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Michael J. Piore
David W. Skinner Professor
of Political Economy

Department of Economics
Massachusetts Institute of Economics
50 Memorial Drive, Room E52-271c
Cambridge, MA 02142
Telephone: 617 253-3377
Email: mpiore@mit.edu

AIG, Executive Compensation, and the Moral Foundations of Capitalism

The furor over the bonuses paid to the AIG executives has dissipated, receding into the background, another in the episodes of anger and resentment which have punctuated the economic crisis and the government's attempt to deal with it. But the issues of compensation and the standards by which it is set are unlikely to disappear. The Federal government is rapidly gaining control over four major industrial sectors, finance and automobiles now, medical care and energy before the end of the year. It's an expansion of Federal clout in the private sector unseen for more than sixty years; and with it comes an unprecedented opportunity to resolve intractable problems. Through the policies it sets in the industries it controls, the Obama Administration has the chance not only to restore faith in our broken markets – but to provide a new foundation for our economic system.

To appreciate what is at stake here, it is important to understand how the compensation structure in the United States has evolved over the course of the last thirty years. From 1980 through 2008, virtually all of the gains in labor productivity have gone to the top one half of one percent of the income distribution. This group includes elite lawyers and Wall Street traders as well as top corporate executives (also star entertainers and sports figures), but the executives constitute a significant component, and their compensation rose as a percent of average worker earnings about four and one-half times, from 30 to 40 times the compensation of the average worker in the late 1970's and early 1980's to 160 to 180 times average compensation. Average compensation over the period as a whole was essentially unchanged. These figure contrasts

sharply with those in the preceding period. In the thirty years following the World War II, all incomes rose at about the same rate: productivity increases were evenly distributed across the distribution, and the relationship between compensation at different levels of the distribution was essentially stable. The ratio of executive compensation, in particular, was about the same in 1975 as it was in the decade of the 1950's.

Why the radical change from the first to the second period occurred and how the society tolerated this enormous redistribution in the fruits of economic growth which it entailed is not well understood. But an important part of answer was the belief that the incomes at the top were a return to the effort and creativity of those whose received them, and as such secured the prosperity of the economy as whole upon which we were all dependent. This message was preached with particular force by Ronald Reagan from the bully pulpit of the White House beginning in 1981, but it was endorsed by his successors throughout the next three decades. This message about effort and creativity was reinforced in a variety of small ways in the society at large, by for example calling the rewards "bonuses" and by the recognition accorded to the likes of Bill Gates and Steve Jobs in the popular and business press. But that prosperity which these rewards was supposed to secure has now been undermined by the crisis; the bonuses around which that compensation was structured are thought to be one of the principle causes of the crisis (when they were actually acting as bonuses and not, as AIG has revealed, a part of regular compensation paid irrespective of any measure of performance).

But if the compensation practices of the pre-crisis period are no longer acceptable, what would constitute viable standards? An obvious alternative is the relationship which prevailed in the early postwar decades, when, as noted, increases in compensation across the board pretty much tracked productivity gains. The relationship between compensation and productivity was grounded in a 1948 accord between GM and the UAW which committed the parties to a basic formula in wage setting of "an annual improvement factor (AIF) plus a cost of living allowance (COLA)", where the AIF was the long-run trend in labor productivity gains for the economy as a whole. The formula then spread through the rest of the economy, as the UAW settlement became the model for other union settlements and non-union firms attempted to forestall the threat of unionization by maintaining rough parity with union wages. The force of this pattern

came from the burden which the setting of compensation placed upon labor/management relations and especially upon union leaders for whom the task of distributing income among their members, which initially seemed a political boon, turned out to be very divisive for the organization and a threat to their careers. The Administration will no doubt come to find this task of wage setting equally burdensome and, if it can no longer attribute the results to the impersonal workings of the market, may well find a formula of this kind equally attractive.

