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Compensation

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Barry Gerhart

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Hill

Compensation

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Barry Gerhart

University of Wisconsin-Madison

COMPENSATION

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About the Author

BARRY GERHART

Barry Gerhart is the Bruce R. Ellig Distinguished Chair in Pay and Organizational Effectiveness, School of Business, University of Wisconsin–Madison. Professor Gerhart received his B.S. in Psychology from Bowling Green State University and his Ph.D. in Industrial Relations from the University of Wisconsin–Madison. Professor Gerhart is a recipient of the Scholarly Achievement Award, the International Human Resource Management Scholarly Achievement Award (twice), the Herbert Heneman Jr. Career Achievement Award, and the Mahoney Mentoring Award, all from the Human Resources Division, Academy of Management. He has also received the Michael R. Losey Excellence in Human Resource Research Award, the career achievement award of the Society for Human Resource Management. Professor Gerhart is a Fellow of the Academy of Management and of the American Psychological Association. He has served as a department chair and/or area coordinator at Cornell, Vanderbilt, and Wisconsin, as well as senior associate dean and interim dean at Wisconsin. He has held visiting appointments at Bayreuth University, King's College London, and Copenhagen Business School.

Preface

Compensation is uniquely important in organizations because it typically represents the single largest operating cost, especially where employee skills or human capital are the source of competitive advantage (e.g., Google/Alphabet, Facebook; investment banking, law, accounting, and consulting firms; professional sports teams; universities). Compensation is also important because employees regularly report it as the most important factor that goes into their decision of whether to take a job or stay in a job. Compensation also plays a major role in what employees choose to do on the job: their effort level, where they direct their effort/what goals they pursue, how cooperative they are, how flexible they are, how ethical they are, and so forth. These all add up to determine how efficient, innovative, customer-oriented and (in the case of for-profit) how profitable an organization is over time. Profits, in turn, create jobs. In the absence of profits, jobs disappear. An organization that pays too much, pays too little, ties too much compensation up as fixed costs, and/or pays for the wrong things puts the company, its investors, and its employees at risk. On the other hand, designing and executing an effective compensation strategy can play a key role in great shared success.

Compensation challenges ebb and flow with changes in the economy. The Financial Crisis of 2008 and the related Great Recession brought job cuts (with the national unemployment rate rising to 10 percent, the highest since 1983), reduced hours, reduced employer contributions to 401(k) retirement plans, reduced bonus/profit-sharing payments, and some wage cuts. With revenue and profits down and with labor costs often the single largest operating cost, employers cut labor costs in these ways. Eventually, as company revenues picked up again, we gradually saw employers put less emphasis on cutting labor costs and more emphasis on hiring. However, job growth was initially quite modest. At the beginning of 2013, the unemployment rate was still at 8 percent. Why? Employers have become increasingly careful about adding new workers because they want to keep costs under control and they don't want to have to reduce the workforce if they guess wrong about increasing revenue growth/product demand (and the need for more workers). As economic growth continued, however, competition for employees increased and employers began to hire. The U.S. unemployment rate declined every year until it was below 4 percent in 2018 and 2019, the lowest it has been since 1969. However, wage gains remain modest. That is because employers are careful not only about hiring, as we have noted. They are also careful about giving wage/salary increases because once those are added to base pay, "they are there forever." Increasingly, employers seek to make labor costs variable, which means greater reliance on bonuses and/or profit-sharing, where payments to employees go up during good times, but automatically go down during bad times when profits and revenues go down. Nevertheless, the low unemployment rates and the scarcity of workers it signaled resulted in a number of employers raising base wages.

Then, of course, the pandemic hit. The unemployment rate went from 3.5 percent in February 2020 to 14.8 percent by April 2020. Employers followed all of the same actions to cut labor costs in 2020 they had followed in response to the Great Recession that began in 2008. Suddenly, many employers went from having to raise wages to be able to hire and retain enough employees to run their businesses to instead having too many employees costing too much to survive without dramatic action. Business strategy became "cut costs enough to survive, while being ready to go when business picks back up." A Conference Board survey reported that one quarter of employers laid off or furloughed employees and 34 percent reduced working hours. Some companies announced salary cuts (temporary) of 30 percent to 50 percent. Contributions to 401k plans were stopped at about 1 in 10 employers. The millions of workers who lost their jobs or who took pay cuts still had bills to pay. Government aid helped some business owners and employees, but not everyone and not always enough.

