The Washington Post

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With executive pay, rich pull away from rest of America

By Peter Whoriskey,

It was the 1970s, and the chief executive of a leading U.S. dairy company, Kenneth J. Douglas, lived the good life. He earned the equivalent of about $1 million today. He and his family moved from a three-bedroom home to a four-bedroom home, about a half-mile away, in River Forest, Ill., an upscale Chicago suburb. He joined a country club. The company gave him a Cadillac. The money was good enough, in fact, that he sometimes turned down raises. He said making too much was bad for morale.

Forty years later, the trappings at the top of Dean Foods, as at most U.S. big companies, are more lavish. The current chief executive, Gregg L. Engles, averages 10 times as much in compensation as Douglas did, or about $10 million in a typical year. He owns a $6 million home in an elite suburb of Dallas and 64 acres near Vail, Colo., an area he frequently visits. He belongs to as many as four golf clubs at a time — two in Texas and two in Colorado. While Douglas's office sat on the second floor of a milk distribution center, Engles's stylish new headquarters occupies the top nine floors of a 41-story Dallas office tower. When Engles leaves town, he takes the company's $10 million Challenger 604 jet, which is largely dedicated to his needs, both business and personal.

The evolution of executive grandeur — from very comfortable to jet-setting — reflects one of the primary reasons that the gap between those with the highest incomes and everyone else is widening.

For years, statistics have depicted growing income disparity in the United States, and it has reached levels not seen since the Great Depression. In 2008, the last year for which data are available, for example, the top 0.1 percent of earners took in more than 10 percent of the personal income in the United States, including capital gains, and the top 1 percent took in more than 20 percent. But economists had little idea who these people were. How many were Wall street financiers? Sports stars? Entrepreneurs? Economists could only speculate, and debates over what is fair stalled.

Now a mounting body of economic research indicates that the rise in pay for company executives is a critical feature in the widening income gap.

The largest single chunk of the highest-income earners, it turns out, are executives and other managers in firms, according to a landmark analysis of tax returns by economists Jon Bakija, Adam Cole and Bradley T. Heim. These are not just executives from Wall Street, either, but from companies in even relatively mundane fields such as the milk business.

The top 0.1 percent of earners make about $1.7 million or more, including capital gains. Of those, 41 percent were executives, managers and supervisors at non-financial companies, according to the analysis, with nearly half of them deriving most of their income from their ownership in privately-held firms. An additional 18 percent were managers at financial firms or financial professionals at any sort of firm. In all, nearly 60 percent fell into one of those two categories.

Other recent research, moreover, indicates that executive compensation at the nation's largest firms has roughly quadrupled in real terms since the 1970s, even as pay for 90 percent of America has stalled.

This trend held at Dean Foods. Over the period from the '70s until today, while pay for Dean Foods chief executives was rising 10 times over, wages for the unionized workers actually declined slightly. The hourly wage rate for the people who process, pasteurize and package the milk at the company's dairies declined by 9 percent in real terms, according to union contract records. It is now about $23 an hour.

"Do people bitch because Engles makes so much? Yeah. But there's nothing you can do about it," said Bob Goad, 61, a burly former high school wrestler who is a pasteurizer at a Dean Foods plant in Harvard, Ill., and runs an auction business on the side to supplement his income. "These companies have the idea that the only people that matter to the company are those at the top."

Through a spokesman, Engles declined to be interviewed. Company officials threatened to call the police as a reporter was interviewing workers outside one of its dairies.

Defenders of executive pay have argued that today's chief executives are worth more because, among other things, companies are larger and more complex.

But critics question why so much of the growth in income should go to the wealthiest. Douglas, the Dean Foods chief from the '70s, died in 2007. But his son, Andrew Douglas, said his father viewed wages in part as a moral issue.

If his father had seen how much executives were making today, Andrew Douglas said, he'd be "spinning in his grave. My dad just believed that after a while, what else would you need the money for?"

Inherent inequality

Inequality, economists have noted, is an essential part of capitalism. At least in theory, "the invisible hand," or market system, sets compensation levels to lead workers into pursuits that are the most productive to society. This produces inequality but leads to a more efficient economy.

As a result, economists have noted, there is an inherent tension in market-oriented democracies because while society aims to endow each person with equal political rights, it allows very unequal economic outcomes.

