Is Executive Pay Excessive?
By PETER F. DRUCKER
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Measured in constant after-tax dollars, incomes of corporation executives in the U S have been going down fairly steadily for the last 25 years. And the gap between the after-tax real income of top management people and of all other employes, from rank-and-file up through middle management, has been shrinking rather than widening during the same period

Yet almost no one knows the facts, and almost no one believes them What is widely believed is that executive compensation has been going up so fast as to have become "excessive," and that incomes within U.S. corporations are steadily becoming less rather than more equal

One reason for this widespread impression is inflation and the impact it has on incomes under our progressive tax system As money incomes rise, even though real incomes remain constant or go down, income tax rates go up

A rank and file worker in American industry today makes perhaps the money income he made 10 years ago, and with fringes his wage cost to his employer is at least two-and-a-half times what it was 10 years ago But his taxes have at least tripled, especially as state and local taxes in many places have been added on top of federal taxes. This ratchet action, however, does not affect the top income earners—the people with earned income of $100,000 per family or more. Their federal tax take is limited to 50% of their earned income.

The second reason why executive compensation is widely considered excessive is the widespread use of tax gimmicks. To shield executives from the rapacity of the tax collector, corporations have availed themselves of every "tax shelter" or "tax loophole" that the law (or lawyers) has created.

Stock options are just one example. Most executives know that the explanations given for these gimmicks are pure hokum. I have yet to meet an executive who really believes that stock options act as an "incentive" or promote performance. Everyone knows that they are tax avoidance, pure and simple Indeed, I have sat in on discussions between a company and an executive it wanted to hire which discussed *only* the net (after tax) sum which the executive was to receive and then turned the design of the right "package" over to the tax lawyers

Tax Gimmicks

But it is hard to resist temptation And so executive compensation plans have become festooned with tax gimmicks to the point where they have lost all shape and coherence.

The consequences have been far from wholesome. In a period of inflation, in particular, these tax gimmicks tend to impede responsible decisions. In the inflation years of the early and mid-'70s most companies knew that their published accounts misrepresented economic reality. They knew they showed "inventory profits," for instance, that were pure inflation; or that they showed profits that simply represented under-depreciation

Yet whenever someone wanted to adjust accounts to economic reality he was stopped, lest this interfere with the value of the executives' stock options or with their profit-sharing bonus "I would do it myself, of course," I have heard more than one chief executive officer say, "but I cannot do this to my colleagues "

Externally the effect has been much worse. These things create—and with good reason—the impression that executives are greedy, that they are out to fatten themselves at the expense of the business and that they are "ripping off" stockholders, employes and customers alike

At the same time, the tax gimmicks do not work. In the few companies I know which resisted the temptation to subordinate economic rationality to tax avoidance in structuring executive compensation—the few companies which just pay current cash or deferred cash, and nothing else—executives have fared no worse than in companies that made the tax lawyers rich

Oh yes, stock options worked beautifully during the bull market. But over a 10 year period, from 1966 to 1976 for instance, executives who did not have options, or phantom stock, or any of the other complicated tax-avoidance gimmicks, have probably done as well as executives under plans that most skillfully took advantage of every single tax loophole a benevolent government offered

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Finally, but perhaps most importantly, a very few top executives in a very few, very big companies have truly enormous earnings. A few—no more than 15 perhaps—have a total "compensation package" that comes to a million dollars or so, pre-tax. A larger number, although probably still no more than 1,000, have "compensation packages" with a total annual pre-tax value of $500,000 or more—including salary, bonus, stock options, retirement guarantees, severance pay and so on.

Economically, these few very large executive salaries are quite unimportant. Socially, they do enormous damage. They are highly visible and highly publicized. And they are therefore taken as typical, rather than as the extreme exceptions they are.

These few very large salaries are being explained by the "need" to pay "the market price" for executives But this is nonsense. Every executive knows perfectly well that it is the internal logic of a hierarchical structure that explains them. The foreman has to get $15,000 after fringes or $20,000 including fringes. And each level above the foreman has to get at least 40% more it is believed. If there are 30 levels, then the top man has to get $500,000 plus, not because this is his "market value," but because otherwise the foreman could not be paid his $15,000

Money is a status symbol which defines an executive's place in the corporate hierarchy. And the more levels there are, the more pay does the man at the top have to get

This rewards people for creating additional layers of management. I have seen it happen more than once A division general manager jacks up his own base-pay by 50% through "reorganizing" his division and creating five levels of management where there were three before.

Yet levels of management should be kept to the minimum An executive plan that rewards executives for adding on levels is a threat to the health of the organization itself. If very large salaries can be justified only because the logic of hierarchical level demands them, then perhaps the number of levels needs to be reduced. At the very least, there should be no reward for building levels—and the very large salaries are exactly that.

What needs to be done is fairly obvious

Business needs to take the initiative in eliminating, or at least in assuaging, the tax-ratcheting of lower and middle income earners in an inflationary era The one meaningful "tax reform," and incidentally the one on which unions would support business, is to adjust income tax rates to the rate of inflation. If this is not done, and soon, the 50% ceiling on the tax on earned income—that is the ceiling on tax on executive incomes—is almost bound to be done away with

Executives thus have a direct self-interest in removing the tax penalty on lower and middle incomes And such a reform would also be an effective way to restrain inflation by removing the incentive to government to raise revenues automatically by inflating the currency.

Radical But Necessary

Finally, the most radical, but also the most necessary innovation would be a published corporate policy that fixes the maximum compensation of all corporate executives, after all taxes but including all fringes, as a multiple of the after-tax and pre-fringe income of the lowest paid regular full-time employe

The exact ratio is less important than that there should be such a ratio. For a small business it might be 15-to-1, which would mean an after-tax compensation package of $150,000 to $180,000 or around $300,000 pre-tax—which is far more than small or medium-sized companies pay as a rule For the large company a $250,000 to $300,000 top net, after-tax compensation package—i e. a $400,000 to $450,000 pre-tax value—would represent a 25-to-1 ratio—and that would take care of all but a very small number of very large companies

But even a 30-to-1 ratio—equal today to $600,000 or so in pre-tax compensation including all fringes—would still be well below what employes, union leaders, college professors, newspaper reporters and middle managers today think the ratio is Most people put it at 50-to-1, or even at 100-to-1 A ratio of 25-to-1 is not "equality " But it is well within the range most people in this country, including the great majority of rank-and-file workers, consider proper and indeed desirable

There should, indeed there must, be exceptions A "star," whether the super-salesman in the insurance company or the scientist in the lab who comes up with half-a-dozen highly profitable research breakthroughs, should be paid without any income limitation

There should also, I am convinced, be a big extra award available for anyone, regardless of rank and title, who makes a truly extraordinary contribution, well beyond "the call of duty." Every organization needs the equivalent of the Congressional Medal of Honor or of the Victoria Cross

If and when the attack on the "excessive compensation of executives" is launched—and I very much fear that it will come soon—business will complain about the public's "economic illiteracy" and will bemoan the public's "hostility to business " But business will have only itself to blame. It is a business responsibility, but also a business self-interest, to develop a sensible executive compensation structure that portrays economic reality and asserts and codifies the achievement of U S business in this century: the steady narrowing of the income gap between the "big boss" and the "working man."

Mr. Drucker is Clarke Professor of Social Sciences at the Claremont Graduate School