cpr asset management

DECODING

Pay gaps within companies, a new financial risk for investors

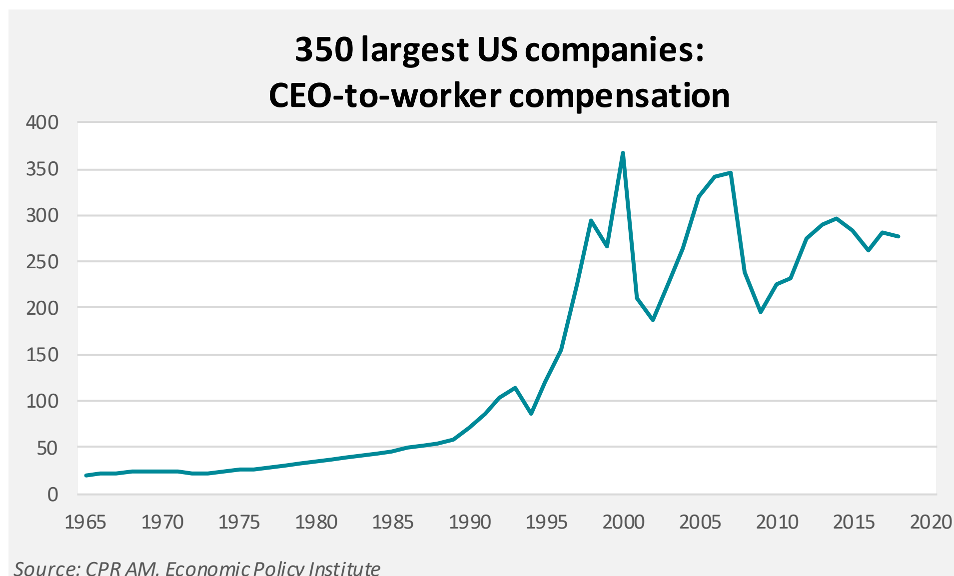
By Bastien Drut, Senior Strategist at CPR AM.

The pay gap within large companies has increased significantly in recent decades and has become one of the symbols of the rise in economic inequality. This is turning into a financial risk for companies for which the pay gap is high because a number of political initiatives aim to target them directly.

Knowing where the acceptable limits are in terms of pay gaps has been debated for a very long time. Social norms obviously depend on societies and times. In his dialogue entitled *Laws*, Plato already explained that the income of the richest person should not exceed 4 times the income of the poorest person, in order to avoid "civil disintegration". In the 1890s, John Piermont Morgan (JP Morgan), who was reputed to be tough when it came to business, explained that he was not in favor of granting loans to companies in which the highest paid employee earned more than 20 times the lowest paid employee, because he feared it would make the situation unstable[1]. In the 1950s, the average American CEO made about 20 times what the average employee in his company earned. In a column published in the *Wall Street Journal* in 1977[2], Peter Drucker, founder of many business management theories, stated that for a large company, the ratio between the highest and the lowest compensation should not not exceed 25, stating later that it was "*the limit beyond which they cannot go if they don't want resentment and falling morale to hit their companies*". However, in 2018, the compensation of CEOs of the 350 largest US companies represented on average 278 the compensation of the average rank-and-file worker[3] ... This ratio was less than 100 before the 1990s.

[1] Stern S. et C. Cooper, 2017, "Myths of management: what people get wrong about being the boss".
[2] « Is executive pay excessive? », *Wall Street Journal*, 23 May 1977.
[3] "CEO compensation kept surging in 2018", *Economic Policy Institute*, 14 August 2019.

All comments and analyses reflect CPR AM's view of market conditions and its evolution, according to information known at the time. As a result of the simplified nature of the information contained in this document, that information is necessarily partial and incomplete and shall not be considered as having any contractual value.



NB: the non-partisan think tank *Economic Policy Institute* (EPI) collects the salaries of the 350 largest American companies for each year. For each of these companies, EPI divides the CEO's compensation by the average compensation of production and nonsupervisory workers in the corporate sector, then calculates the average for the 350 companies.

