

Should Maryland Reward Corporate Practices That Nurture Defective Enterprises?

Testimony on Senate Bill 395: Denial of Deduction
for Excessive Compensation of Officers and Directors

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Sam Pizzigati, Progressive Maryland

My name is Sam Pizzigati, and I currently sit on the board of directors of Progressive Maryland, our state's leading advocate for working families.

I'm here this afternoon, on behalf of Progressive Maryland, to urge the passage of Senate Bill 395, the legislation that Senators Pinsky and Madaleno have introduced to discourage excess in corporate executive compensation.

SB 395, if enacted, would deny corporations a state tax deduction on any executive compensation that runs over 30 times the pay of a company's "lowest paid full-time employee."

Why do we need this legislation? Simple economic justice, I could argue this afternoon, demands that we take this small, modest step toward encouraging more equity in corporate compensation. I certainly believe this to be the case.

But I don't want to talk about economic justice this afternoon. I want to talk instead about management science, the academic discipline that has generated incredibly rich research, over recent decades, about the factors that make enterprises effective and efficient.

This research ought to matter, and matter deeply, to anyone who cares about our state's economic future. We need the enterprises that do business here in Maryland to be effective enterprises. The more effectively our enterprises operate, the more wealth they will create, the higher the standard of living for all Marylanders can become.

So what does the effective enterprise research tell us?

We live in a new "Information Age," this research reminds us, an age that places a premium on customizing products to individual consumer needs — and figuring out how to produce these customized products faster, smarter, and ever more efficiently.

Effective corporations can best succeed at these tasks, researchers have found, by actively involving their employees. Who, after all, better understands what customers want than employees at the front lines, in direct customer contact? And who better to help figure out how to produce more efficiently than workers directly involved in a company's producing?

Effective enterprises, consequently, value the information — and wisdom — that employees have to offer. They tap this knowledge by actively involving employees in decision making, by working to flatten the corporate hierarchies that inhibit communication and frustrate creativity.

American business faces, in short, an Information Age imperative to create — and nurture — enterprises that involve employees and respect the work they do.

Unfortunately, Corporate America's current compensation practices have exactly the opposite effect. These practices — by concentrating rewards in the pockets of top executives — send the message that only executives really matter.

Think about it. Top executives in the United States now routinely make more in a morning than their workers make in an entire year. If my CEO's work is worth several hundred times more than my work as an employee, then how much value can there be to my work?

Peter Drucker, the eminent founder of modern management science who died just over a year ago at the age of 95, believed that corporations ought to compensate top executives at no more than 20 times their worker pay.

Drucker first began urging a 20-to-1 ratio in the early 1980s, at a time when major corporations were typically paying their executives about 40 times over what they paid their workers.

How distant those 40-to-1 days seem today. Last fall, I edited the annual *Executive Excess* CEO pay survey published by the Institute for Policy Studies and United for a Fair Economy. In 2005, this study documented, top CEOs averaged 411 times the pay of their workers, almost quadruple the 107-to-1 ratio that existed back in 1990.

Let's give these numbers a human face.

In 1975, Reginald Jones, then the CEO at General Electric and widely regarded, in business circles, as the nation's most talented chief executive, took home \$500,000, a sum that equaled 36 times the income of that year's typical American family.

In 2000, the most widely acclaimed executive in the United States would be Jack Welch, who also happened to be the CEO at General Electric. Jack Welch took home \$144.5 million in 2000, a sum that equaled 3,500 times the income of that year's typical American family.

Corporate boards and their flacks have engaged in all sorts of verbal gymnastics to justify today's enormous concentration of wealth at the top of our corporate ladder. Executive windfalls, they assure us whenever share prices rise, represent a fitting reward for outstanding performance.

And if share prices fall? We must reward executives handsomely anyway, we are told, or risk losing their talents to some other company.

In other words, “heads” executives win, but “tails” executives win, too.

The rest of us lose. We lose because excessively wide pay gaps within our corporations nurture defective, not effective, enterprises.

So what can we in Maryland do about all this? Legislators in Maryland cannot, of course, dictate to major national corporations what they pay their executive elite.

But Maryland legislators can certainly stop rewarding corporations that concentrate rewards at the top.

Under our current state tax code, these rewards flow freely. The more in “incentives” that corporations lavish upon their executives, the more they can deduct off their taxes. Average Maryland taxpayers, in effect, are subsidizing CEO pay excess.

Now apologists for the CEO pay status quo regularly insist that our economy will ground to a virtual halt if we take any action that limits “incentives” to perform.

As a society, I agree, we do need incentives. But that doesn’t mean that all incentives make equal sense. Do we want our teachers, for instance, to give \$100 bills to students who get A’s on their report cards? Of course not. If teachers gave out \$100 bills, the pressure to cheat would become enormous. Classrooms would become cutthroat environments.

The wrong incentives can create cutthroat environments in the corporate world, too. The more grotesquely huge that rewards at the top of the corporate ladder become, the more grotesquely corporate executives behave to win those awards.

We see this dynamic all around us. Top executives are rushing into foolish mergers that leave employees without jobs and consumers with higher prices. They are investing less in research. They are raiding pension funds. And, if all else fails, they are cooking their corporate books.

In 2002, the annual *Executive Excess* study found that the CEOs of companies under investigation for shady accounting practices earned 70 percent more than average CEOs.

In 2003, this study’s next edition documented that the biggest paychecks in Corporate America are going to CEOs at the companies that have downsized the most workers, shorted pension funds the most dollars, and exploited loopholes to avoid the most taxes.

In 2004, *Executive Excess* researchers revealed that executives at the companies that did the most outsourcing of jobs saw their personal compensation increase by over five times as much as the overall executive pay average increase.

Our top executives today seem to be devoting more energy to manufacturing fortunes — for themselves — than to manufacturing quality products. These executives are regularly making decisions that sacrifice long-term enterprise health for short-term gains that benefit, first and foremost, their personal bottom lines.

One of our nation's most astute business observers, the investor Warren Buffett, has suggested that our willingness as a nation to curb CEO pay excess may well be “the acid test of corporate reform.”

We are flunking this test.

Now we have an opportunity, here in Maryland, to begin to change all that. SB 395 would help Maryland make some long overdue corporate reform history.

Let us send our corporations a simple message. We want you to succeed. We want you to operate effectively and efficiently. We want you to take to heart the enterprise lessons that management science has to offer. But if you choose to ignore these lessons, if you choose to lavish far more rewards on your elite executives than your workers, don't expect a pat on the back — or tax breaks — from the great state of Maryland.

Thank you.