rising stock prices can reflect a CEO's direct productivity is in high-tech industries. Microsoft's software, Intel's more powerful chips, Google search engines, exemplify firms whose CEOs are trained innovators, willing to devote whatever energy it takes to introduce a new Ipod, I-phone, or Blackberry. In all these cases, CEOs directly developed new devices which produced astronomical sales (e.g. cell phones) with the direct result that corporate profit and share market price rose dramatically. In other industries where increased stock prices is directly caused by CEO effort, the governance challenge is for the board to develop oversight techniques that accurately monitor and measure the direct causal relation between the CEO's pay-package cost, and his productivity.

72. Bebchuk, *Pay Without Performance*, 18.

take favorable action on their compensation. The list of CEO strategies to influence board votes is limited only by imagination, but includes: selecting a pliable majority of directors (e.g., three on a five-person board) and cultivating them with favors including hiring their friends or relatives to fill job vacancies, hiring a board member as an independent consultant, buying corporate supplies from a company owned by a director,⁷³ or taking a favored director on a fishing trip in the company plane.⁷⁴ Directors are also restrained by lack of time and information to pursue corrective action and the fearsome cost of litigation that often ensues when directors aggressively oppose CEOs. All of these factors often lead to decisions counter to the shareholders' interests.

Janet Yellen, president of the Federal Reserve Bank of San Francisco, concluded that CEO compensation has risen to such high levels that it is a contributing factor in the rising incomes of the top 1% of wage earners—a finding with disturbing implications for the future of equality of opportunity in America.

Looking for the cause of inordinately high CEO pay, she stated that it is *inefficient functioning of the CEO labor market that gives rise to excessive compensation*.⁷⁶ Causes of inefficient CEO labor markets are similar to those listed in earlier surveys above: (1) boards “beholden” to the CEO whose influence is sufficiently strong to affect their votes on pay packages; (2) inadequate board monitoring of CEO and CFO activities; (3) not contracting to obtain accurate “prevailing salary” data that is indispensable to keep salaries and perks in line with the market, and (3) “lack of transparency”⁷⁷ which usually refers to offending shareholders by undue board secrecy in salary, bonus, retirement perks, and stock option grants.⁷⁸

73. The law requires contracting with a director's company to be fully disclosed to the board which then votes approval with the interested director abstaining from voting. Even with a board OK the contract can still be so profitable as to influence a director to reciprocate at CEO bonus time.

74. Other tactics: buying lunch; baseball-football-golf-theatre tickets; exploiting director's desire to maintain collegiality. A co-author, serving 30 years as director of two savings & loans, a bank holding co., three global firms, and a U.S. highway construction company, has witnessed these tactics.

76. However, Ms. Yellen noted that some observers believe that CEO labor markets operates efficiently, and that high CEO pay results from scarce supply of talent and a big demand.

77. Janet L. Yellen, “Economic Inequality in the United States” in Federal Reserve Bank of San Francisco Economic Letter, Number 2006-33-34, December 1, 2006. Taken from the 2006-2007 Economics of Governance Lecture delivered at the Center for the Study of Democracy, University of California, Irvine, on November 6, 2006.

78. The new SEC proxy rule (See “Responses” section above) has virtually eliminated the “lack of transparency” problem. Ahead of Yahoo's annual meeting, when outside shareholders learned from the new SEC proxy statement that the CEO's pay for 2006 totaled \$71.7 million, while the stock had dropped 10%, their advisors said to vote against the board's 3-person pay compensation committee—a billionaire and 2 retired executives. The board was reelected with a 66% vote, not the usual 97%. R. Richmond, “Anger at Yahoo's Board,” *Wall Street Journal*, 13 June 2007, B5

An in-depth statistical study of Core, Holthausen, and Larcher pinpointed key factors behind rapidly rising CEO pay.⁷⁹ Levels of executive compensation were compared with several characteristics of their boards. Their conclusion was like the surveys discussed earlier: a randomly selected, loose-knit board of directors enabled the CEO move into a dominant position, from which he used his influence to maneuver higher pay with little or no reference to outside labor market rates. Thus, CEO pay rates were found to be larger (above market rates) when (1) the CEO was also board chairman; (2) there was a very large board; (3) there was a larger percentage of outside directors; and (4) outside directors were older and served on more than three boards.