For some, there was opportunity. Amazon's business strategy continued to be growth, and it added 427,300 employees (a more than 50 percent increase) between January and October of 2020. That this was necessary can be seen from the fact it grew its revenue from $87.4 billion in the quarter ending December 31, 2019 to $125.6 billion in the quarter ended December 31, 2020. Amazon paid many workers bonuses to work through the pandemic and remain with Amazon. There were some retailers who went beyond bonuses and raised wages to make sure they would have the workforce to respond to growth in business. In June 2020, Target announced it would increase its hourly minimum to $15, following increases to $11 in 2017 and $13 in 2019. The new hourly minimum allows Target to compete better for workers with Amazon and Costco, which had a $15 minimum hourly wage (Costco subsequently raised it to $16/hour in February 2021) and with Walmart, which also raised wages. By August 2020, many companies that had made temporary salary or benefits (usually 401k) cuts began to rescind them. Economic forecasts suddenly began to turn positive with the deployment of effective vaccines. In early 2021, The Congressional Budget Office (CBO) projected a rapid economic recovery to pre-pandemic levels by 2022, including a strong drop in the unemployment rate and thus a return to wide competition for employees. (Further, that projection did not consider the impact on economic growth of the $1.9 trillion American Rescue Plan Act of 2021 enacted in March 2021.) Things were about to go full circle, from economic boom until early 2020, to economic hard times (for most, not all) starting March 2020, and looking in the crystal ball (or using forecasts like that of CBO just above), employers need to shift back to recruiting (and retention) mode (and quickly) to be able to take advantage of the strong business recovery unfolding in 2021. (The unemployment rate was down to 6.0 % by April 2021.) Success in recruiting and retention will depend on competitive compensation. Not acting quickly enough or not setting compensation at a sufficiently competitive level means losing out on employees who choose to work elsewhere and thus losing out on sales and profits.

We will also talk about the use of pay as an incentive to influence choices of effort and behavior. Let's just take a trip part-way around the globe here. To take a not so down to earth example, if you were a Russian cosmonaut, you could earn a bonus of $1,000 for every space walk you took (technically known as "extravehicular activity"), up to three per space trip. A contract listing specific tasks to be done on a space mission permits you to earn up to $30,000 above the $20,000 you earn while you are on the ground. Conclusion: *Pay matters.*

(As a small aside, in contrast to the Russian cosmonauts, private citizens have the opportunity to visit the International Space Station, without having to meet the troublesome requirements and preparation to become a cosmonaut or an astronaut. But, it will cost them. Axiom Space, based in Houston, using a SpaceX rocket, will give a ride to three customers in 2022, each of whom will pay around $55 million for the trip and an 8-day stay.)

After you have read this book, you will also better understand that *what you pay for matters.* Many years ago, when Green Giant discovered too many insect parts in the pea packs from one of its plants, it designed a bonus plan that paid people for finding insect parts. Green Giant got what it paid for: insect parts. Innovative Green Giant employees brought insect parts from home to add to the peas just before they removed them and collected the bonus.

The Houston public school district also got what it paid for when it promised teachers bonuses of up to $6,000 if their students' test scores exceeded targets. Unfortunately, several teachers were later fired when it was discovered that they had leaked answers to their students and adjusted test scores. Teachers were motivated to raise test scores, just not to raise them in the way desired (improved student learning). Wells Fargo wanted customers to sign up for more of its products to increase its potential for revenue and profit growth. To achieve this goal, Wells Fargo incentivized its employees so they would be rewarded for achieving this goal (and/or penalized if they did not achieve it). This incentive certainly "worked," if you think this includes employees setting up fake accounts, which the customers did not sign up for, in order to achieve their targets

for performance (new account sign-ups). Again, employees were motivated to achieve the outcome, but not necessarily in the appropriate way.

Such problems are global. A British telephone company paid a cash bonus to operators based on how quickly they completed requests for information. Some operators discovered that the fastest way to complete a request was to give out a wrong number or—even faster—just hang up on the caller. "We're actually looking at a new bonus scheme," says an insightful company spokesperson. Conclusion: *What you pay for matters.*

After you have read this book, you will also have learned that *how you pay matters.* Motorola ended its old-fashioned pay system that employees said guaranteed a raise every six months if you were still breathing. The new system paid for learning new skills and working in teams. Sound good? It wasn't. Employees resented those team members who went off for six weeks of training at full pay while remaining team members picked up their work. Motorola was forced to get rid of its new-fashioned system, too.

Wells Fargo also, not surprisingly, had to change *how* it pays and *what* it pays for.[2] Specific changes made include:

- No product sales goals.
- Performance evaluation based on customer service, usage and growth, not simply on new accounts opened.
- Incentives associated with direct customer feedback and product usage.
- A higher percentage of employee compensation comprised of base salary, rather than variable incentives.
- More employee performance metrics focused on the goals of a given bank branch, instead of on an individual worker.

To summarize, compensation is a powerful tool that has major consequences for the success or failure of an organization. Our aim is to put you in a better position to design and/or execute compensation strategies to make success more likely. That will be helpful whatever the scale and scope of your responsibility, from a unit of a few employees to an entire organization. Our book will also help you better understand how your own compensation is managed and how that can help you achieve your own career goals.

