Ms. Elizabeth M. Murphy March 16, 2011
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Submitted electronically via rule-comments@SEC.gov

RE: Comments on Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act

Dear Ms. Murphy:

We write to offer our views on Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires public companies to disclose the ratio of total compensation of the chief executive officer (CEO) to that of the median of all their employees.

The Institute for Policy Studies is an independent research organization founded in 1963. For the past 18 years, we have issued an annual review of executive compensation trends and related policy reform proposals.

Summary

Our nation's long-term economic health will depend, in large part, on the productivity of our enterprises. Section 953(b), if vigorously implemented, can significantly enhance that productivity — and, as a result, U.S. competitive capacity.

The corporate commentary on Section 953(b) has so far generally asserted the exact opposite. Corporate representatives are arguing that pay ratio disclosure places an expensive burden on business enterprises — all for the sake of information that has no real value to investors or, for that matter, the general public.

Other public interest groups presenting comments will, we expect, fully rebut the claim that full pay ratio disclosure would require overly burdensome record keeping. In these comments, we concentrate on the other prime corporate claim against rigorous 953(b) enforcement: that pay ratio data serve no real purpose.

We argue that shareholders have a material interest in this data. Extreme pay differentials between CEOs and their workers undermine enterprise effectiveness for three main reasons:

1. They reinforce rigid corporate hierarchies and bloated bureaucracies that discourage workers from being creative contributors to enterprise success.

2. They lead to lower morale and higher turnover rates that undermine productivity.

3. They reinforce a "celebrity CEO" culture that is not conducive to high executive performance.

Recommendation: Rigorous enforcement of 953(b) that requires corporations to disclose the pay ratio between their CEOs and all their domestic and foreign workers. Over time, we believe this will encourage corporations to narrow the gap between executives and workers and, in the process, help U.S. corporations become more efficient and effective.

1. Pay Gaps, Corporate Hierarchies, and Bloated Bureaucracies

Management Science: From Taylorism to Empowerment

Large enterprises have been driving the American economy for well over a century, and Americans have been debating, for almost as long, just what needs to be done to make enterprises effective. At the end of the nineteenth century, industrial engineer Frederick Winslow Taylor asserted that managers should always "fully" plan out every single task every single worker "is to accomplish, as well as the means to be used in doing the work."[1] Taylorism — this notion that workers need to be carefully scripted, motion by motion — would go on to flourish in the early twentieth century.

Today, this approach seems a relic of a distant past. No contemporary business leader would suggest that employees only do good work when management tells them exactly what to do and how to do it. Instead, modern executives speak of *empowering* workers, about the importance of creating workplaces that encourage employees to exercise their creativity.

In the old days of mass production, with workers standing at assembly lines, performing the same mindless tasks over and over, corporations didn't really need to know what workers thought. They just needed workers to do what they were told. But that mass-production world no longer exists. The Industrial Age has given way to an Age of Information.

In the new Information Age, enterprises only do well when they *customize* products to what customers want. And who knows what customers want? The workers at the front lines, the employees who interact directly with consumers. These workers, through their contacts with customers, gain incredibly significant information. An effective enterprise values this information — and the employees who have it.

Today's effective enterprise also values workers on the production line, because modern production operations must be constantly changing to keep up with evolving consumer preferences. Who better to help figure out how to change, how to produce products ever faster, smarter, and more efficiently, than the workers actually involved in the producing? Corporate success requires that all employees, not just managers, "must add significant value."[2] Employee involvement gives corporations smart enough to try it the "ultimate competitive advantage."[3]

This empowerment ethos swept through corporate America in the 1980s and 1990s. But few companies have actually created empowering workplaces.[4] Only a small fraction of the companies that claim to be empowering workers, a *Journal of Business* study has shown, are actually engaging in any serious empowerment work.[5] One leading management consultant estimates that "fewer than 10 percent of American employers (probably *far* fewer) work for firms that practice true, systemic employee participation."[6] Another study, published in the *Administrative Science Quarterly*, concludes that executives are essentially going through the motions of empowerment, without making meaningful changes in practice.[7]

The Pay Gap Barrier to Modern Enterprise Effectiveness

Instead of pursuing empowerment strategies, CEOs have maintained rigid corporate hierarchies in which they have a personal vested interest. Such steep hierarchies help ensure that excessive executive pay remains excessive. They amount, in essence, to income-maintenance programs for top executives.