Another cause of escalating high-salary CEO contracts is the increasing use of salary consultants. Executives retain them because of their expertise in maximizing pay packages by using salary data on the “high side” of the market. The employing corporation often (but not always) retains its own compensation consultant to offset the applicant CEO’s data. Not infrequently, where the CEO desires to maximize the starting salary and perks, the hiring corporation’s board may also conclude it doesn’t want to just pay “average” for their CEO, with the result that both sides agree to above-median compensation and CEO pay is constantly “ratcheted up” to higher and higher levels.

All of the studies that have been quoted found that the main cause of runaway executive pay was due to poor corporate governance which indicates inefficient functioning of the labor market for the particular kind of CEO involved. In many cases upon hiring executives, and later at salary review time, there was not even a token effort to gather market pay data. As one of the quoted surveys noted, board compensation committees tend to shy away from salary-perk data or arm’s length negotiations of CEO pay packages.⁸⁰ Yet such negotiations can be a magic wand that blocks skyrocketing compensation and shareholder outrage because of two facts: (1) the labor market for a CEO is *an imperfect market*, and (2) imperfect markets have a wide negotiating range (economists call it the “*range of indeterminateness*”) in which data-based bargaining can just as easily and successfully set CEO pay near the bottom of the range as near the top.

79. Data was from 205 publicly traded US firms with median sales over \$3 billion, 1982-1984, a period immediately predating the period when executive pay began to escalate rapidly.

80. Cf. note 73, *supra*.

We have seen how income and wealth disparities grew in the last two decades, propelled by the explosion of executive compensation in the form of *stock options* and *restrictive stock*--often worth millions more than the value of the CEO's productivity for the corporation. This waste, or *market failure*, is largely due to misunderstanding the nature of CEO labor markets which are *imperfect markets*, significantly different from *competitive markets*.

In reality, there is *no single market* for CEOs; instead there are hundreds of different CEO labor markets in the United States—one for each of the hundreds of American industries such as steel, coal, oil, chemicals, and service industries—with a separate CEO labor market for the various stages of each industry such as manufacturing, wholesaling, and retailing. A CEO for manufacturer Campbell Soup Co. will obviously be found in a different labor market than a CEO for mega-retailer Wal-Mart.

The most important characteristic of a CEO labor market is that it is an *imperfect market that functions under conditions of imperfect competition*.

In economics, a *perfectly competitive labor market* has three characteristics: (1) many buyers (employers) and sellers (workers), (2) every worker is essentially the same from the employers' viewpoint,⁸¹ and (3) there are no barriers to entry, so that any person with the physical and mental ability may enter the market.

Clearly, all three of the above requirements are absent in any CEO market, where there are not many buyers (firms) and sellers (CEOs) who meet the strict job requirements which are a *major barrier to entry*. For example, a candidate for CEO of a manufacturer of chemical compounds for cleaning oil wells, might find the job required a Ph.D. (inorganic chemistry), M.B.A. (international business), 10 years' industry experience, knowledge of law regulating manufacture, safety, storing, and shipping of chemicals, and fluency in Russian (since the firm contracts to clean hundreds of Russian oil wells). Obviously, these qualifications would be a barrier to entry of all but five or ten persons in America. Similarly, there are less than five such producers of this specialty in America.⁸² Self-evident also is the fact that no two applicants for this CEO job will look the same to the employer.⁸³ Age, education, years of experience, fluency

81. i.e., a common laborer; as long as each worker is young, heavy-set, muscular, with no ailments, from an economic standpoint, each such worker appears the same to employers, though names differ. For a comparison of competition in perfect and imperfect labor markets, see Appendix A.

82. Co-author G. Severance was salary consultant and attorney for a chemical corp. for 15 years.

83. e.g., one applicant has a Ph.D. in organic chemistry, MBA (global business), and speaks fluent Russian. Another's Ph.D. (inorganic chem.) is preferred, but isn't fluent in Russian but speaks Arabic, a help to growing

in languages, appearance, compatibility, leadership, and speaking ability will all be quite different. Likewise, no two producers of industrial oil well cleaning compounds are identical.⁸⁴ All these factors (few buyers and sellers who are all different, with barriers to entry for CEO candidates) point to the conclusion that the market for a CEO of this chemical firm is indeed, an *imperfect labor market*. Yet it is this very market imperfection that gives the company a golden opportunity to hire a CEO for moderate pay, rather than at excessive rates. How can this be?

