

Corporate Compensation and the Human-Centered Enterprise

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Why do business enterprises today so often engage in socially and environmentally unsustainable behaviors? For any initiative that seeks to encourage the expansion of human-centered enterprise, no question could be more important. Shared prosperity and inclusive economic growth will, after all, likely remain little more than empty rhetorical goals if business leaders have ongoing incentives to conduct themselves unsustainably.

In today's business world, incentives for unsustainable behavior certainly do exist. They come first and foremost from excessive executive compensation.

How excessive? Over recent decades, the rewards available for top corporate executives worldwide have increased by tenfold and more. A half-century ago, in the mid 20th century, few executives anywhere on earth took home over 30 times the earnings of their employees. In some nations today, that gap regularly spills over 300 times.¹

One recent analysis, based on data from the Bloomberg Global CEO Pay Index, found that major corporate chief executives in South Africa on average make as much in 7.3 hours of work as South African workers can average in a year. Top executives in the United States need a bit more time, 13.2 hours, to equal annual American worker pay. Even in Norway, a nation widely regarded as a global egalitarian pacesetter, chief executives need labor less than a week, just 39 hours, to match what Norwegian employees must work for an entire year to earn.²

Corporate pay disparities have now become an issue that transcends political party labels of left and right. British Conservative Party leader Theresa May, for instance, made an attack on excessive corporate executive pay one of her first orders of business after becoming prime minister in 2016.

"There is an unhealthy and growing gap," May pronounced, "between what these companies pay their workers and what they pay their bosses."³

Such sentiments have been especially commonplace in political and analyst circles ever since the 2008 financial crash that ushered in a global Great Recession. An OECD report on that breakdown charged that executive "compensation schemes have often led to excessive risk taking."⁴ Executive pay patterns, added then-U.S. President Barack Obama "have contributed to a reckless culture and quarter-by-quarter mentality that in turn have wrought havoc in our financial system."⁵

Outrageously high rewards, executive pay critics contend, give top executives an incentive to behave outrageously not just in high finance, but throughout the economy. The greater the potential reward, the greater the temptation to grab that reward by any means necessary — by speculating irresponsibly, by shortchanging worker training and slashing funding for research and development, by overcharging and cheating consumers, and, should all else fail, by simply "cooking the books."

The broad outrage over these sorts of behaviors has not yet translated into any consensus over solutions. CEO pay reformers have essentially split into two distinct camps.



One camp looks to corporate *shareholders* for salvation. Reformers in this camp are demanding a “say on pay” for shareholders as well as changes in corporate governance that give dissident shareholders a meaningful opportunity to unseat incumbents on corporate boards of directors.

Reformers in the second camp readily support all these moves to empower shareholders. But they question the unspoken assumption that underlies much of shareholder advocacy, the notion that we can rely on shareholders — and shareholders alone — to restore common sense to executive compensation.

“Why should we let shareholders be the ultimate arbiter on the size of CEO rewards,” as one second camp report has noted, “when these rewards can and do create incentives for CEO behaviors that hurt people who aren’t shareholders?”⁶

A Stakeholder Approach to CEO pay

Consumers, workers, and communities all have a stake in how corporations pay CEOs, this *stakeholder* camp argues. Shareholders, from this perspective, count as just one corporate stakeholder among many, with interests that may not align with the interests of other stakeholders. One example: A community that hands a corporation generous tax breaks to boost local employment will not be pleased if that corporation’s chief executive proceeds to aggressively outsource jobs to distant locales. Shareholders may well react much more positively — if the outsourcing raises the company share price.

Most societies already recognize this divergence of interests between shareholders and other corporate stakeholders. Few societies, for instance, leave to shareholders the responsibility for making sure that corporations refrain from fouling the environment. Instead, nations typically legislate how corporations can behave environmentally.

By the same token, most societies do not expect shareholders to monitor the fairness of corporate employment practices. Instead, many nations make this a governmental responsibility and often deny government contracts to companies that discriminate by race or gender. Tax revenues, these nations believe, should not subsidize enterprises that widen race or gender inequality.

Stakeholder-oriented reformers extend this analogy to executive compensation. Tax revenues, they maintain, should also not subsidize enterprises that widen *economic* inequality.

Tax revenues today undeniably do. A wide variety of government contracts, subsidies, and tax breaks annually flow to enterprises that pay their executives hundreds of times more in compensation than their workers receive. Exactly how much more has been difficult to discern, since corporations have historically been under no mandate to publicly disclose both their executive and worker compensation.

But that reality has begun to change. In 2010, in the wake of the financial crisis, the U.S. Congress passed legislation that requires publicly held corporations to annually reveal the ratio between their top executive and median worker pay. U.S. corporations will have to calculate these ratios for the first time in 2017. The first ratio disclosures will start appearing early in 2018.