Peter Drucker, the father of modern management theory, first detected and described this income-maintenance dynamic in the early 1980s. In any hierarchy, Drucker noted, every level of bureaucracy must be compensated at a higher rate than the level below. The more levels, the higher the pay at the top.[8] Hierarchies would remain appealing to executives, he argued, as long as they push up executive pay. His solution? To make hierarchies less appealing to executives, Drucker suggested, limit executive pay. No executives, Drucker wrote in 1982, should be allowed to make more than twenty times the compensation of their workers.[9]

A Brookings Institution analysis supported this general view, stating "large differences in status can inhibit participation."[10] Four other researchers in another major study agreed that "extreme wage differentials between workers and management discourage trust and prevent employees from seeing themselves as stakeholders."[11]

In the classic corporate hierarchy, workers sit at the base of a steep pyramid. Above them rest layers upon layers of management. The more layers, the steeper the pyramid, the greater the distance between actual workers and ultimate corporate decision-making authority. To succeed in the Information Age, analysts contend, enterprises need, above all else, to "flatten" these towering pyramids.[12]

For a time, in the early 1990s, corporate America claimed to be following the reformers' advice. America's corporations, observers pronounced, were shearing off management fat layer by layer. But these claims, once subjected to review, would not hold up. Corporate America's demand for managers, the *Wall Street Journal* would report in 1996, "is booming."[13] The war against hierarchy, since then, has gone no better. Employees remain largely shut out from decision-making.

To be serious about reducing bureaucratic bloat, about ending command-and-control, about creating effective organizations for a modern economy, enterprises simply must narrow wide reward differentials. Shareholders have a material interest in knowing whether firms are ignoring gaping differentials in compensation between top and bottom.

2. Extreme Pay Gaps and Worker Loyalty and Morale

Smart executives have always understood that managerial success ultimately depends on having workers willing to contribute their best. "Executives succeed," as business commentator Dale Dauten puts it, "when employees decide to bestow the gift of excellence upon them."[14]

But employees do not — and will not — bestow this gift when they feel others are capitalizing unfairly on their labors.[15] Employees, be they white-collar, blue-collar, or pink-collar, do not expect to make as much as their bosses. But they do expect to share fairly in the wealth they create.

John Mackey, CEO of Whole Foods, supports a company policy that limits his cash compensation to no more than 19 times the average for workers at his firm. "Because of the yawning gap between the leaders and the led, employee morale is suffering, talented performers' loyalty is evaporating, and strategy and execution is suffering at American companies," Mackey says. "Employees really do care about this issue, and a smaller gap makes for greater solidarity, and as a result better performance, throughout the workplace."[16]

What makes inequality, in the business world, so poisonous? Psychological studies have shown that we do our best work when we enjoy what we are doing, when our motivation comes from within.[17] No enterprise can turn work into play. Enterprises that pay well and offer benefits that bring peace of mind can free employees to concentrate on the job at hand. But good pay and good benefits do not guarantee a workplace where employees take pleasure from their work. Where workers see rewards distributed unequally, and grossly so, pleasure will seldom proliferate. Why should that be the case? Unequal rewards remind us that we are working under compulsion. We enrich someone else with our labor — we let ourselves be exploited — only because we have no choice.

The starker the inequity in any workplace, the less pleasurable the work becomes. The less pleasurable the work, the less workers will likely contribute to enterprise success. In the workplace, in other words, justice matters. The "sense of injustice," as the British political scientist Harold Laski noted in 1930, "acts as an inhibition fatal to the doing of one's best."[18]

Not all employees, of course, *must* continue laboring in situations where they see and feel inequity. Some have nest-eggs large enough to tide them over — or good prospects for quickly finding another job or starting their own business. These employees, if they find themselves in situations where executives monopolize rewards, have the freedom to simply walk away. And they do. In workplaces where justice disappears, so does loyalty.

"What you see are people leaving who know a lot about the firm and the industry," the Stanford Business School's Charles O'Reilly once observed. "If they feel they are inequitably treated, then they are gone."[19]

The High Cost of Employee Turnover

Enterprises pay a heavy price for high turnover and auditors can actually calculate the cost. They start with the unused vacation time that must be converted into dollars, add in the severance that must be shelled out, the recruitment ads that must be placed, the staff time that must be spent interviewing applicants, the training that must be conducted when the new hire finally comes on board. How much does all this total? Some human experts "place the cost of a single turnover at between 100 and 300 percent of the employee's annual wages or salary." Other estimates run higher. Modern enterprises, one analyst concludes, almost always experience serious damage "every time an experienced, competent, talented worker leaves the firm voluntarily."[20]