Since no two firms are alike and no two CEO candidates are alike, it follows that the “comparable salary data” for CEOs paid by “competitors” are for CEOs who *do not have exactly the same qualifications* as the applicant CEO. Likewise, these other CEOs whose pay data is being quoted all work for companies that are *not identical to our firm*. Thus, a board negotiating committee⁸⁵ by careful research can point out to the CEO candidate that the high executive salary paid by “Company X is not at all comparable, because the CEO there works for a company that has twice the dollar volume of business, but it comes mostly from producing diamond drilling bits; that X’s stricter qualifications are for a higher position so the data is not comparable.

Thus, a firm recruiting a CEO, by carefully selecting data on salaries of comparable firms and critically scrutinizing a CEO candidate’s resume, can succeed in hiring *at or near the bottom* of the bargaining “range of indeterminateness” that exists in this imperfect labor market. Such an outcome is attainable because in the *imperfect labor market’s range of indeterminateness, neither party knows the exact value of the CEO*. The goal of good corporate governance is this: to recruit a CEO whose starting pay package is skillfully negotiated in the labor market, which will be amplified by an annual bonus tied to CEO performance and productivity.

Alternatively, there is the *inefficient labor market* where the directors involved in CEO negotiations have not done their homework and have accepted the candidate’s “comparable CEO pay data” without challenge, thus hiring at the *top end of the “range of indeterminateness;”* and in the ensuing years, the board has *failed* to carefully ensure that executive pay is a direct reflection of executive productivity. Such failure could be due to a board neglecting to use a

Saudi Arabia business. Another has all qualifications except MBA, but has a law degree and 4 years at a U.S. agency regulating chemical firms.

84. e.g., one firm may have no international business; another’s main chemicals are solvents for washing airplane and train exteriors, with oil well cleaners only a sideline; another has no Russian business, but is active in South America. Another devotes half its resources to R & D.

85. Most CEOs use a salary consultant as should the firms seeking to hire a CEO candidate.

reliable measuring rod to evaluate precisely as possible exactly how the CEO increased productivity. When the board uses unreliable methods to evaluate performance, makes no effort to correlate productivity and profitability or to compare CEO pay with comparable compensation paid by competitors, economists call it *market failure*. It has failed because the directors are needlessly wasting corporate dollars for a CEO whose cost may be millions of dollars more than his productivity or the market rate for his kind of work. Worse yet, the market may have failed because the board used the *wrong market—the stock market*—in issuing stock options. The *right markets* to evaluate the CEO's worth should have been CEO *labor market* salary comparisons, or evaluating CEO productivity in the *product market*.⁸⁶

Even worse governance and market failure come about from lazy apathy or intentional wrongdoing. Many of the boards exposed in the stock option scandal knew that rising stock prices didn't measure CEO efficiency, but voted for stock options to avoid governance responsibility of bargaining to hire the CEO at or near the bottom of the market range. Other boards, once having hired a CEO, wanted to avoid the oversight task of evaluating CEO productivity. The nadir of irresponsibility was reached when the CEOs of Enron, WorldCom, and Adelphia⁸⁷ conspired with officers or directors to steal from the corporation or show paper profits to keep stock prices rising while they sold their own shares. They boosted CEO pay, directors' fees, issued back-dated stock options⁸⁸ and charged fictitious commissions. Eventually, the day of reckoning arrives with a criminal prosecution or minority stockholder's law suit, or both.⁸⁹

Whether poor corporate governance consists of insufficient oversight by directors or outright illegal or corrupt activities, any corrective measures would require the directors to follow the precepts of good governance discussed above. Probably the most powerful, effective

86. Economists call this the CEO's "marginal product." In a competitive capitalistic economy, workers (whether common laborers or CEOs) are paid according to the market value of the marginal product that they produce. A CEO's marginal product is the value of his increased production and sales directly resulting from his effort. Many boards fail to set up effective measures of CEO productivity, and concede to his demand for stock options that generally have little or no correlation with CEO productivity. Issuance of hundreds of options injures minority shareholders by diluting per-share earnings and stock value.

87. Founder J. Rigas, 82, sentenced for 15 years, son (CFO) Timothy, for 20 years, both convicted for securities and bank fraud, and imprisoned 8/14/07, *Houston Chronicle*, 14 August 2007, D3.

88. On 8/8/07 Brocade Communications CEO Greg Reyes was found guilty in the first criminal trial for back dated stock options, a violation of the 1933 Securities Act. U.S. prosecutors expected to file many more criminal prosecutions, "Leading News," *Wall St. Journal*, 8 August 2007, A3.

89. Such "derivative" suits are brought in the corporate name by stockholders who exercise their right to inspect corporate records, discover fraud, and sue directors and officers to return money to the corporation. Shareholders also can recover attorney fees.

force to prod directors toward diligent oversight of the CEO and their corporation are the outside, minority shareholders. Directors are spurred into action by fear that this sleeping giant is beginning to awaken.