ABOUT THIS BOOK

This book focuses on the strategic choices in managing compensation. We introduce these choices, real-world issues that managers confront from New York to New Zealand and all points between, in the total compensation model in Chapter 1. This model provides an integrating framework that is used throughout the book. Major compensation issues are discussed in the context of current theory, research, and practice. The practices illustrate new developments as well as established approaches to compensation decisions.

We live in interesting times. Anywhere you look on the globe today, economic and social pressures are forcing managers to rethink how people get paid and what difference it makes. Traditional approaches to compensation are being questioned. But what is being achieved by all this experimentation and change? What is merely fad and fashion, and what, instead, is supported by the evidence? In this book, we strive to separate beliefs from facts, wishful thinking from demonstrable results, and opinions from research. Yet when all is said and done, managing compensation is part science, but also part art.

Each chapter contains at least one *e-Compensation box* to point you to some of the vast compensation information on the Internet. Real-life *Your Turn* cases ask you to apply the concepts and techniques discussed in each chapter. For example, the Your Turn in Chapter 9 draws on Jerry Newman's experience when he

worked undercover for 14 months in seven fast-food restaurants. The case takes you into the gritty details of the employees' behaviors (including Professor Newman's) during rush hour, as they desperately worked to fill customers' orders and meet their own performance targets set by their manager. You get to recommend which rewards will improve employees' performance (including Professor Newman's) and customers' satisfaction. We tackle major compensation issues from three sides: theory, research, and practice—no problem can survive that onslaught!

The author, together with George Milkovich, also publishes *Cases in Compensation,* an integrated casebook designed to provide additional practical skills that apply the material in this book. The casebook is available directly from the authors (e-mail: cases.in.compensation@gmail.com). Completing the integrated cases will help you develop skills readily transferable to future jobs and assignments. Instructors are invited to e-mail for more information on how *Cases in Compensation* can help translate compensation research and theory into practice and build competencies for on-the-job decisions.

But *caveat emptor!* "Congress raises the executive minimum wage to $565.15 an hour," reads the headline in the satirical newspaper *The Onion* (**www.onion.com**, "America's Finest News Source"). The article says that the increase will help executives meet the federal standard-of-easy-living. "Our lifestyles are expensive to maintain," complains one manager. Although the story in *The Onion* may clearly be fiction, sometimes it is more difficult to tell. One manager told us that when she searched for this textbook in her local bookstore, store personnel found the listing in their information system—under fiction!

WHAT'S NEW

All chapters have been revised, in recognition of ongoing changes at organizations and in their competitive environments around the world. Many examples are provided of the current pay strategies or practices used in specific, named companies. Some of these are well established and successful (Apple, IBM, Lincoln Electric, Microsoft, Merrill Lynch, Nucor, SAS Institute, Tesla, Toyota, Walmart), some face real problems (airlines, domestic car companies), and others are using unique practices (Google, Whole Foods). Whenever possible, we observe how the challenges faced by these companies have evolved over time. We have created six brand new end- of-chapter *Your Turn* cases, which include an examination of the role of compensation at companies such as Amazon, Walmart, Apple, and Starbucks. This includes a focus on environmental, social, and governance (ESG) issues. Other new Your Turns have to do with new benefits, including those important during the pandemic. We have also introduced a dozen new exhibits, many of which document the causes and consequences of compensation (e.g., how much does pay increase when someone voluntarily changes jobs?). This edition continues to emphasize the importance of total compensation and its relevance for achieving sustainable competitive advantage. It reinforces our conviction that beyond *how much* people are paid, *how* they are paid really matters. Managing pay means ensuring that the right people get the right pay for achieving objectives in the right way. Greater emphasis is given to theoretical advances and evidence from research. Throughout the book,+ we translate this evidence into guidance for improving the management of pay.

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work and compensation from a different perspective. To do this, he did something unusual: he stepped away (temporarily!) from being a distinguished professor and actually went to work as a crew member (he knows his way around a deep fryer) at several well-known quick service restaurants. (Think Undercover Boss.) You might enjoy reading about it in his interesting and fun book, *My Secret Life on the McJob.*

All to say, I am grateful to have had the honor (and good fortune) to work with two people like George and Jerry and to carry on their work in *Compensation* going forward. Indeed, you will often find the use of "we" instead of "I" in the book, indicating that what you read reflects the influence of all three of us.

Many other people have contributed to our understanding of compensation and to the preparation of this textbook over the years and editions. We owe a special, continuing debt of gratitude to our students. In the classroom, they motivate and challenge us, and as returning seasoned managers they try mightily to keep our work relevant:

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Part I
Introducing The Pay Model And Pay Strategy

Why do we work? If we are fortunate, our work brings meaning to our lives, challenges us in new and exciting ways, brings us recognition, and gives us the opportunity to interact with interesting people and create friendships. Oh yes—we also get a paycheck. Here in Part 1 of the book, we begin by talking about what we mean by "pay" and how paying people in different ways can influence them and, in turn, influence organization success. Wages and salaries, of course, are part of compensation, but so too, for some employees, are bonuses, health care benefits, stock options, and/or work/life balance programs.