That damage can be particularly devastating when the exiting employee happens to have been an important part of a company's management team. In the 1990s, as pay gaps between CEOs and their subordinates within management widened, these sorts of exits became more and more frequent. Pay disparities within management ranks, the Harvard Business School's Jay Lorsch has argued, foster "unspoken jealousy" at the top management level and prompt "talented executives to seek high paying positions elsewhere."[21] By contrast, John Mackey says that Whole Foods, with its 19-to-1 pay ratio cap, "has never lost to a competitor a top executive that we wanted to keep since the company began more than 30 years ago."[22]

Two Notre Dame researchers have analyzed turnover rates, over a five-year period, among executives at nearly 500 firms. Senior executives at companies with wide management pay gaps, they found, appear twice as likely to exit as senior executives at companies where pay was more equally distributed.[23] A company that spends "big dollars attracting and retaining a top CEO," Notre Dame's Matt Bloom notes, winds up "reducing the cohesion, knowledge and experience of the managerial team it relies on to make key decisions."

"Unless a board can provide compelling evidence for why one person is overwhelmingly more important than all the other employees," concludes Bloom, "shareholders and employees probably have good reasons to be very concerned about large pay gaps."

These sorts of warnings from business school professors have made little impact on corporate America's top decision makers despite the increased importance of loyalty in the Information Age. Generations ago, in the heyday of command-and-control, enterprises could survive high turnover. New employees just came in and did what they were told. But today, in the Information Age, enterprises need employees able and willing to do far more than what they are told to do. Modern enterprises need employees who can collaborate with colleagues and co-workers in problem-solving, high-performance teams. But teams only perform well when the people on them trust in each other. Trust building takes time. Employees in high-turnover workplaces never get to take that time.

Enterprises that devalue loyalty, that welcome high turnover, will always be defective. Extreme gaps between CEO and worker compensation will always make that devaluing inevitable.

3. Extreme Pay Gaps and Celebrity CEOs

Skeptics argue that the rewards pumped to the top couldn't possibly make as much of a difference as critics of executive pay charge. For a mega-billion company, mega-million executive windfalls amount to mere peanuts, not dangers, they say. But the danger comes not from the "peanuts," but from what executives will do to grab as many peanuts as they can. To keep their pockets stuffed, executives will nurture the hierarchies that frustrate enterprise empowerment. They will devote themselves to making their companies bigger, not better. Corporations that lavish multiple millions on their executive superstars, even if those millions be mere "peanuts" in the grand corporate scheme of things, create great fortunes for their executives. They do not create great enterprises.

Jim Collins, a former scholar at the Stanford Graduate School of Business who launched his own management laboratory, has documented this reality with a research team that spent five years trying to determine "what it takes" to turn an average company into a "great" one. Collins and his colleagues "systematically scoured a list of 1,435 established companies to find every extraordinary case" where a company made the "leap from no-better-than-average results to great results." A company, to be defined as great, "had to generate cumulative stock returns" that, over 15 years, had "exceeded the general stock market by at least three times" — and had to have made this remarkable showing "independent of its industry."[24]

The Collins research team eventually identified eleven firms that had successfully made the leap to "great." Not a single one of the companies had a high-paid, celebrity CEO.[25]

A celebrity CEO, Collins would explain, turns a company into "one genius with 1,000 helpers." The presence of a celebrity in the chief executive suite "creates a sense that the whole thing is really about the CEO."[26] And that sense, the Collins research concluded, will always make for enterprise mediocrity.

The Need for a Strong 953(b)

The new 953(b) disclosure mandate, if effectively enforced, will:

- improve information available for shareholders and the public and focus attention on a "metric" fundamental to enterprise success.

- force top corporate executives and their boards to contemplate the pay gaps within their enterprises, and, hopefully, encourage them to narrow this gap by raising median worker pay and/or reducing pay at the top.

- give scholars a research capacity they have never had, the ability to compare individual corporations and *fully* evaluate the relationship between pay — unequal and equal — and performance.

We urge the SEC to prepare 953(b) regulations that make this full disclosure an annual event, covering all domestic and foreign workers. The disparity between U.S. and global employee compensation is relevant for shareholders to understand the widespread trend of moving operations outside the United States. And in a globalized labor pool, the effects of extreme pay gaps are just as poisonous in foreign workplaces as they are in the United States.

We would be pleased to have further discussions with respect to these issues.