Encouraging Signs Of Improving Corporate Governance

The litany of recent cases where shareholders were outraged over CEO pay rising to the sky while the firm's stock was headed toward the cellar has had the general effect of making America's boards more keenly aware of the fact that there are limits to the patience of shareholders and the public; that if the shareholders are aroused into action, there can be serious consequences. These include a lawsuit against directors by one or more shareholders,⁹⁰ and dozens of causes of action by state and federal regulatory agencies alerted by public outcry, and finally, by state legislatures and Congress who can become aroused by misconduct or greed of directors and inside shareholders. From 2000 to 2007 not only has there been a steady increase of shareholder and regulatory agency suits against directors, but state legislatures and Congress have responded quickly to shareholder outcry.⁹¹

To date, a few companies with high corporate governance standards have evidenced encouraging signs of progress. Some boards have tied stock option grants more tightly to corporate earnings.⁹² Others have shortened option periods to less than five years, thus eliminating undeserved windfall profits due to the fact that over a longer period even shares of a poorly-guided firm will eventually exceed their grant date market price, so the option could be cashed in for a profit. Some firms have included business sales goals or share performance standards to make *vesting of options more* difficult. Other boards have taken "the option out of options" by removing the executive's ability to choose when to exercise them, substituting instead objectively defined fixed goals which must be met before the option would vest and be exercisable.⁹³

90. A derivative suit initiated by a shareholder owning a relatively small amount of stock (fixed by statute in each state) can be brought in the name of the corporation against a director for fraud, negligence, breach of fiduciary duty, or for seizing a corporate opportunity for himself.

91. Cf. notes 47,48,58,59,61.

92. Schering-Plough Corp. tied 20% of its options to a specified earnings-per-share target. The options are exercisable only if the corporation hits the target.

93. Bristol-Meyers Squibb Co. has required its shares to rise 15% above exercise price for 7 days before options vest so that executives can exercise them. "Theory & Practice," *Wall Street Journal*, 30 April 2007, B3.

Public outrage over high CEO pay and low performance has forced some corporations and CEOs to change their ways. Many firms, sensitive to hostile public opinion, have reduced perks to avoid public criticism.⁹⁴ In a surprising reversal of escalating CEO pay, WholeFoods CEO John Mackey reduced his annual salary to \$1, adopted a rule that no executive can be paid more than 19 times the average wage of all employees (\$30,000 in 2006), thus imposing a \$570,000 ceiling on executive pay. This is a significant reversion to the 1980s practice of evaluating (and limiting) executives by a fixed ratio between them and lower-paid workers.⁹⁵ In 2007, a growing number of boards have simply begun to bargain harder with their CEOs.⁹⁶

Even more significant than the above voluntary actions by boards following the high road of good governance is the remarkable way former recalcitrant boards are suddenly listening intently to the outcry of minority shareholders. Now, thanks to a new SEC rule, they are armed with minute details of executive pay, stock options, retirement pensions, and perks.⁹⁷ The rising transparency of board decisions has increased vocal shareholder demand for reform, giving rise to a discernible trend: boards will increasingly remove “insulation” from the wall that separates them from shareholders and insert the additional insulation into the wall that insulates them from the CEO’s influence and higher pay demands.⁹⁸

As demand for direct shareholder interface with boards grew, it was logical that large minority stockholders would lead the way. Recently, union pension funds, state pension funds, and mutual funds⁹⁹ have combined their voting power to pressure their corporate boards to trim extravagant CEO pay and needless perks. Sometimes when these groups see excessive executive

94. General Mills ordered its CEO to stop free personal rides on company aircraft. In January, 2007, Exxon Mobil and Lockheed Martin Corp. stopped paying CEO country club dues. Cf. “Full Disclosure,” *Wall Street Journal*, 13 January 2007, A1.

95. C. Levy, “Mack the Nice,” *Wall Street Journal*, 2 August 2007, A-10.

96. “Directors Enter Negotiations with Limits on Pay,” *Wall Street Journal*, 21 May 2007, B-1; “Boards Skip Stars,” *Wall Street Journal*, 21 May 2007, B1.

97. SEC Amend. to Item 402, Regulation S-K and S-B. The purpose was to provide investors with “more complete and useful disclosure.” The revised rule exceeds 450 pages. Firms must submit required information in their quarterly reports or in proxy statements. <http://www.sec.gov/rules/final/2006/33-8765> PDF. (accessed 27 July 2007).