Compensation is one of the most powerful tools organizations have to influence their employees. Managed well, it can play a major role in organizations successfully executing their strategies through their employees. We will see how companies like Costco, Whole Foods, Nucor, the SAS Institute, Microsoft, Alphabet/Google, and others use compensation to attract, motivate, and retain the right employees to execute their strategies. We will also see how companies like Apple sell premium products at attractive price points, to an important degree by using suppliers that have low labor costs. When they are managed less well—as bankruptcies at General Motors, Chrysler (now part of Stellantis), Lehman Brothers, and American Airlines (which stated at the time that it needed to reduce labor costs by $1.25 billion per year to be competitive), for example, might indicate—compensation decisions can also come back to haunt you. In Part 1, we describe the compensation policies and techniques that organizations use and the multiple objectives they hope to achieve by effectively managing these compensation decisions.

Although compensation has its guiding principles, we will see that "the devil is in the details"—how a compensation program is specifically designed and implemented will help determine its success. We want you to bring a healthy skepticism when you encounter simplistic or sweeping claims about whether a particular way of managing compensation does or does not work. For example, organizations, in general, benefit from pay for performance, but there are many types of pay-for-performance programs, and it is not always easy to design and implement a program that has the intended consequences and avoids *unintended* consequences. (As examples of what can go wrong, search the Web for Wells Fargo or Novartis and the term, scandal.) So, general principles are helpful, but only to a point.

Thus, in Part 1, our aim is to also help you understand how compensation strategy decisions interact with the specific context of an organization (e.g., its business and human resource strategies) to influence organization success. We emphasize that good theory and research are fundamental, not only to understanding compensation's likely effects, but also to developing that healthy skepticism we want you to have toward simplistic claims about what works and what does not.

Chapter **One**
The Pay Model

Chapter Outline

Compensation: Does It Matter? (or, "So What?")

Compensation: Definition, Please (Stakeholders)

- *Society*
- *Stockholders*
- *Customers*
- *Managers*
- *Employees*

How Pay Influences Behaviors: Incentives and Sorting Effects

- *Global Views—Vive la Différence*

Forms of Pay

- *Cash Compensation: Base*
- *Cash Compensation: Merit Increases/Short-Term Incentives (Merit Bonuses)/COLAs*
- *Cash Compensation: Incentives*
- *Long-Term Incentives*
- *Benefits: Income Protection*
- *Benefits: Work/Life Balance*
- *Benefits: Allowances*
- *Total Earnings Opportunities: Present Value of a Stream of Earnings*
- *Relational Returns from Work*

A Pay Model

- *Compensation Objectives*
- *Four Policy Choices*
- *Pay Techniques*

Book Plan

Caveat Emptor—Be an Informed Consumer

- *1. Is the Research Useful?*
- *2. Does the Study Separate Correlation from Causation?*
- *3. Are There Alternative Explanations?*

Your Turn: Compensation at the World's Largest Company

Still Your Turn: Who Are Amazon's Peer Companies for Comparing Compensation?

COMPENSATION: DOES IT MATTER? (OR, "SO WHAT?")

Why should you care about compensation? Do you find that life goes more smoothly when there is at least as much money coming in as going out? (Refer, e.g., to the lyrics for the Beatles' song "Money."[1] To exaggerate a bit, they say something like: Money doesn't buy everything, but if money can't buy it, I can't use it.) In the movie, It's a Wonderful Life, George Bailey is in a difficult spot. An (inexperienced) guardian angel by the name of Clarence has been sent to help George. When Clarence implores George to let him help, George asks if he has $8,000 on him. Clarence replies "No, we don't use money in Heaven" to which George responds: "Well, it comes in real handy down here, bud!"

Of course, it is the same for companies. It really does help to have as much money coming in (actually, more is better) as going out. Until recently, production workers at Chrysler received total compensation (i.e., wages plus benefits) of about $76 per hour. U.S. workers doing the same jobs at Toyota received $48 per hour, and the average total compensation per hour in U.S. manufacturing was $25 (and $3 in Mexico–not surprisingly, many new automobile supply and assembly plants have gone to Mexico in recent years). It is one thing to pay more than your competitors if you get something more (e.g., higher productivity and/or quality) in return. But Chrysler was not. So its "strategy" was not sustainable. Chrysler ended up going through bankruptcy, being bought out by Fiat, and then reducing worker compensation costs as part of its strategy for a return to competitiveness. Specifically, Chrysler took steps (as part of its bankruptcy plan) to bring its hourly labor costs down to about $49.[2] (Fiat Chrysler is now part of Stellantis.)

