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Fairness Considerations and the Growing Executive/ Employee Wage Gap

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In March 1993, the *New York Times* reported major layoffs of employees at IBM along with a report on the multimillion-dollar compensation package of its new CEO, including a \$5 million signing bonus (Ciulla, 2004). Little did anyone know at the time that events like this would become the norm, rather than the exception, in corporate America. As early as the 1980s, CEO after tax salaries rose by a factor of two-thirds while the take home pay of average workers dropped by about 7% (Gordon, 1996). During the 1990s, a survey of over 360 of the nation's largest corporations disclosed that corporate profits and CEO compensation soared, while worker pay decreased or remained stagnant and layoffs increased (Aslam, 1999; Cooper, 1998; Wolman & Colamosca, 1997).

2005 was a watershed year for top American executives. Median CEO compensation for the nation's top 100 companies rose another 25%, and a record number of CEOs broke the \$100 million mark for total compensation (Strauss & Hansen, 2006). At the same time, the pace of layoffs, downsizing, loss of jobs to foreign countries, loss of health and pension benefits, and the wage gap between average workers and top executives increased (Strauss & Hansen, 2006).

Cooper (1998) states that "tax policies and the use of stock options as part of corporate executives' compensation packages are helping to divert a growing portion of the nation's wealth to the richest Americans and away from the poor and the middle class" (p. 337). The value placed

on top business executives continues to climb, apparently at the expense of the average worker. Executives' living standards have become lavish; some executives are among the wealthiest people in the country. Workers, on the other hand, face increasing uncertainty, instability, and financial risk.

McCall (2004) reports that "in 1981, the average pay for the top ten CEOs [in the country] was \$3.5 million; in 2001, it was \$155 million" (p. 245). This is an increase of 4429% over that time period. Consider also that executives typically

get medical insurance, nonperformance and performance related bonuses, stock options, restricted stock grants (where full ownership of the equity vests over a specified time period), pension contributions, guaranteed separation payments, loans (often at below-market rates), the ability to defer compensation at guaranteed rates of return (and to shelter that compensation from taxes), life insurance contracts, and frequently other perquisites such as cars, club memberships, housing allowances, and so on. (McCall, 2004, p. 246)

On average, CEO compensation is rising much faster than corporate profits, and in certain cases, it is rising in spite of falling profits (Cooper, 1998; Lavelle, 2002; Lublin, 2006; "Share and Share Unalike," 1999). Unbelievably, executives often reap huge rewards from their organizations at the same time those organizations

suffer incredibly poor performance (Ciulla, 2004; Lavelle, 2002; Strauss & Hansen, 2006). In fact, McCall (2004) reports studies that show “no significant link between a firm’s performance relative to its peers and increased executive compensation” (p. 247).

For example, during Roger Smith’s reign over General Motors, the company lost 20% of its market share, yet he continued to reap millions in compensation from the company and received a retirement package of over a million dollars per year (Ciulla, 2004). Likewise, at a time when United Airlines’ profits dropped by 71%, the CEO received compensation of 1,200 times that of new flight attendants (Ciulla, 2004). This disconnect between pay and performance is due in part to the fact that executives are in a better position to influence their compensation packages than are average workers (McCall, 2004).

An exclusive club mentality drives the membership and relationships of most boards and their executives. On average, executives and board members enjoy relatively cozy relationships. Frequently, a group of CEOs will sit on each others corporate boards, and social and political concerns may play a significant role in the approval of compensation packages over performance-driven criteria (Chingos & Doubleday, 2004; “CEOs: Why They’re so Unloved,” 2002; Lublin, 2006; McCall, 2004; Strauss & Hansen, 2006). For example, the re-pricing of stock options after a decline in stock price to insure that executives can withdraw equity from the company has been common practice in recent years, as has been the downward adjustment of performance targets to insure payment of executive bonuses.

The option-grant component of executive pay is also thought to have played a causal role in the corporate financial and accounting scandals of recent years (McCall, 2004). The temptation of short-term rewards provides executives with an incentive to manipulate short-term increases in stock price either through efforts that have long-term negative consequences for the organization or through creative accounting (McCall, 2004). Needless to say, all of this can add up to devastatingly bad results for the stakeholders.