98. Cf., Bebchuk & Fried, *op. cit.*, p. 11.

99. There are hundreds of mutual funds which hold millions of shares of virtually all listed stocks. For this reason it is difficult to get all of the funds to vote for reform measures. In 2006, 76% of shareholder-proposed resolutions were for governance reform, yet only 44% of mutual funds supported them. Often a particular fund will be the largest minority shareholder of a corporation. Though every mutual fund has a legal duty to vote in the interests of its own shareholders, sadly, they do not always vote in a responsible way. In 2006, voting records of 702 mutual funds showed that the largest funds voted mostly for management-sponsored issues. Fidelity and Vanguard, the largest, supported few shareholder proposals. Many funds delegate voting to service firms, “Market Summary,” *Houston Chronicle*, 14 March 2007, D4.

pay as a threat to their investment, they consolidate their votes and seek to elect a director to take their fight to the board room. In order to offset this growing aggression and to minimize fierce fights with activist shareholders seeking a board seat, many progressive companies¹⁰⁰ are exploring ways to give minority shareholders a greater voice in elections. Healthways Inc., Saks Inc., and many other firms have been considering expanding governance in the direction of ongoing dialogue with a *standing committee* of large minority shareholders.¹⁰¹

Minority stockholder views on CEO pay and other issues can be quantified by an *advisory shareholders vote* which tells the board the exact strength of their opinion. British law gave shareholders such an advisory vote in 2003. A refinement of this idea would encourage a large minority shareholder committee to prepare a ballot for more detailed compensation issues, such as (1) tougher performance targets for bonuses, (2) abolishing severance pay, (3) eliminating written contracts for executives, and (4) requiring CEOs to “serve at the will of the board.”¹⁰² The SEC has voted to place on its agenda (1) a provision allowing shareholders to change company bylaws to permit nomination of their own candidates for directors at the annual election, and (2) a plan to allow owners of five percent of stock to propose bylaw changes relating to elections.¹⁰³ Such rules would also strengthen shareholder activities. Until the Congress or the SEC mandates an advisory shareholder vote, an effective alternative is a well-timed press release.¹⁰⁴

100. The Carpenters’ union, U.S. Chamber, Citigroup Inc., and DuPont Co. have met to discuss executive compensation issues, “Managing,” *Wall Street Journal*, 16 July 2007, B4.

101. In 2006, United Health Group formed an advisory committee of large shareholders to placate their anger over the company’s stock option backdating scandal. Home Depot has been talking with big shareholders to establish a similar group. Many boards ask shareholders to mail nominations. “Theory & Practice,” *Wall Street Journal*, 16 April 2007, B3.

102. The CEO of General Electric, one of America’s largest conglomerates, serves “at the will of the board,” “Weekend Investor,” *Wall Street Journal*, 6 January 2007, B3. In 2007 activist investors have submitted proposals to 60 major corporations seeking to amend the bylaws to require an “advisory” shareholder vote on executive pay. Yale University’s Center for Corporate Governance Fellow Stephen Davis recently studied the U.K. experience and found that an advisory vote stimulated directors to link pay to performance. The U.K law granting a shareholders advisory vote on executive pay policies has generated improved shareholder-board discussion. “Managing,” *Wall Street Journal*, 26 February 2007, B1.

103. The company would also be required to disclose the identity of owners of 5% of stock. “Leading the News,” *Wall Street Journal*, 25 July 2007, A-3; July 26, 2007, A1.

104. The release announces that the group is withholding votes for compensation committee chairman because of the exorbitant executive pay, or any other objectionable feature of compensation system. Amalgamated Bank, Proxy Governance, and LongView Funds pooled their voting power with two unions, announced non-support for directors because homebuilder Toll Brothers Inc. was paying its CEO 565% above the median for peer companies (\$50 million in 2004, \$41 million 2005, and \$29 million in 2006). K. Whitehouse, “Second Shareholder Balks at How Toll Pays Officers,” *Wall Street Journal*, 28 February 2007, D8.

More recently, mutual fund companies, union pension funds, and 50 state pension funds that collectively hold trillions of dollars in corporate securities have cooperated to combine their shareholder voting power to pressure corporate boards to trim extravagant CEO pay plans¹⁰⁵ and needless perks.¹⁰⁶ But whether the recent minority shareholder efforts to reform corporate governance (so as to conform CEO pay to market levels) will succeed in the short run remains to be seen.

