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By Kevin Orfield

High executive compensation has grabbed headlines lately, with the SEC passing new rules calling for greater disclosure and Congress debating legislation to give shareholders "say on pay."

Congress has been under increasing public pressure to act. Since the early 1980s, compensation for top executives has soared from 30 to 40 times the average worker pay to more than 400 times average worker pay today. In 2005, chief executives at America's 500 biggest companies earned \$5.4 billion, or an average of \$10.9 million each.

But some would argue the wide disparity between executives and the average worker is nothing new. Bruce Ellig, BBA '59, MBA '60, retired corporate vice president of Pfizer and author of "The Complete Guide to Executive Compensation," cites George Washington as an early example. Washington made \$25,000 a year as our first president—many times the average annual salary of \$50 at the time.

Today, the president of the United States makes \$800,000, nowhere near the pay of CEOs at top companies, whose salaries approach the stratospheric level of entertainers and professional athletes. But that comparison's not new either. Babe Ruth once quipped about making more than President Herbert Hoover: "I had a better year than he did."

Like the Babe, Ellig is a big believer in performance-based pay. "I do not have a problem with very significant pay packages if they are tied to performance," he says. "But I have a problem if there's big pay and no performance."

One way companies are aligning pay with performance is by requiring CEOs to hold onto a significant portion of company stock they acquired until they retire. "This gives an executive an incentive to keep the stock price high, so they are working for the benefit of shareholders," explains Ellig. "Once the individual has sold the stock, there's no incentive to keep it up."

Barry Gerhart, professor of Management and Human Resources at the School of Business, explains that comparing CEO pay to shareholder return is more relevant than comparing it to worker salary. "On average, the growth of compensation and shareholder return are pretty much in alignment," he explains. "But this is not the case in all companies. High CEO compensation becomes an issue when the company isn't doing well and workers are asked to share the pain. Morale starts to take a hit when a CEO comes in and starts cutting benefits, jobs and pay, while he or she is doing very well financially."

Big jump in last quarter century

Concern about executive pay began to emerge in the early 1980s, when deep cuts in the top marginal federal income tax rate took effect. Until then, high top-bracket income tax rates—91 percent on income over \$400,000 until 1964 and 70 percent on income over \$200,000 until 1981—gave boards little incentive to offer million dollar pay packages since most of it would be taxed away.

CEO salaries really began to pull away from workers when compensation shifted from cash bonuses to stock options, especially during the boom market of the late '80s and early '90s. Salaries and cash bonuses accounted for 90 percent of executive pay during the early '70s, but by the mid '90s, stock represented 90 percent of compensation.

"Options ballooned in the '90s because people got it in their heads that if a little incentive was good, a lot of incentive was better, while losing sense that there was a

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3. **Henry R. Silverman**,
Cendant,
\$139.96 million
4. **Bruce Karatz**,
KB Home,
\$135.53 million

lot of risk," explains David Swinford, senior managing director, Pearl Meyer & Partners. Swinford spoke at last fall's Directors' Summit™, an annual corporate governance program offered by the Executive Education unit of the School of Business.

Benchmarking has played a significant role in driving up executive compensation says Jim Woodrum, program director of Mid-Management Development programs in the Executive Education unit of the School of Business. Woodrum was a longtime executive compensation consultant with Hewitt Associates LLC, and consulted with Fortune 500 companies. "Far more companies peg executive compensation at above the industry average than below industry average," Woodrum explains. "This has created a perpetual upward motion that has been continuing for the last 20 years."

Also contributing to escalating salaries is the ubiquitous notion that CEOs are worth almost any sum of money if they can turn a company around. "Boards are much more comfortable going out and finding a proven commodity than an untested, unproven one," says Woodrum. "And guess what? Proven commodities are expensive and you have to compensate them for the risk associated with moving from one company to another."

Today's trend is to grow a successor from within. "There's the strong sense that if you hire someone from the inside, you don't have to pay as much," explains Swinford. "Even if you provide the same salary, bonus and equity grant to an insider, you don't have to provide all the protections against failure. People promoted from within rarely negotiate against the board."

Congress takes aim at executive pay

Congress is also getting into the act. In March 2007, Representative Barney Frank, D-Mass., introduced legislation that would give shareholders a non-binding vote expressing approval or disapproval on a company's executive compensation program.

The law won't force corporations to redesign their pay packages, although a no vote would probably have that effect. "This approach of giving shareholders a greater voice has worked well in the United Kingdom," says Woodrum. "Boards are going to have a hard time ignoring shareholders."

Nevertheless, shareholders have reason to be concerned about any Congressional foray into trying to tame executive pay. "The problem is when you try to regulate things like compensation, there can be unintended consequences," says Gerhart. "A common concern, for example, is that if supply and demand no longer govern compensation, you could see a shift of some talent away from the CEO position and possibly create a shortage of qualified candidates. Also, companies are creative at getting around things such as wage and price controls and finding loopholes."

A classic example is Section 162(m) of the Internal Revenue Code. In 1992, Congress passed a provision limiting the tax deductibility of executive pay to \$1 million, and as a result, many CEO salaries immediately rose to \$1 million. Because the legislation contained an exception for performance-based pay, compensation began flowing into stock awards and options. Many companies simply bypassed the rule by setting easy-to-reach performance-based goals so they could deduct almost all executive pay.

While Congress debates Frank's legislation, the Securities and Exchange Commission has issued new rules requiring greater disclosure about executive pay, including pensions, deferred compensation and severance packages. "The SEC guidelines have already resulted in changes," says Swinford. "Companies are cutting back on golden parachute payments and perquisites."

Whatever changes are in store, some people will never be satisfied, says Swinford. CEO pay has become symbolic in the national debate about the concentration and distribution of wealth. But he is cautiously optimistic that enhanced disclosure and greater shareholder voice will result in more reasonable compensation packages.

"Better disclosure and access to the ballot at the annual meeting should help push pay away from entitlements toward performance-based compensation, such as incentive plans, that have really challenging goals and to equity programs that require shareholders to gain value as executives gain value," he says.

Kevin Orfield is a Wisconsin-based business writer.

5. **Richard S. Fuld Jr.**,
Lehman Brothers Holdings,
\$122.67 million
6. **Ray R Irani**,
Occidental Petroleum,
\$80.73 million
7. **Lawrence J. Ellison**,
Oracle,
\$75.33 million
8. **John W. Thompson**,
Symantec,
\$71.84 million
9. **Edwin M. Crawford**,
Caremark Rx,
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10. **Angelo R. Mozilo**,
Countrywide Financial,
\$68.95 million

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UPDATE
 5151 Grainger Hall
 975 University Ave.
 Madison, WI 53706-1323

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