Sincerely,

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[1] Quoted in Harry Braverman, *Labor and Monopoly Capital*. New York: Monthly Review Press, 1974, 118.

[2] Edward E. Lawler, III, *From the Ground Up: Six Principles for Building the New Logic Corporation*. San Francisco: Jossey Bass, 1996, 22.

[3] This phrase from the work of Edward Lawler is quoted in Barry M. Staw and Lisa D. Epstein, What Bandwagons Bring: Effects of Popular Management Techniques on Corporate Performance, Reputation, and CEO Pay, *Administrative Science Quarterly*, September 2000.

[4] "Providing frontline employees with the skills, motivation, and freedom to improve how they do their jobs can greatly increase both productivity and worker satisfaction," a Brookings Institution report concluded in 1995. Yet "substantive employee involvement remains the exception in the U.S. work force." David I. Levine, *Reinventing the Workplace: How Business and Employees Can Both Win*. Washington, D.C., The Brookings Institution, 1995, 1.

[5] G. S. Easton and S. L. Jarrell, The effects of total quality management on corporate performance: An empirical investigation, *Journal of Business*, April 1998.

[6] William G. Lee, *Mavericks in the Workplace*, New York: Oxford University Press, 1998, 60.

[7] Barry Staw and Lisa Epstein, What Bandwagons Bring: Effects of Popular Management Techniques on Corporate Performance, Reputation, and CEO Pay.

[8] Peter F. Drucker, *The Changing World of the Executive*. New York: Times Books, 1982, 22.

[9] Drucker would stick to this position over the ensuing years, even as executive pay soared. In the mid 1990s, with CEOs taking home compensation that outpaced worker pay by *hundreds* of times, Drucker was still contending, notes biographer Jack Beatty, "that the ratio of pay between worker and executive can be no higher than twenty to one without injury to company morale." Jack Beatty, *The World According to Peter Drucker*. New York: The Free Press, 1998, 83.

[10] David I. Levine, *Reinventing the Workplace: How Business and Employees Can Both Win*. Washington, D.C., The Brookings Institution, 1995, 53.

[11] Eileen Applebaum, Thomas Bailey, Peter Berg, and Arne L. Kalleberg, *Manufacturing Advantage: Why high-performance work systems pay off*. Ithaca, New York: Cornell University Press, 2000, 44.

[12] Edward F. Lawler III, *High-Involvement Management*. San Francisco: Jossey-Bass Publishers, 1991, 194.

[13] Managerial joblessness was "approaching historic lows." Alex Markels, Firms' demand for managers is growing despite layoffs and restructurings, *Wall Street Journal*, September 26, 1996.

[14] Dale Dauten, Give Workers Room To Rise To Occasion, *Chicago Tribune*, June 25, 2000.

[15] "It becomes difficult to espouse partnership, empowerment, and a service orientation," notes Peter Block, one of America's most widely read effective enterprise theorists, "while those at the top enhance their wealth at the expense of those at lower levels." Peter Block, Stewardship: *Choosing Service Over Self-Interest*. San Francisco: Berrett-Koehler Publishers, 1993, 65.

[16] John Mackey, Why Sky-High CEO Pay Is Bad Business, *Harvard Business Review*, June 17, 2009.

[17] One classic psychological experiment is described in H.M.J.J Snelders and Stephen E.G. Lea, Different kinds of work, different kinds of pay: an examination of the overjustification effect, *Journal of Socio-Economics*, Winter 1996.

[18] Harold J. Laski, *A Grammar of Politics*. London: George Allen & Unwin Ltd., 1930, 212.

[19] Joann S. Lublin, A Better Way, *Wall Street Journal*, April 9, 1998.

[20] Robert W. Moody, Going, Going, Gone, *Internal Auditor*, June 2000.

[21] Jay W. Lorsch. CEO pay: facts and fallacies, *Corporate Board*, May-June 1999.

[22] John Mackey, Why Sky-High CEO Pay Is Bad Business, *Harvard Business Review*, June 17, 2009.

[23] The study was by professors Matt Bloom and John Michel. Rick Jurgens, Look Out Below, *Wall Street Journal*, April 6, 2000.

[24] Jim Collins, Good to Great, *Fast Company*, October 2001.

[25] Jim Collins, *Good to Great: Why Some Companies Make the Leap ... And Others Don't* (HarperBusiness, 2001). Sidebar to Jim Collins, Good to Great, *Fast Company*, October 2001.

[26] Great Answers to Good Questions, *Fast Company*, October 2001.