General Motors (GM), like Chrysler, has for decades paid its workers well—too well, perhaps, for what it received in return. So what? Well, in 1970, GM had 150 U.S. plants and 395,000 hourly workers. In sharp contrast, GM now has 32 U.S. manufacturing plants (including 11 vehicle assembly plants) and 87,000 U.S. workers (up from 57,000 U.S. hourly workers a few years ago).[3] In June 2009, GM, like Chrysler, had to file for bankruptcy (avoiding it for a while thanks to loans from the U.S. government—i.e., you, the taxpayer). Not all of GM's problems were compensation related. Building too many vehicles that consumers did not want was also a problem. But having labor costs higher than the competition's, without corresponding advantages in efficiency, quality, and customer service, does not seem to have served GM or its stakeholders well. Its stock price peaked at $93.62/share in April 2000. Its market value was about $60 billion in 2000. That shareholder wealth was wiped out in bankruptcy. Think also of the billions of dollars the U.S. taxpayer had to put into GM. Think of all the jobs that have been lost over the years and the effects on communities that have lost those jobs. (The good news is that as of 2021, GM's market value was over $80 billion. However, that is a ways behind what is now the most valuable U.S. carmaker, Tesla, at $635 billion, depending on the day, or about 8x greater than GM.)

On the other hand, Nucor Steel pays its workers very well, relative to what other companies inside and outside of the steel industry pay. But Nucor also has much higher productivity than is typical in the steel industry. The result: Both the company and its workers do well. Apple Computer is able to charge lower prices for its iPads and iPhones by outsourcing manufacturing to China in facilities owned by the Hon Hai Precision Industry Co., Ltd. (Foxconn), a Taiwanese company. (See **Chapter 7**.) As we will see later, doing so generates billions (yes, billions with a "b") of dollars in cost savings per year. Google and Facebook are companies that are known for paying very well. So far that seems to have worked, in that their high pay allows them to be very selective in who they hire and who they keep, and they would say that their talent-rich strategy has helped them to foster growth and innovation.

Wall Street financial services firms and banks used **incentive** plans that rewarded people for developing "innovative" new financial investment vehicles and for taking risks to earn a lot of money for themselves and their firms.[4] But several years ago, during the Great Financial Crisis of 2008, the markets discovered that many

such risks had gone bad. Blue chip firms such as Lehman Brothers slid quickly into bankruptcy, whereas others, like Bear Stearns and Merrill Lynch, survived to varying degrees by finding other firms (J.P. Morgan and Bank of America, respectively) to buy them. The issue has not gone away. U.S. Federal Reserve officials have "made it clear that they believe bad behavior at banks goes deeper than a few bad apples and are advising firms to track warning signs of excessive risk taking and other cultural breakdowns." In the words of one Fed official, "Risk takers are drawn to finance like they are to Formula One racing." An important driver of risk taking among traders and others is the incentive system that encourages them to be "confident and aggressive" and that often results in those who thrive under this incentive rising to top leadership positions at the banks.[5]

Novartis is a health care solutions company based in Switzerland that includes medicines, pharmaceuticals, and eye care. The U.S. Justice Department announced a $678 million settlement with Novartis over improper inducements to persuade doctors to prescribe Novartis drugs, including Lotrel for hypertension. It is the largest whistleblower settlement under federal law. The key whistleblower was Ozzie Bilotta. According to NBC News, when he began working at Novartis, it was his dream job. But, "he never thought he'd be bribing doctors and wearing a wire for the feds." He ended up taking this sort of "drastic action" because he felt it was necessary to change how the pharmaceutical industry operated. Novartis subsequently changed its sales compensation such that pay no longer depends only on sales. It also now depends on an evaluation of whether sales were achieved in a way that is consistent with the Novartis Code of Ethics. There is also an Anti-Bribery Policy document that includes directing employees to "Always ask yourself before offering, giving, or promising anything of value to any person if what you are considering could be viewed as having an illegitimate purpose. If the answer is yes, you must not proceed."[6] Novartis has also increased its investment in data collection and analytics to monitor compliance with its Code of Ethics.

How people are paid affects their behaviors at work (as we have seen, for good or bad), which affect an organization's success.[7] For most employers, compensation is a major part of total cost, and often it is the single largest part of operating cost. These two facts together mean that well-designed compensation systems can help an organization achieve and sustain competitive advantage. On the other hand, as we have recently seen, poorly designed compensation systems can likewise play a major role in undermining organization success.

Our book, we hope, can play a role in helping to better educate you, the reader, about the design of compensation systems, both for managers and for workers. That includes not only how compensation can make things work better, but just as importantly, how compensation can make things go wrong, sometimes very wrong, as in our above examples.

COMPENSATION: DEFINITION, PLEASE (STAKEHOLDERS)

How people view compensation affects how they behave. It does not mean the same thing to everyone. Your view will probably differ depending on whether you look at compensation from the perspective of a member of society, a stockholder, a manager, or an employee. Thus, we begin by recognizing different perspectives.