Lawmakers in India adopted a similar pay ratio disclosure mandate in 2013. The first disclosures began appearing two years later.⁷ A British ratio disclosure mandate now seems imminent, and other nations will almost certainly be following suit shortly.

Will this new wave of pay ratio disclosure mandates generate enough shame and embarrassment in corporate executive suites and board rooms to slow the widening gap between executive and worker compensation? Many executive pay reformers don’t believe so. They see top executives and corporate boards as beyond shame. But these reformers do see ratio disclosure as an important first step toward measures that could begin reversing our contemporary corporate compensation trends.

The measures these reformers are advancing place consequences on excessive executive-worker compensation ratios. In the United States, one major city — Portland, Oregon — has recently tied CEO-worker pay ratios to business tax rates.⁸ Enterprises doing business in Portland will soon have to pay a 10 percent surtax on the tax they currently pay if their CEOs earn more than 100 times what their workers are earning and a 25 percent surtax if CEO pay extends over 250 times worker pay levels. Other cities across the United States, including San Francisco, are now contemplating comparable actions.

Related legislation that would tie government procurement to a firm's CEO-worker pay gap is now pending at the U.S. state level. **One bill under review in Rhode Island would give firms with CEO-worker pay ratios of less than 25-to-1 preferential treatment in contract bidding process.**

Legislative initiatives like these will likely proliferate as pay ratio disclosure mandates become more widespread. Advocates for these measures make two distinct points. Our societies, they argue, need to stop incentivizing corporate executive behaviors that undermine worker and community well-being.

The Benefits of Narrow Pay Gaps for the Bottom Line

Our societies, these reformers also argue, need to understand that wide corporate pay divides undermine the viability and efficiency of enterprises themselves, a point analysts have been making ever since Peter Drucker, the founder of modern management science, began considering how pay divides impact corporate cultures. A wide pay disparity within an enterprise, Drucker believed, "destroys mutual trust between groups that have to live together and work together."⁹

Subsequent research has deepened Drucker's insight. "Large differences in status," one Brookings Institution analysis has concluded, "can inhibit participation."¹⁰ "Extreme wage differentials between workers and management," agreed four scholars in another major study, "discourage trust and prevent employees from seeing themselves as stakeholders."¹¹

Those who care deeply about building effective enterprises have drawn one clear conclusion from this research. To be serious about creating effective organizations for a modern economy, enterprises simply must narrow wide reward differentials. Enterprises that crave the best their employees have to offer, but ignore gaping differentials in compensation between top and bottom, do so at their peril.

In today's Information Age, top-down decision making no longer suffices. To be effective, enterprises need the knowledge their front-line employees possess about customers and production processes. This knowledge in hand, enterprises can deliver on what consumers want — by providing products and services at a quality and cost that customers will find impossible to pass up. Effective enterprises, in other words, concentrate on customers, first, last, and always.

But the leaders of too many enterprises today go about their work preoccupied by their own selfish interests. No one should expect otherwise. Where we allow corporate wealth to concentrate without limit, corporate executives will concentrate first and foremost on grabbing their piece of that wealth. Holding corporate executive compensation within reasonable pay-ratio limits, more and more observers are coming to believe, needs to become an enterprise imperative.

A human-centered business model that incorporates this imperative would speed the enterprise transformation the modern world so desperately needs to see.

¹ AFL-CIO, Executive PayWatch, May 2016. Accessed from <http://www.aflcio.org/Corporate-Watch/Paywatch-2016>

² Aamna Mohdin, The world's highest paid CEOs have already earned more than most people will this year, *Quartz*, January 5, 2017.

³ Mark Thompson, U.K.'s next prime minister: I'll tackle executive pay, *CNN*, July 11, 2016.

⁴ Gert Wehinger, Lessons from the Financial Market Turmoil: Challenges ahead for the Financial Industry and Policy Makers. Organization for Economic Co-operation and Development (OECD) Financial Market Trends No. 95, January 8, 2009.

⁵ President Obama's Remarks on Executive Pay, *New York Times*, February 4, 2009.

⁶ Institute for Policy Studies and United for a Fair Economy, *Executive Excess 2006*, Washington, D.C.

⁷ Editorial, Runaway Pay, *The Hindu BusinessLine*, July 8, 2015.

⁸ Jerry Large, Portland targets CEO pay to save the American dream, *Seattle Times*, December 12, 2016.

⁹ Rick Wartzman, Put a Cap on CEO Pay, *BusinessWeek*, September 12, 2008.

¹⁰ David I. Levine, *Reinventing the Workplace: How Business and Employees Can Both Win*. Washington, D.C., The Brookings Institution, 1995, p. 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, p. 44.