Sometimes trail-blazing Americans whose genius acquires billions have the common sense to give back fortunes which they can't keep in order to gain that which they can't lose—respect and gratitude of America's future generations. Rags-to-riches Andrew Carnegie, declaring “He who dies rich, dies disgraced,” and endorsing progressive taxation of incomes and estates, virtually invented American philanthropy. He gave over \$4 billion (in 2000 dollars) to build 3,000 libraries in 47 states. At death (1919), his last \$30 million also went to charities.¹⁰⁷ Since 2000, high profile wealth creators such as Bill Gates, Warren Buffet, and Oprah Winfrey¹⁰⁸ have followed the Carnegie path, giving billions to charitable trusts. They offer the advantage that donors with the ingenuity to accumulate vast wealth are better skilled to oversee its distribution, and federal estate taxes are avoided. In coming years, many more American billionaires will follow Carnegie's trail.

As boards see that the facts of executive compensation are now public; as their fiduciary duty prods them to hear and act upon the reasonable demands of organized minority shareholders; as the image of recent high-profile criminal trials for corporate fraud fixes itself in the minds of apathetic boards; as directors recognize that imperfect CEO labor markets enable them to save millions through arm's length bargaining; as government encourages board-shareholder interface; as boards follow corporate governance standards; as they rely on efficient market principles by returning to arm's length bargaining in CEO labor markets; disparate income and wealth can be rectified by the market—or by legislation if needed. Then corporate

105. “The Insiders,” *Wall Street Journal*, 13 March 2007, A1.

106. Starbucks in 2006 paid \$1 million for its CEO's personal flights and security services. Golf club membership, vacation trip costs are trivia for multi-billion-dollar business, but offend the public and investors. On extravagant perks, as Professor C. Elson, chair, University of Delaware Law School's corporate governance, said: “It's like taking the company car to Disney World. You don't do it.” “Market Summary,” *Houston Chronicle*, 30 January 2007, D7.

107 David Nasaw, *Andrew Carnegie*. N.Y., Penguin, 2006.

108 Oprah Winfrey earns \$260 million a year. *Houston Chronicle*, 27 July 2007, A2.

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growth can flourish, investor confidence return, and rank-and-file employees, outside shareholders, and the public can again have restored faith in the system's fairness.

TABLE 1

Share of Aggregate Income Received by Each Fifth and Top 5 % of Households: 1984 to 2005

| Year | Number Households (thous.) | 1 Lowest fifth | 2 Second fifth | 3 Third fifth | 4 Fourth fifth | 5 Highest fifth | X Top 5 percent |
|------|----------------------------|-------------------|-------------------|------------------|-------------------|--------------------|--------------------|
| 2005 | 114,384 | 3.4 | 8.6 | 14.6 | 23.0 | 50.4 | 22.2 |
| 2004 | 113,343 | 3.4 | 8.7 | 14.7 | 23.2 | 50.1 | 21.8 |
| 2003 | 112,000 | 3.4 | 8.7 | 14.8 | 23.4 | 49.8 | 21.4 |
| 2002 | 111,278 | 3.5 | 8.8 | 14.8 | 23.3 | 49.7 | 21.7 |
| 2001 | 109,297 | 3.5 | 8.7 | 14.6 | 23.0 | 50.1 | 22.4 |
| 2000 | 108,209 | 3.6 | 8.9 | 14.8 | 23.0 | 49.8 | 22.1 |
| 1999 | 106,434 | 3.6 | 8.9 | 14.9 | 23.2 | 49.4 | 21.5 |
| 1998 | 103,874 | 3.6 | 9.0 | 15.0 | 23.2 | 49.2 | 21.6 |
| 1997 | 102,528 | 3.6 | 8.9 | 15.0 | 23.2 | 49.4 | 21.7 |
| 1996 | 101,018 | 3.6 | 9.0 | 15.1 | 23.3 | 49.0 | 21.4 |
| 1995 | 99,627 | 3.7 | 9.1 | 15.2 | 23.3 | 48.7 | 21.0 |
| 1994 | 98,990 | 3.6 | 8.9 | 15.0 | 23.4 | 49.1 | 21.2 |
| 1993 | 97,107 | 3.6 | 9.0 | 15.1 | 23.5 | 48.9 | 21.0 |
| 1992 | 96,426 | 3.8 | 9.4 | 15.8 | 24.2 | 46.9 | 18.6 |
| 1991 | 95,669 | 3.8 | 9.6 | 15.9 | 24.2 | 46.5 | 18.1 |
| 1990 | 94,312 | 3.8 | 9.6 | 15.9 | 24.0 | 46.6 | 18.5 |
| 1989 | 93,347 | 3.8 | 9.5 | 15.8 | 24.0 | 46.8 | 18.9 |
| 1988 | 92,830 | 3.8 | 9.6 | 16.0 | 24.2 | 46.3 | 18.3 |
| 1987 | 91,124 | 3.8 | 9.6 | 16.1 | 24.3 | 46.2 | 18.2 |
| 1986 | 89,479 | 3.8 | 9.7 | 16.2 | 24.3 | 46.1 | 18.0 |
| 1985 | 88,458 | 3.9 | 9.8 | 16.2 | 24.4 | 45.6 | 17.6 |
| 1984 | 86,789 | 4.0 | 9.9 | 16.3 | 24.6 | 45.2 | 17.1 |