"American society proclaims the worth of every human being," economist Arthur M. Okun, former chairman of the Council of Economic Advisers, wrote in his 1975 book on the subject, "Equality and

Efficiency.” But the economy awards “prizes that allow the big winners to feed their pets better than the losers can feed their children.”

Americans have been uneasy about the income gap at least since the ’80s, according to polls.

Repeated surveys by the National Opinion Research Center since 1987 have found that 60 percent or more of Americans agree or strongly agree with the statement that “differences in income in America are too large.”

The uneasiness arises out of the fear that extremes of wealth can unfairly reduce the economic opportunities and political rights of everyone else, according to sociologists. The wealthy, for example, can afford better private schools for their children or acquire political might by purchasing campaign advertising or making campaign donations. Moreover, as millions struggle to find jobs in the wake of the recession, the notion that the very wealthiest are gaining ground strikes some as unfair.

“Americans think income inequality is excessive and have done so consistently for years,” said Leslie McCall, a sociology professor at Northwestern University who is writing a book on the subject. “Their concerns arise when it seems that extreme incomes for some are restricting opportunities for everyone else.”

Whatever people think of it, the gap between the very highest earners and everyone else has been widening significantly.

Income inequality has been on the rise for decades in several nations, including the United Kingdom, China and India, but it has been most pronounced in the United States, economists say.

In 1975, for example, the top 0.1 percent of earners garnered about 2.5 percent of the nation’s income, including capital gains, according to data collected by University of California economist Emmanuel Saez. By 2008, that share had quadrupled and stood at 10.4 percent.

The phenomenon is even more pronounced at even higher levels of income. The share of the income commanded by the top 0.01 percent rose from 0.85 percent to 5.03 percent over that period. For the 15,000 families in that group, average income now stands at $27 million.

In world rankings of income inequality, the United States now falls among some of the world’s less-developed economies.

According to the CIA’s World Factbook, which uses the so-called “Gini coefficient,” a common economic indicator of inequality, the United States ranks as far more unequal than the European Union and the United Kingdom. The United States is in the company of developing countries — just behind Cameroon and Ivory Coast and just ahead of Uganda and Jamaica.

Democratic leaders, whose constituents have expressed more alarm over the divide, have used the phenomenon to justify their policies, such as universal health care.

“A nation cannot prosper long when it favors only the prosperous,” President Obama said in his inaugural address.

Breakdown of earners

But exactly what the government ought to do about the income gap hasn't been clear, because economists have been divided over what is causing it to grow.

They weren't even sure, for example, who was making all that money. Sure, people like Bill Gates and LeBron James made lots. But it wasn't at all clear who the other roughly 140,000 earners were in the top 0.1 percent — that is, people earning about $1.7 million a year, including capital gains.

Then, late last year, economists Bakija, Cole and Heim completed their massive analysis of income tax returns.

Little noticed outside academic circles, their research focused on the top 0.1 percent of earners. From those tax returns, they could glean a taxpayer's occupation, which is self-reported. Using the employer's tax identification number, the researchers found the industry they were employed in.

After executives, managers and financial professionals, the next largest groups in the top 0.1 percent of earners was lawyers with 6.2 percent and real estate professionals at 4.7 percent. Media and sports figures, who are often assumed to represent a large portion of very high-income earners, collectively made up only 3 percent.

"Basically, executives represent a much bigger share of the top incomes than a lot of people had thought," said Bakija, a professor at Williams College, who with his co-authors is continuing the research. "Before, we just didn't know who these people were."

Acceptable greed

Defenders of executive pay argue, among other things, that the rising compensation is deserved because firms are larger today. Moreover, this group says, more packages today are based on stock and options, which pay more when the chief executive is successful.

Critics, on other hand, argue that executive salaries have jumped because corporate boards were simply too generous, or more broadly, because greed became more socially acceptable.

Again, in settling these arguments, economists were hampered by a lack of data, particularly any that might give some historical perspective.

It wasn't until economists Carola Frydman from MIT's Sloan School of Management and Raven E. Molloy of the Federal Reserve collected and analyzed data going back to 1936 — an exhaustive task because of the lack of computerized records going that far — that the longer-term trends became clear.