EXHIBIT 1.1 Indicators of Economic Standard of Living, United States (all dollar amounts in constant $), by Year

	1990	2000	2010	2020	Growth 1990-2020
Panel A. Gross Domestic Product (GDP) per Employed Person[a]					
	84,062	100,468	118,578	127,378	52%

	1990	2000	2010	2020	Growth 1990-2020
Panel B. Average Annual Earnings[b]					
	42,518	44,711	45,758	52,156	23%

	1990	2000	2010	2017	Growth 1990-2017
Panel C. Household Income, by Income Level[c]					
Before Transfers and Taxes					
All	76,500	100,100	98,000	110,700	45%
Top 1 Percent	886,000	1,722,800	1,561,800	1,961,500	121%
Top 1 Percent Share (of Income)	13%	21%	19%	22%	64%
Highest Quintile	182,500	264,500	260,600	309,400	70%
Middle Quintile	60,100	68,600	68,800	49,700	−17%
Lowest Quintile	15,700	19,600	20,100	21,300	36%
After Transfers and Taxes					
All	61,900	79,700	84,200	93,300	51%
Top 1 Percent	640,300	1,167,100	1,105,800	1,343,000	110%
Top 1 Percent Share (of Income)	12%	17%	15%	17%	46%
Highest Quintile	137,200	191,400	198,800	229,700	67%
Middle Quintile	49,700	57,900	62,900	68,000	37%
Lowest Quintile	21,400	26,900	32,800	35,900	68%

Panel D. Net Household Wealth and Population					
	1990	2000	2010	2020	Growth 1990-2020
Net Household Wealth (millions)[d]	44,832,962	66,745,710	78,832,798	130,154,587	190%
Population[e]	250,181,000	282,398,000	309,774,000	330,152,000	32%
Panel E. Net Individual Wealth Share[f]					
	1990	2000	2010	2018	Growth 1990-2018
Top 1% Wealth Share	30%	33%	37%	38%	27%
Top 10% Wealth Share	68%	73%	77%	77%	13%

[a]Adjusted for Purchasing Power, 2017 Dollars. Source: WorldBank.
https://data.worldbank.org/indicator/SL.GDP.PCAP.EM.KD

[b]U.S. Bureau of Labor Statistics. Usual Weekly Earnings. Multiplied by 52 and converted to 2020 dollars.

[c]2017 Dollars. Source: Congressional Budget Office (2020). The Distribution of Household Income, 2017. October 2020. Transfers are means-tested (i.e., depend on income) and include, for example, Medicaid. Taxes are federal and include income tax, payroll tax, corporate, and excise tax.
https://www.cbo.gov/system/files/2020-10/56575-Household-Income.pdf

[d]2020 Dollars. Source: Board of Governors of the Federal Reserve (U.S.). Households and Nonprofit Organizations; New Worth, Level.
https://fred.stlouisfed.org/series/HNONWRA027N

[e]https://fred.stlouisfed.org/series/POPTOTUSA647NWDB

[f]Emmanuel Saez and Gabriel Zucman. The Rise of Income and Wealth Inequality in America: Evidence from Distributional Macroeconomic Accounts. Journal of Economic Perspectives, 2020, 34, 3–26. Uses "tax units" (individuals) rather than households.

Society

Exhibit 1.1 summarizes information on indicators of economic standard of living. All dollar amounts are in constant (also called real) dollars (i.e., adjusted for price changes/inflation). At the top, we start with Panel A, economic output (GDP) per Employed Person, a measure of national productivity. We see that productivity has increased by 52 percent since 1990. As a general rule, increases in productivity are necessary to generate increases in income and wealth for most of the population. We also note that the level of productivity in the United States in 2020, $127,378, is the highest among the 30 largest economies in the world. Panel B shows that (real) average annual earnings have increased 23 percent since 1990. Panel C moves from individual earnings from work to household income from all sources, including earnings, but other sources also (e.g., employer contributions for health care premiums, unemployment compensation, business income, capital income/gains, among others). We provide two sets of household income, before and after taxes (generally higher at higher income levels) and (means-test, meaning based on income) transfers (e.g., Medicaid; Children‘s Health Insurance Program; these transfers are generally higher at lower income levels). We see that income overall (All) has grown by 45 percent since 1990, before transfers and taxes and 51 percent after adjusting for taxes and transfers. Growth in economic output is the basis for growth in overall income (and wealth). However, the way income and wealth is distributed is also important. We show the income shares for

the top 1 percent of income group and for selected quintiles (each one-fifth of the distribution). We see that income of the top 1 percent in 2020, after transfers and taxes, was $1,343,000 and it has grown by 110 percent since 1990. In contrast, the other quintiles have income that is considerably lower in 2020 (e.g., 68,000 in the middle quintile) and, although their growth rates are positive and significant, ranging from 37 percent to 68 percent, their growth has been considerably lower than for the top 1 percent group. Finally, Panels D and E show household wealth and individual wealth, including shares at the top. Again, there is good news in that household wealth has grown substantially over time, nearly tripling from 1990 to 2020. In this case, we need to account for the fact that the population also grew. Clearly, however, population growth was much smaller, indicating that the wealth of Americans really has increased substantially over time. However, wealth is very concentrated. We see that the top 10 percent hold 77 percent of the country's wealth and the top 1 percent hold 38 percent of its wealth. We also see that the concentration of wealth has increased since 1990.