At the same time that CEOs are reaping huge rewards based on a rationale of self-interest, employees are expected to deny their self-interests for the benefit of organizational interests and goals (Ciulla, 2004). If the pay of the average worker had increased at the same rate as CEO compensation, then in the year 2000 the average nonagricultural, nonsupervisory worker would have made \$120,000 instead of \$24,600 (McCall, 2004). Instead, real

wages generally have been decreasing since the early 1970s. In 1994 dollars, between 1972 and 1994 the buying power of the average worker dropped by more than \$4,200 per year (Gordon, 1996). Company provided health and pension benefits are disappearing and early-out programs are now commonplace (Wolman & Colamosca, 1997). Additionally, workers who lose their employment through downsizing eventually find other full-time work, but at about half of their previous salary, and even profitable companies are reducing employee wages by up to 40% (Thurow, 1996). Those who are forced into part-time, temporary, and contract work typically earn wages far below their previous earnings, and the probability of these people having pensions or health benefits is less than a third that of full-time workers (Thurow, 1996). For many, the dream of a comfortable retirement has slipped away.

Applicable Theory

“The widening wage gap between senior management and average workers is perhaps the most blatant unfairness” (Dalla Costa, 1998, p. 161). Executives who have the power to maximize their own compensation and minimize worker compensation, thereby enhancing their own wealth disproportionately to the levels of contribution and risk associated with their organizational duties, are engaged in a form of theft which is patently unfair (Dalla Costa, 1998). Clearly, “fairness considerations . . . suggest that executive compensation has become morally distorted” (McCall, 2004, p. 253).

Stabile (2002) suggests that “the real reason such a huge and widening gap in pay between executive and rank and file workers exists is market failure in the mechanisms of setting executive pay, aggravated by the shareholder primacy norm” (p. 115). Rising executive compensation is driven primarily by option grants. The rationale behind using option grants as a significant portion of executive compensation is the belief that alignment of executives’ interests with those of shareholders will motivate executives to achieve the financial success sought by shareholders and the financial markets. Likewise, the rationale behind minimizing worker compensation is maximizing profit and thereby shareholder value. However, McCall (2004) suggests “there are serious moral questions to be raised about an exclusive focus on shareholder wealth” (p. 248). Such a focus, and alignment of executives’ personal goals with those of shareholders, ignores the inherent incongruence between the one-dimensional nature of the shareholder’s interest in an organization versus the multidimensional responsibilities of executives.

Executives can be considered fiduciaries of shareholders, but that does not mean they have the right or the obligation to increase share value by any available means (Ciulla, 2004; McCall, 2004). Ethical leadership includes both the results sought and the means used to achieve those results. Share value must be increased in ways that reflect the leader's moral obligation to respect the rights of nonshareholder stakeholders, such as employees and customers (McCall, 2004).

When a leader acts out of one-dimensional self-interest, the probability that his or her decisions and actions will result in benefits for all stakeholders is low (Ciulla, 2004). Moral leadership implies a duty to all stakeholders and includes the ability to defer short-term lower-order needs, wants, and desires in favor of higher-order goals and values (Ciulla, 2004). Such leaders recognize the interdependent nature of stakeholder relationships, and the need for equity in nurturing those relationships (Dalla Costa, 1998). They temper self-interest with patience, concern, and caring for the interests of other stakeholders. They understand that the balance between competing interests leads to maximization of overall results for all stakeholders over the long term.

Such moral capacity is particularly necessary when significant tradeoffs must be made or moral dilemmas must be confronted. In fact, deferring self-interest in favor of the greater good is rational behavior for a truly virtuous leader. Self-sacrifice conveys to followers the importance of the common cause, and from a utilitarian perspective, the leader may then garner more respect, loyalty, and trust from followers, which enhances the probability of long-term success for the organization as a whole, and thereby for all stakeholders (Ciulla, 2004).

Critical to the quality of the leader-follower relationship is the perception each has of the other (Ciulla, 2004; "CEOs: Why They're so Unloved," 2002). Fairness concerns mandate that workers deserve compensation in proportion to their contributions to the organization (Dalla Costa, 1998). Disturbingly, the widening wage gap can result in a power distance, which causes executives to devalue or ignore altogether the worth of the average worker, thus manipulating them as mere objects (Ciulla, 2004). This drives perceptions of inequity and unfairness among employees, thus increasing turnover rates and decreasing employee trust, loyalty, and productivity (McCall, 2004; O'Reilly, 1997).

When assessing the growing wage gap, one must also consider the negative effects on other stakeholders. For shareholders, stock value dilution is a negative

consequence of multi-million dollar stock grants that often goes unnoticed (McCall, 2004). Also, a sole focus on short-term profitability can cause insufficient investment in longer-term initiatives thereby resulting in long-term damage to the organization and thereby to the shareholders (McCall, 2004). Additionally, the detrimental impact on employees discussed above has an indirect negative impact on shareholders due to the less than efficient, effective, productive work environment that results when employee morale suffers and turnover is high. Finally, customers suffer when employees are not fully committed participants in a business enterprise. Like a row of dominoes, the increasing wage gap can create negative effects among all who interact with the organization in question.