SOURCE: U.S. Census Bureau, Current Population Survey, 2006 Annual Social & Economic Supplements, located at http://pubdb3.census.gov/macro/032006/hhinc/new05_000.htm (Accessed 26 June 2007).

(Authors' note: Column 5 minus Column X = Percentage of Household Income received by the next 15% of Households just below the "Top 5%".)

APPENDIX A:

The Economics of Estimating a CEO's Marginal Product

Economic theory of the labor market is a useful framework to cast light on the problem of whether an award of stock options to a CEO is an effective measure of his or her *productivity*. In a competitive capitalistic economy, a worker (whether machinist, computer technician, or CEO) is paid according to his *marginal productivity*. In any firm, the *marginal product of a worker* is the increase in output of the last person hired. As long as hiring one more worker who will turn out a product—the *marginal product*--that produces more revenue than the *cost* of that labor, the employer will keep hiring until the revenue from the product of the last man hired just equals his cost. Obviously to avoid waste, the employer must be diligent to identify the marginal product of the last worker, and to keep track of the revenue derived from that product.

We can illustrate with an example of a *competitive labor market*, say, for farm workers who will be hired to knock almonds during the harvest. In a *competitive labor market* three conditions are present: (1) There are many buyers (almond growers) and sellers (almond knockers), (2) In the view of the employer almond growers, every farm worker is the same as every other worker, i.e., all the almond workers have the same qualifications of stamina to work 8 hours, good health, and the same degree of dexterity to carry long poles to knock down the ripe almonds unto the canvas on the ground. (3) There are no barriers to entry, i.e. no licenses, no educational requirement other than understanding English, no union to say: "For every 5 men you hire, you have to hire a supervisor who must be paid 20% more."

Now suppose Smith, a California almond grower has 100 acres of almonds, some ready to fall, some almost ready, for harvest. He hires 20 migrant farm workers at \$40.00 a day (\$5.00 an hour) to "knock almonds," harvesting those that are ripe, and later on as other sections of the orchard become ripe, the crew moves to harvest those. The average product per worker each day is 200 lbs of almonds. The market price of almonds is \$1,000 a ton. Smith doesn't hire a 21st worker, because there are not enough additional almonds ripening each day to be harvested. Since the marginal worker (#21) will not produce enough pounds of almonds (#21's marginal product) to cover his wages (after deducting depreciation of the orchard and equipment, and other costs), Smith will not hire #21.

Suppose, however, that #21 worker Joe comes to Smith and says: "I'll work for you on a per-pound basis. I'll go through the orchard and where the others have not knocked all the almonds down, glean them, and you give me \$32.00 for every 200 lbs. of almonds. Smith will hire Joe because the additional revenue Smith can get for selling his almonds to the wholesaler just equals the cost of Jones, the 21st man.

Estimating a CEO's Marginal Product

A CEO knocks heads instead of almonds, but his position in the more rarefied market for corporate bosses is still analogous. Indeed, more than one board of directors since 2005 has harvested more than one nut for a CEO. In hiring a CEO, every Board of Directors, like Smith,

must weigh the *cost* of the CEO (his salary plus perks) and attempt to evaluate his *marginal productivity*, i.e. how many gold nuggets (not almonds) will he bring in to increase the net profit of the corporation. One way directors can actuate the concept of a CEO's productivity (i.e. his *marginal product*) is to ask and diligently try to answer this question:

Since our last CEO has retired, and our Assistant to the President (or our next person below CEO) is temporarily now running the company, how much more profit above the \$70 million we just made last year, can we expect will be realized by hiring the CEO candidate who is now seeking the post and asking for salary plus perks of \$5 million? Answering the question would involve estimating the prospective CEO's *special skills* that could boost sales (*advertising, packaging*), generate revenue from new product development (*engineering, patent law*), expand new global markets (*prior international business experience, language skills*), and expand business by acquisition of subsidiaries (*finance, corporation & anti-trust law*).