The AIF acquired additional force as the basis for Federal income policy in 1962. Here the formula was promulgated by President Kennedy's Council of Economic Advisors, independently of the GM-UAW accord and certainly without reference to it, as a purely technical standard for price stability. So long as the distribution of national income between labor and capital remained essential fixed, as it had during most of the industrial history of the United States, the maximum increase in wages which was consistent with price stability, the Council argued, was the average increase in labor productivity for the economy as a whole. The formula continued to constitute the basic standard for wages through the period of active incomes policy which extended through both Democratic and Republican administrations into the early 1970's. To the extent that it was a real factor in wage determination, its success must have come in part from the way it reinforced the weight of the auto formula, and possibly moderated the role of the cost of living portion of the GM-UAW which built inflationary expectations into the economy and was definitely excluded by the CEA formula. Income policy, particularly in the later period, also put a great emphasis on respecting (and hence preserving) existing wage relationships. These formulas were never applied mechanically. For both the unions keyed to the GM-UAW accord and the Council of Economic Advisors keyed to a much more technocratic version, it was basically a benchmark, and within it a lot of adjustment at the margin took place.

Interestingly and importantly, the AIF formula, and the stability which it seemed to introduce into compensation practices, was not inconsistent with rewards for effort or creativity. Unions made major efforts in the postwar period to systematize and regularize bonus systems in a variety of industries – most notably for example, in steel and in ladies' garments – but they did not eliminate them. And beginning in the 1950's, stock options became a very common component of executive compensation. Thus it seemed that wage setting in the first thirty years

of the postwar period was distinguished from wage setting in the second thirty years more by the extent to which pay differentials recognized differences in individual contributions, not by a refusal to recognize individual differences at all.

But the AIF suggests a very different story about economic advancement and technological change than the compensation practices of the years immediately preceding the crisis. The latter emphasizes the role of individual inventors and entrepreneurs, and is epitomized by the prominent place accorded pictures of Eli Whitney, Alexander Graham Bell, and Thomas Edison in American history texts for elementary and high school students. But the AIF formula points instead to the phenomenon of simultaneous discovery, the also-rans of the history of technology (in telephones, Innocenzo Manzetti, Antonio Meucci, Johann Philipp Reis, Elisha Gray, and Thomas Edison; for electric lights, George Westinghouse, Joseph Swan, Henry Woodward; with the cotton gin, Catherine Littlefield Greene Hogden Holmes, Robert Watkins, William Longstreet, and John Murray), who were hot on the trail and would have soon have introduced the cotton gin, the telephone or the electric light if those to whom we now do homage in our textbooks had not gotten there first. It paints a picture of economic progress as a collective enterprise drawing on the history of science and technology which we all share and depending more on the way our perspective shifts gradually over time so that all of us come, more or less at the same time, to see the things in new ways. Here the cellular telephone is paradigmatic. No one gets credit for the cell phone. Indeed it is hard to cite a moment when the cell phone as we think of it today actually emerged. It derived from the car mounted radios of the police and taxi and evolved gradually into a handheld device carried on the street, which nobody imagined when the technology began, as manufacturers watched the way consumers were using their products and made each generation of phones a little smaller than the one which preceded it.

Because of these broader implications, the shift toward the AIF can serve as a framework not only for executive compensation but also for thinking about a much broader range of issues, including trade and migration. It points, for example, toward a justification of open trading regimes which rest not on the supposed advantages of the market, but on the common heritage,

as human beings, which we share not only with our fellow citizens in the United States but with the rest of the world as well.

Ultimately, we need to reformulate our understanding of the nature of market capitalism itself. The economic theory of the competitive market is a very complex story. It has both an individual and a communitarian component. The individual component is about the way in which the competitive market generates rewards and punishments to which individuals respond, and that is the piece of the story which has been emphasized in the politics of the last thirty years. But the market is also a story of community and cooperation. This second story stresses the way in which a modern economy develops through specialization as we move progressively away from isolated Robinson Crusoes, each of us more or less self-sufficient, but not very productive, to highly specialized producers, very efficient in a much narrower range of activities but also highly dependent on other people to produce the full range of goods and services which we need to survive and which as Robinson Crusoes we were once able to produce for ourselves. In the second story, the market is the mechanism which coordinates all of us and ensures that the highly specialized units work together in an efficient and effective manner. In this second story, the competitive market is both the expression of our interdependence and the institutional structure which makes that interdependence possible. This piece of the story has been lost in the last thirty years. But if it can be recaptured and made central once again to our political discourse, it will provide the moral basis which the economy needs to recover and survive.