The focus on the distribution of income and its implications for justice or equity is also seen in the attention paid to earnings differences by demographic groups.[8] For example, a comparison of earnings between men and women highlights what many consider inequities in pay decisions. Among full-time, year-round workers in the United States, women earn 82 percent of what men earn (up from 60 percent in 1980).[9] If women had the same characteristics as men, especially years and continuity of work experience and worked in the same occupations and industries, the gap narrows by one-half or more (see **Chapter 17**).[10] However, even with that, women would earn 93 percent of what comparable men earn, thus still leaving a sizable gap. Society has taken an interest in such earnings differentials. One indicator of this interest is the introduction of laws and regulations aimed at eliminating the discrimination that causes them.[11] (See **Chapter 17**.)

Based on the discussion above, it seems clear that people care greatly about their income. However, one well-known study on this issue by Kahneman and Deaton has sometimes been incorrectly (and/or incompletely interpreted) to mean that money only matters up to a point.[12] For example, based on the study, $75,000 (let's call it more like $95,000 adjusted for inflation) has been identified as the magic amount of annual income that makes people happy and paying them more had severely diminishing returns such that annual income beyond $75,000 did not increase their happiness any further. However, that result is based on asking people about the emotional well-being ("happiness) they experienced yesterday. Perhaps not surprisingly, having had a "headache" yesterday or reporting "zero social time with friends or family yesterday, including telephone and email-contact" had much larger effects on the emotional well-being/affect they felt yesterday than did whether their annual income was above $75,000. In contrast, when asked about life evaluation on a scale ranging from 0 ("worst possible life for you") to 10 ("the best possible life for you"), there was almost no diminishing return to higher income (measured on a log scale, equivalent to using percentage increases in income). As Kahneman and Deaton put it, there is "a fairly steady rise in life evaluation" in proportion to increases in income "over the entire range." Even returning to "happiness," Deaton and Kahneman caution: "Our data speak only to differences; they do not imply that people will not be happy with a raise from $100,000 to $150,000, or that they will be indifferent to an equivalent drop in income." In summary, the Deaton and Kahneman findings can be interpreted to mean, first, that increases in income that help people avoid poverty or the threat of poverty (or what is called financial precarity) have a major positive impact on both happiness and life evaluation. Second, these increases in income have diminishing returns for increasing happiness (as measured by emotional well-being the day before) beyond $95,000 in today's dollars. Third, it would be a mistake to think that reducing anyone's pay to $95,000 would do anything but make them unhappy. Fourth, higher pay is associated with higher life satisfaction and that association continues beyond $95,000.

Benefits given as part of a total compensation package, like wages/salaries, may also be seen as a reflection of equity or justice in society. As we will see, private sector employers spend about 42 cents for benefits on top of every dollar paid for **wages** and **salaries.** (State and local government employers pay even more: 62 cents in benefits on top of every wage dollar.)[13] Individuals and businesses in the United States spend $3.6 trillion per year, or about 17 percent of U.S. economic output (gross domestic product) on health care.[14] Nevertheless,

as we will see, many (over 30 million) of people in the United States (over 8 percent of the population) have no health insurance.[15] (Prior to implementation of The Affordable Care Act of 2010, over 48 million were uninsured.)[16] A major reason is that the great majority of people who are under the age of 65 and not below the poverty line obtain health insurance through their employers, but small employers, which account for a substantial share of employment, are much less likely than larger employers to offer health insurance to their employees. As a result, the great majority of uninsured in the United States are from working families. (Of the uninsured, 85 percent have a full-time worker in the family and another 11 percent have a part-time worker in the family.)[17] Given that those who do have insurance typically have it through an employer, it also follows that whenever the unemployment rate increases, health care coverage declines further. (Some users of online dating services provide information on their employer-provided health care insurance. Dating service "shoppers" say they view health insurance coverage as a sign of how well a prospect is doing in a career.)