If, like Home Depot's Nardelli, the corporate gross revenue is increased by \$200 million, but his bargaining skill in negotiating his contract included provision for severance pay of \$200 million, his "marginal product" is the same as that of a less skilled CEO who might have been hired, who probably couldn't produce an extra \$200 million of gross profit, but who wouldn't have negotiated a \$200 million bonus. Certainly most boards (albeit with less precision than an almond grower) must *weigh the estimated addition to net profit resulting from the CEO's special skills (his marginal product) against his salary plus options plus perks (his marginal cost)*.

How to Avoid Waste: Negotiate a CEO's Contract at the Low End of Scale.

Another *labor market failure* occurs when boards fail to negotiate skillfully, granting exorbitant pay packages with a total dollar cost at the top of the CEO range, instead of hiring at the lower end of the range. In each market for CEO labor there is indeed what labor economists call "a range of indeterminateness" which is often much wider than corporate directors realize. This range exists because there are actually hundreds of specialized markets for CEOs—not a single nationwide market. These specialized markets involve oligopolists (a few CEO sellers) and oligopsonists (a few corporate buyers). The main point here is that *the numerous specialized markets for CEOs are not governed by principals of competition, but by principles pertaining to what economists call "monopolistic competition."*¹⁰⁹

¹⁰⁹ The reasons that hundreds of little CEO oligopolistic markets in specialized industries throughout the United States do not meet the three standard characteristics of a *competitive* market are best explained by contrasting these markets with the above example of the farm workers harvesting almonds who were hired in a *competitive labor market*. There a single little grower facing a host of sellers of labor encountered a single \$32.00-a-day price (wage rate) that was *dictated by the market*. In contrast, the CEO labor market is not a single national market, but is made up of hundreds of little, specialized markets where CEO qualifications call for experience in a particular industry, and often require the specialized education of a physician, lawyer, engineer, C.P.A., or science Ph.D.

These specialized markets are not competitive markets because (1) there are *not* "many buyers and sellers." With a market for CEOs narrowed down to the specific industry of the company-employer (e.g., manufacturing, retailing, banking) the result is not one "CEO labor market" but many little separate markets. The market for "national office supply retailers," might consist of only 4 or 5 *corporate employer-buyers of CEO labor* in the nation. With the market limited to specific industries, there are likewise *not many sellers* of CEO labor in each of these narrow

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Because of the narrow industry qualifications, special experience and educational requirements required of a CEO candidate, a corporation will find that the resume of five candidates, their speech, experience, educational background, mannerism, personal life, will be entirely different. The result is that these 5 candidates are not in the same kind of direct competition with each other for the job, as the farm workers, who are looked upon by their prospective employer as having identical qualifications to do the required work. The fact that 5 CEO candidates *are not the same* is the reason that there is a “range of indeterminateness”—a low and a high—within which there is a promising opportunity to bargain. For example, suppose Candidate Al has 10 years of industry experience and asks for \$1 million a year. Candidate Bill has 13 years experience and is asking for \$1.2 million. The directors think the two are about equal, but Bill is the best choice. There’s an opening for the board negotiator to say: “The Board is very much impressed with you Bill, but we do have another candidate who is equally impressive and is asking for \$1 million salary. If you can see your way clear to drop to \$1 million, I believe the Board can be convinced to bring you aboard!”

In negotiations, there are dozens of such opportunities.

markets. (2) Recall that in the *competitive* farm labor market, all the laborers *appeared to the employer to look alike* in physical-work qualifications. The reverse is true in the various narrow CEO labor markets. Thus if Blue Shield Health Insurance was looking for a CEO, 5 existing CEOs of national health insurance companies might apply, and their background, characteristics, speech, education, will all be vastly different. Thus in CEO labor markets, all the sellers of CEO services do *not have identical job qualifications and so the corporate buyers see them as all being different, not the same*. (3) Recall that in competitive labor markets there are no barriers to entry. In CEO markets, employers’ requirement of industry experience and specialized training also constitutes a *barrier to entry for CEOs who do not have qualifications for a particular narrowly-defined industry markets*. Thus a nation-wide title insurance company’s requirement that its CEO be a real estate attorney would bar entry of scores of CEO candidates who are not lawyers.

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