Worker Pay vs. CEO Pay

BY TIM SABLIK

In the debate over the causes of the financial crisis of 2007-2008, many commentators have singled out executive compensation packages at financial firms as playing a key role. They argue that in the run-up to the crisis, pay packages encouraged CEOs to take excessive risks.

Among other things, the 2010 Dodd-Frank Act directed financial regulators to address these concerns. One of its provisions, "say on pay," was implemented in 2011 by the Securities and Exchange Commission (SEC). Say on pay is designed to give shareholders more influence over executive pay. (See "Checking the Paychecks," *Region Focus*, Fourth Quarter 2011.) Several countries have adopted such laws, and a 2013 cross-country study by Ricardo Correa of the Federal Reserve Board and Ugur Lel of Virginia Tech found that they have generally been associated with reduced executive compensation that is more sensitive to firm performance.

On Aug. 5, 2015, the SEC adopted a complementary rule that requires public companies to calculate and disclose the ratio of their CEO's compensation to that of their median worker, starting in 2017. Firms are given some flexibility in how they determine their employee population for purposes of the rule. For example, they may exclude some of their non-U.S. employees from their total count and generally can choose to update their calculation only every three years. According to a statement by SEC Chair Mary Jo White, the rule is intended to provide shareholders with "additional company-specific information that they can use when considering a company's executive compensation practices."

Many on both sides of the issue have raised questions about how much effect the new rule will have. Supporters of such disclosure have argued that the flexibility granted to firms under the rule, designed by the SEC to address companies' concerns about the costs of calculating the ratio, makes the ratio subject to manipulation by firms. Others have argued that the disclosure offers little new information. Firms have long been required to disclose the compensation of top executives, and many large firms report total compensation as well as number of employees, making it possible to compute average salary.

In fact, economists and think tanks have used such information to construct their own ratios of CEO and worker pay. In June 2015, the Economic Policy Institute reported that CEOs at the largest 350 firms in the S&P Index earned over 300 times the average worker in their industries, a more than 10-fold increase from the 1970s. On the other hand, Jae Song of the Social Security Administration, Fatih Guvenen of the University of Minnesota, Till von Wachter of the University of California, Los Angeles, and David Price and Nicholas Bloom of Stanford University looked at a larger pool of firms and found that much of the growth in earnings inequality can be attributed to increased differences in compensation between firms rather than within firms. Relative incomes within even high-paying firms have remained largely unchanged for three decades. This would suggest that measuring wage inequality within firms could be less meaningful.

Economists are also divided over the causes and the significance of rising executive pay. Some suggest that the large increase is a symptom of executives' strong influence over their own compensation through friendly boards, which would suggest that measures to improve corporate governance like say on pay and the new ratio could be effective at checking such behavior. But in a 2008 article, Xavier Gabaix of New York University and Augustin Landier of the Toulouse School of Economics found that rising CEO pay is tied to the growth of firms, since larger, more complex companies require a broader pool of skills to manage.

It's also unclear how large a role financial pay packages played in the financial crisis. A 2011 article in the *Journal of Financial Economics* by Rüdiger Fahlenbrach of the Swiss Finance Institute and René Stulz of Ohio State University found no evidence that firms with CEOs whose compensation was tied to company performance fared better during the financial crisis of 2007-2008; in fact, they found some evidence that they actually performed worse.

To the extent that the ratio has more to do with the debate over wage inequality than investor protection, critics have argued that the SEC does not have a role to play. Daniel Gallagher, one of the two SEC commissioners who voted against the rule, stated in his dissent that "addressing perceived income inequality is not the province of the securities laws or the Commission."

On the other hand, it's possible that public disclosure of the ratio of CEO to median employee pay could help improve corporate governance in other ways. In a 2001 article, Nobel Prize-winning economist Jean Tirole first advanced the idea of a "stakeholder society." Tirole argued that, when thinking about corporate governance, economists should also consider the effect that managerial decisions have on "natural stakeholders," such as employees, customers, and suppliers.

Requiring the disclosure of CEO-to-employee pay ratios could be seen as one step in helping to inform such a stakeholder society, forcing managers of firms to increase their consideration of employees' welfare when making decisions. Indeed, experiments conducted by Bhavya Mohan, Michael Norton, and Rohit Deshpande of the Harvard Business School found that consumers were more willing to buy from companies that reported lower CEO-to-worker pay ratios, even if that meant paying slightly more for the product. Time will tell whether the new disclosure rule will affect the behavior of consumers — and boards. **EF**