The Costco and Wal-Mart Comparison

The Costco Model

Costco's corporate philosophy includes the belief that "a loyal, well-compensated workforce means a more efficient and productive one" (Herbst, 2005, ¶ 1). The company pays its average workers a living wage of about \$17.00 per hour (Crystal, 2005; Herbst, 2005), well above the industry average. Its turnover rate is about 22% as compared to the industry average of about 65%, and its labor costs are about 9.8% of revenues (Herbst, 2005).

Costco's CEO total compensation averaged about \$1.5 million per year over the last five years, while the share-price increased by about 69% over the same time period ("NASDAQ Stock Performance History," 2006; Institute of Policy Studies, 2005). Costco's ratio of CEO pay to average U.S. worker pay is about 44 to 1 (Institute of Policy Studies, 2005).

The Wal-Mart Model

Wal-Mart is frequently criticized for not paying its workers a living wage. "[M]any employees of the world's largest company must rely on government healthcare, food, housing, and other aid . . . [They] receive on average \$2103 per year in federal subsidies" (Institute of Policy Studies, 2005). The company pays its average workers about \$10.00 per hour (Crystal, 2005; Herbst, 2005), which puts most of its employees under federal poverty limits. Its turnover rate is about 50% as compared to the industry average of about 65%, and its labor costs are about 17% of revenues (Herbst, 2005).

Wal-Mart's CEO total compensation averaged about \$22 million per year over the last 5 years, while the share-price suffered about a 25% loss over the same time period ("NASDAQ stock performance history," 2006; Institute of Policy Studies, 2005). Wal-Mart's ratio of CEO pay to

average U.S. worker pay is about 871 to 1 (Institute of Policy Studies, 2005).

Discussion

Why is it that Costco pays almost twice as much to average workers as Wal-Mart, yet has lower labor costs as a percentage of revenues? Both companies have lower than industry-average turnover rates, but Costco's is less than half of Wal-Mart's. The cost savings to Costco associated with relatively low turnover contributes significantly to its bottom line. In addition, why does Costco's market value appear to be relatively strong compared to Wal-Mart? Of course, there are many different factors that influence the ups and downs of these numbers, but I propose that Costco's emphasis on corporate social responsibility, including good old-fashioned fairness, plays a very significant role in Costco's relative success.

Consider the rationale of aligning executives' interests with shareholders interests by granting executives huge stock option packages. This philosophy taps into the executive's basal qualities, such as greed, and selfishness. And with which subgroup of shareholders are the executive's interests to be aligned: the shareholders with long-term goals including company stock as part of their retirement plans or the day traders? This rationale is simplistic and flawed. Chief executives have (or should have) broader interests and responsibilities than shareholders, and the stock-grant bribe just do not reflect those broader responsibilities. This is showing up in Wal-Mart's share price over time. On the other hand, Costco's concern for the longer-term health and well-being of the company and for the stakeholders is also showing up in its share price over time.

Wal-Mart shareholders are being treated unfairly via the huge disparity between compensation of Wal-Mart's top executives and that of average workers. The value of shares is diluted considerably every time an executive exercises a multimillion-dollar option grant, thus decreasing shareholder wealth. Also, short-sighted strategies that focus on short-term profits and share value, including minimizing worker compensation, typically hurt companies over the long haul. Without a change of course, Wal-Mart will eventually pay the price for its unfair policies. Consider that Eastern was once the country's most successful airline, and Wang was once the hottest new name in computers. Where are these companies now?

Regarding fairness toward employees, Wal-Mart shareholders take yet another hit. Employees who cannot afford the basic necessities of life for their families cannot be fully motivated, loyal, productive, and consciously present at their jobs. The shareholders pay the price as

evidenced by Wal-Mart's relatively high cost of labor as a percentage of revenue; even though Wal-Mart pays less than Costco, Wal-Mart employees are not as productive as Costco employees. This is an anchor on Wal-Mart's return on assets.

Wal-Mart's current CEO, Lee Scott, once commented that people never have and never will make better than average wages in the retail industry (Herbst, 2005). Yet Scott himself, a member of the retail industry, is making much better than average wages; he contradicts himself via his own pay package. Moreover, Wal-Mart's employees suffer with below-average wages, and poor benefits if any at all. By engaging in double standards, Scott alienates his workforce and loses their loyalty.

Consider what the disparity at Wal-Mart does to the company as well as to the employees and their families. Employees who suffer financial stress also suffer from low morale, if not depression. Poor morale at work means low productivity, which hurts the company over the long run. Employees are unlikely to be at their best when dealing with customers, suppliers, each other, and the community at large. Many are on government assistance and have no hope of making ends meet. The stress they suffer is evidenced by the high turnover rate of about 50% per year at Wal-Mart. For many of these people who are stressed out and without much hope for the future, the probability of the occurrence of spousal and child abuse, divorce, bankruptcy, and drug and alcohol abuse, is higher than in families that earn a living wage. If all of this is true, then clearly Wal-Mart is engaged in basic unfairness in not paying employees a living wage, and is exacting a huge price in terms of societal distress at the same time.