What the research showed is that while executive pay at the largest U.S. companies was relatively flat in the '50s and '60s, it began a rapid ascent sometime in the '70s.

As it happens, this was about the same time that income inequality began to widen in the United

States, according to the Saez figures.

More importantly, however, the finding that executive pay was flat in the ’50s and ’60s, when firms were growing, appears to contradict the idea that executive pay should naturally rise when companies grow.

This is a “challenge for the market story,” Frydman said.

So what happened since the ’70s that has sent executive pay upward?

While no company over this period of time — from the 1970s to today — can be considered completely typical, Dean Foods offers a better comparison than most because fundamentally it hasn’t changed.

The dairy business is still the root of the company; it was on the Fortune 500 by the late ’70s and remains there today. It grew then and more recently through acquisition.

Moreover, both chief executives — Douglas and Engles — could boast records of growing the company and profits.

From 1970 to 1979, while Douglas was the chief executive, sales at Dean Foods tripled and profits increased tenfold, to $9.8 million, according to company records. Similarly, from 2000 to 2009, sales at what would be Dean Foods had roughly doubled, and so had profits, to $228 million. (Engles became chief executive after the company he led bought Dean Foods in 2001 and adopted its name.)

Yet there are vast differences in the way the two men were paid, even when you adjust for the effects of inflation.

In the late 70s — 1977, 1978 and 1979 — Douglas made about $1 million annually in today’s dollars. The largest part of that was a salary; some came from a long-term incentive based on the stock price that would not mature until he retired.

By contrast, in the late 2000s — 2007, 2008 and 2009 — Engles averaged $10.5 million annually, most of it in stock and options awards and other incentive pay, according to proxy statements. After ’09, which was a particularly bad year, Engles’s compensation dropped to $4 million in 2010. If profits return, so will his higher earnings.

The case of Dean Foods appears to bolster the argument that executive compensation moves with company size: The profits for Dean Foods in 2009 were roughly 10 times what they were in 1979, adjusted for constant dollars. Engles’s compensation has averaged 10 times that of Douglas.

“It’s a different company today,” company spokesman Jamaison Schuler said. He declined to comment further.

But some economists have offered an alternative, difficult-to-quantify explanation: that the social norms that once reined in executive pay have disappeared.

This new attitude, according to this view, was reflected in epigrammatic form by the 1987 movie

"Wall Street," which made famous the phrase "greed, for lack of a better word, is good." Americans were growing more comfortable with some extremes in pay. Payoffs for the stars on Wall Street, in the movies and in pro sports were rising.

But back in the '70s, something was holding executive salaries back.

Harold Geneen, the president of ITT, then one of the nation's largest companies, told Forbes in 1975 that while he might be worth six times as much to the company as he was making, he hadn't sought a raise.

"No one moved up there, and I didn't dare do it alone," he explained.

Over at Dean Foods, Kenneth Douglas was likewise resistant to making more. Most years, board members at Dean Foods wanted to give Douglas a raise. But more than once, Douglas, a former FBI agent who literally married the girl next door, refused.

"He would object to the pay we gave him sometimes — not because he thought it was too little; he thought it was too much," said Alexander J. Vogl, a members of the Dean Foods board at the time and the chair of its compensation committee. "He was afraid it would be bad for morale, him getting a big bump like that."

"He believed the reward went to the shareholders, not to any one man," said John P. Frazee, another former board member. "Today we get cults of personality around the CEO, but then there was not a cult of personality."

Outside one of the Dean Foods dairies recently, the workers at the plant for the most part only rolled their eyes when asked about Engles's salary. But they spoke admiringly of Douglas.

"People back then thought enough was enough," said Ron Smith, 63, who maintains the machines at the plant.

Some were reluctant to criticize Engles to a reporter. Others defended him.

"You're king of the hill, and you get paid for that," said Ray Kavanaugh, 61, who operates a filler at the dairy. "He's worth it if he keep the company making money."

The employees said they only occasionally dwell on Engles's riches, anyway. Their primary focus is on making ends meet, they said.

Joe Bopp, 55, said he has a second job taking care of a cemetery during the summer months, mowing the grass and digging graves.

"Twenty-three dollars an hour sounds like a lot of money," he said. "But when you pay $4 a gallon for gas and $3.29 for a gallon of milk, it goes away real fast."

This is the first in an occasional series.