Job losses (or gains) within a country over time are partly a function of relative labor costs (and productivity) across countries. People in the United States worry about losing manufacturing jobs to Mexico, China, and other nations. (Increasingly, white-collar work in areas like finance, computer programming, and legal services is also being sent overseas.) **Exhibit 1.2** reveals that annual salary cost per employee (these numbers do not include benefits) in Mexico is $17,594, or about one-quarter of the $65,836 average salary in the United States. China's estimated annual salary of $12,430 is less than one-fifth of the U.S. rate. However, the value of what is produced also needs to be considered. Productivity in China is also roughly one-fifth that of U.S. workers, whereas Mexican worker productivity is about one-third of the U.S. level. Finally, if low wages are the goal, there always seems to be somewhere that pays less. Some companies (e.g., Coach) are now moving work out of China because its hourly wage, especially after recent increases, is not nearly as low as in countries like Vietnam, India, and the Philippines.[18] However, for other companies—such as Foxconn, which builds iPhones and iPads for Apple—even with increases in wages in China, labor costs remain very low in China compared to those in the United States and other advanced economies. Foxconn appears to be poised to continue having a large presence in China, a part of the world where most of its supply chain is. However, recent events are leading it, like others, to work to diversify its production and supply chain to be less dependent on any one country. We return to the topic of international comparisons in **Chapter 7** and **Chapter 16**.)

Some consumers know that pay increases often lead to price increases. They do not believe that higher labor costs benefit them. But other consumers lobby for higher wages. While partying revelers were collecting plastic beads at New Orleans' Mardi Gras, filmmakers were showing video clips of the Chinese factory that makes

EXHIBIT 1.2 Annual Salary and Economy-Wide Productivity (Gross Domestic Product [GDP] per Employed Person), in U.S. Dollars

	Annual Salary (excludes benefits)	Productivity (GDP per employee)
United States	65,836	127,378
Mexico	17,594	45,172
Japan	38,617	78,297
China	12,430	30,074
Germany	53,638	105,234
Czechia	29,281	81,079

Source: Annual salary (not including benefits) is from the Organization for Economic Cooperation and Development (OECD.org). https://data.oecd.org/earnwage/average-wages.htm, Salary data for China are from: Table 4-12, China Statistical Yearbook 2019. National Bureau of Statistics of China. http://www.stats.gov.cn/tjsj/ndsj/2019/indexeh.htm. Converted from yuan to USD using average exchange rate for 2019. Productivity is gross domestic product (GDP), in constant 2017 PPP $, divided by total employment in the economy. Purchasing power parity (PPP) adjustments are made to adjust for what can be purchased in different countries with the equivalent of a U.S. dollar. Source: The World Bank. https://data.worldbank.org/indicator/SL.GDP.PCAP.EM.KD.

the beads. In the video, the plant manager describes the punishment (5 percent reduction in already low pay) that he metes out to the young workers for workplace infractions. After viewing the video, one reveler complained, "It kinda takes the fun out of it."[19]

Stockholders

Stockholders are also interested in how employees are paid. Some believe that using stock to pay employees creates a sense of ownership that will improve performance, which in turn will increase stockholder wealth. But others argue that granting employees too much ownership dilutes stockholder wealth. Google's stock plan cost the company $600 million in its first year of operation. So people who buy Google stock (stockholders) are betting that this $600 million will motivate employees to generate more than $600 million in extra stockholder wealth.

Stockholders (also called shareholders) have a particular interest in executive pay.[20] (Executive pay will be discussed further in **Chapter 14**.)[21] To the degree that the interests of executives are aligned with those of shareholders (e.g., by paying executives on the basis of company performance measures such as shareholder return), the hope is that company performance will be higher. There is debate, however, about whether executive pay and company performance are strongly linked in the typical U.S. company.[22] In the absence of such a linkage, concerns arise that executives can somehow use their influence to obtain high pay without necessarily performing well. **Exhibit 1.3** provides descriptive data on chief executive officer (CEO) compensation. Note the large numbers (total annual compensation of $12.3 million) and also that the bulk of compensation (stock-related) is connected to shareholder return or other (primarily short-term, or one year or less) performance measures (bonus). As such, one would expect changes in CEO wealth and shareholder wealth to generally be aligned. We will return to this topic in more depth in **Chapter 14**.

In **Chapter 14** we will suggest that, on average, CEO interests and shareholder interests appear to be significantly aligned, but there are important exceptions and it is certainly an ongoing challenge to ensure that executives act in the best interest of shareholders. For example, during the meltdown in the financial services industry, top executives at Bear Stearns and Lehman Brothers regularly exercised stock options and sold stock during the period 2000–2008 prior to the meltdown. One estimate is that these stock-related gains plus bonus payments generated $1.4 billion for the top five executives at Bear Stearns and $1 billion for those at Lehman Brothers during the 2000–2008 period. "Thus, while the long-term shareholders in their firms were largely decimated, the executives' performance-based compensation kept them in positive territory." The problem here is that shareholders paid a huge penalty for what appears to have been overly aggressive risk-taking by

EXHIBIT 1.3 Annual Compensation of Chief Executive Officers, U.S. (S&P 500) Public Companies

	Median
Compensation Component	
Salary	$ 1,200,000
Bonus	$ 2,000,000
Stock Grants	$ 6,500,000
Stock Option Awards	$ 0[a]
Total Annual Compensation	$ 12,300,000

[a]The mean was $2.0 million.

Source: Equilar, CEO Pay Trends. Equilar.com. Because medians are used, compensation components do not add up to equal total annual compensation.