Costco, on the other hand, is in the enviable position of attracting many more applicants for its openings than the company can accommodate. Costco workers can expect to cover their basic needs and avoid the financial stress that comes from not being able to make ends meet. They have health insurance for their families, may be able to send their children to college. They can have hope for a brighter future, and, thus, are more likely to be motivated, loyal, productive, and fully focused on their jobs to the significant benefit of the long-term health and well-being of the organization. Costco's CEO, James Sinegal, has made it very clear, in response to pressure from Wall Street to reduce employee pay, that he will not betray Costco's employees for short-term gains and risk long-term decay of the company; he is in it for the long haul (Herbst, 2005)

Sinegal's relatively small executive pay package reflects his concern for equitable treatment of stakeholders, and

the impact of this is not lost on employees. Knowing that they make higher than average income while Sinegal makes lower than average income has created a culture of mutual trust, respect, loyalty, devotion, and commitment at Costco that obviously pays dividends for the company. This is something that is substantially missing from Wal-Mart's culture. To be fair, compensation needs to be proportionate to one's contribution to the enterprise. Sinegal recognizes the value that each and every employee brings to Costco; he recognizes that he cannot do it all himself and that the quality and dedication of employees are major factors in Costco's success. As such, he does not seek all the glory for Costco's success, refuses annual bonuses during down years, and pays himself only what he believes is fair even when his board offers him increases. In fact, he has been known to spend a lot of time down on the floor helping customers and cleaning up.

Sinegal seems to understand the systemic interdependence among stakeholders, and the importance of treating all stakeholders with fairness and concern for their rights as human beings. Beneficial synergies can occur in a culture like that of Costco. When people are respected and treated fairly, and when they feel like they are part of a win-win formula, they are able to let their guards down and focus on organizational goals. On the other hand, when people are used by others, and when they feel like they are part of a win-lose formula, they are constantly on guard, on the edge, unmotivated, and ready to give up at the drop of a hat.

In the long-run, everybody pays at Wal-Mart, and everybody wins at Costco. Customers, although enamored with Wal-Mart's low prices, do not receive the level of service they deserve, which ultimately hurts the enterprise and shareholders. Likewise, Wal-Mart's low prices are at least in part based on lower quality products than one might purchase elsewhere, which can hurt the enterprise over the longer-term. Because of Wal-Mart's obsession with cost cutting, suppliers are subjected to heavy price-pressure. This most often guarantees that Wal-Mart gets the better end of the deal, and sometimes puts the

economic health of the supplier in jeopardy. As for the broader community, all its members pay when a company's employees need government assistance, and we all suffer a bit when members of our communities have financial and related personal problems.

Costco has embarked on a socially responsible course that includes concern for basic fairness and equity in its relationships with stakeholders. It seeks to close the gap between the *haves* and the *have nots* and share wealth in a way that guarantees equitable distribution of resources for all; the benefit of some does not at the expense of many. Wal-Mart, on the other hand, is engaged in a more limited societal role that does not appear to include basic fairness and equity concerns toward all of its stakeholders. Wal-Mart seeks to perpetuate a system of resource distribution that is patently unfair and rewards the few at the expense of the many. This system may be unsustainable over the long term. Society benefits when socially responsible organizations continue to evolve and develop a model for others to follow.

Conclusion

Generally speaking, the current disparities in executive and employee wages are inherently unfair and are not based on any defensible rationale. Executives are exploiting the power and control they have in organizations through their exorbitant compensation schemes, and employees are being subjected to abuses because of the lack of power and control they have in the organizational world. I believe that this trend is unsustainable. The short-term focus on share value and profitability comes at the expense of the long-term financial health and well-being of organizations. Therefore, over the long-term, these practices will put U.S. companies at greater competitive disadvantage with respect to foreign companies than is now the case. In the long run, socially responsible companies like Costco are bound to possess the formula for true enduring success, where companies like Wal-Mart risk eventual decay based on practices that are inherently unfair to some, if not all, of its stakeholder groups.

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Biography

Michael J. D'Amelio is a cum laude graduate of the School of Engineering at the University of Massachusetts in Amherst and a graduate of the Arizona State University College of Law in Tempe. He has held various positions in business and industry over the last two decades, including engineering, legal, and senior administrator positions. He also served as an adjunct professor of Justice and Legal Studies at Phoenix College in Arizona.