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Tuesday, October 27, 2009

The real pay scandal

Assessing the fruits of undercompensation

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By Richard W. Rahn

Assume your boss told you that the only pay raise you and your fellow workers would ever receive would be a "cost of living" increase to keep up with inflation - which is no real increase - no matter how productive you were. Would this motivate you to work harder, or might you cut corners and just make the minimum effort to keep your job?

American salaried workers, on average, make about three times as much in real (inflation-adjusted) dollars as they did a century ago ($12,537 versus $38,376 in current dollars). However, one group of salaried workers has not had a "real" pay increase since 1907 - members of Congress.

In 1909, members of Congress were paid $7,500 per year, which translates into about $172,000 in current dollars. The current pay of members of Congress is $169,300 per year, which means they have suffered a small pay cut from what they were paid a century ago.

The income tax was not created until 1913, so the folks who served in Congress before that time also had tax-free income and thus had significantly higher disposable incomes than those who currently serve.

Congress and the administration named a "pay czar "early this year, Kenneth Feinberg, to set compensation for the senior officials of companies the government had bailed out. His stated goal was to establish and encourage "performance-based" compensation systems.

Last week, Mr. Feinberg demanded very significant (average 90 percent) pay cuts for many executives in the named companies. The head of Bank of America, Kenneth Lewis, was required to go without any salary this year and pay back $1 million from what he previously had earned because of the losses and poor performance of Bank of America during the past two years.

Public opinion polls show the performance rating of Congress at record low levels. Given that Congress and top administration officials are requiring pay cuts for those in the private sector whose companies have performed poorly, should not the same standard apply to those in government who have had a major responsibility for running the economy into the ground? (Note: Presidents and members of Congress always claim credit when the economy is performing well, so isn't it fair to blame them when the economy is in a mess?)

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compensate themselves for any loss of income caused by inflation and devise numerous nontaxable and hidden perks for themselves. Such a system gives them no vested interest in protecting the rest of us from inflation or any interest in pro-growth economic policies.

In fact, many of them act as if they believe that harmful economic policies are in their self-interest because they promote dependency on government and thus increase the power and influence of the political class.

If members of Congress had maintained the relative value of their 1907 salary (the year they increased their salary to $7,500) to the growth in wages in the private sector, they would be paying themselves approximately $510,000 per year.

Before you say that is outrageous and they are not worth the $169,300 they receive now, consider this: If you had the choice of owning stock in a company where the chief executive officer was paid $200,000 per year and the average annual appreciation in the value of your stock was 3 percent yearly or owning stock in a company where the CEO was paid $20 million a year but the average annual appreciation in the value of your stock was 10 percent per year, which stock would you choose to own?

Personally, I would be very pleased to pay members of Congress, top executives in the administration and members of the Federal Reserve a half-million dollars each per year if they would deliver economic growth of 4 percent or more each year. (This would have the additional benefit of their not calling every small-business person who makes $250,000 per year "rich.")

That would be a much better deal for the taxpayers and all other citizens than paying members of Congress less (with no incentives for better results) and having economic growth range only from zero to 3 percent per year.

Again, I do not pretend to know the right salary level for the political class in Washington, but like the claims of the politicians, I do believe in pay-for-performance. So let us offer them this deal: They will automatically receive a pay raise equal to the after-tax percentage increase in personal income that the average American receives each year, provided the debt burden as a percentage of gross domestic product has not increased, in which case there would be no pay raises. We could call it "The Federal Pay Economic Growth and Fiscal Responsibility Incentive Act."

If such a pay policy had been in place for the past 100 years, members of Congress would be paid several times more than they earn now, but chances are everyone also would be earning much more, and the country would have far fewer poor citizens and much less debt.

Richard W. Rahn is a senior fellow at the Cato Institute and chairman of the Institute for Global Economic Growth.

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