The widening gap between the compensation of business leaders and that of their employees, particularly in very large companies, has been regularly pointed out as one of the symbols of the rise in economic inequality in developed countries. However, understanding the mechanisms of increasing inequalities within companies and between companies is still the subject of research and academic debate. A paper published in the *Quarterly Journal of Economics* in 2018[4] focusing on the United States showed that two thirds of the rise in the variance of earnings over the period 1978-2013 occurred between companies and one third within companies. However, researchers show that the realities in the labor market differ greatly according to the size of firms: they conclude that for large firms (more than 10,000 employees), 42% of the increase in variance of earnings between 1978 and 2013 took place within companies, as median earnings fell and as the earnings of the top 10% employees rose sharply. On the other hand, the real compensation of the highest paid 1% increased by 137% in large companies but only by 45% in small firms companies. In other words, in the United States, pay inequality has increased more within large groups than among small companies since 1978.

Following the 2008 financial crisis and in order to meet demands for more transparency, the US Congress passed the *Dodd-Frank Act* in 2010, which required listed companies to publish CEO compensation every year, the median compensation of the non-CEO employees and the ratio of these two figures (commonly known as the *CEO pay ratio*). After several years of consultations and work carried out at the SEC (Securities and Exchange Commission), this law finally came into effect from the fiscal year 2018. For that year, Tesla was the company of the S&P 500 with the highest CEO pay ratio (40668).

The fact that the publication of the CEO pay ratio is now mandatory for listed US companies can facilitate political decision-making aimed at directly countering the rise in income inequality within companies. This scenario is possible in the United States where Bernie Sanders, one of the favorites of

---

[4] Song G., D. Price, F. Guvenen, N. Bloom & T. von Wachter, 2018, "Firming up inequality", *Quarterly Journal of Economics*.

[5] https://berniesanders.com/issues/income-inequality-tax-plan/

[6] In the example cited, Bernie Sanders should win the Democratic nomination, win the presidential election, the Senate become a Democrat, and moderate Democrats in Congress be convinced by this surcharge.

All comments and analyses reflect CPR AM's view of market conditions and its evolution, according to information known at the time. As a result of the simplified nature of the information contained in this document, that information is necessarily partial and incomplete and shall not be considered as having any contractual value.

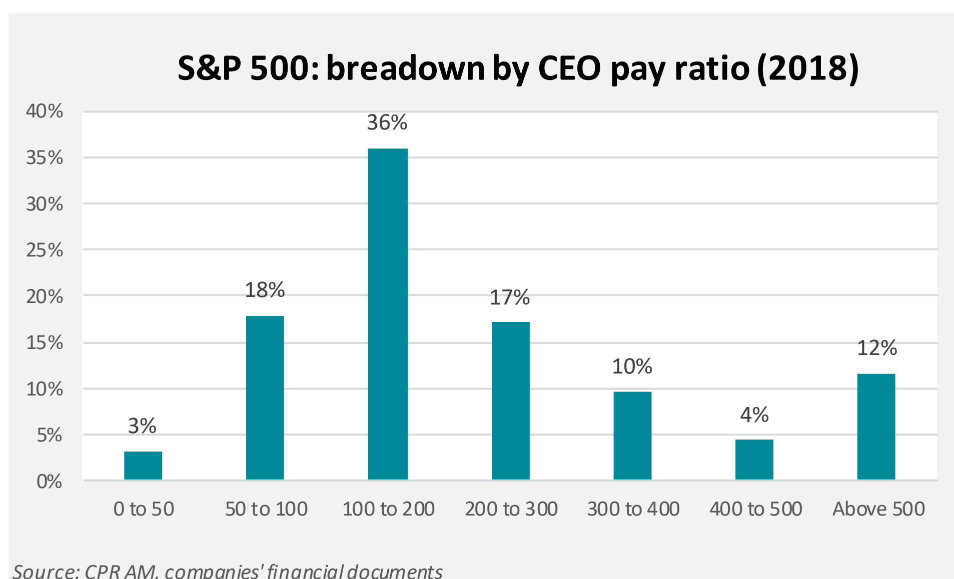
cpr

the Democratic primaries, proposes to adjust the corporate tax rate (which currently stands at 21%) according to the CEO pay ratio[5]. A bill, titled *Tax Excessive CEO Pay Act*, has been introduced at the House of Representatives (Elizabeth Warren, also a Democratic nomination candidate, sponsors the bill in the Senate). For companies with sales over $ 100 million, Bernie Sanders proposes to raise the tax rate by:

- 0.5 point when the CEO pay ratio is between 50 and 100,
- 1 point when the CEO pay ratio is between 100 and 200,
- 2 points when the CEO pay ratio is between 200 and 300,
- 3 points when the CEO pay ratio is between 300 and 400,
- 4 points when the CEO pay ratio is between 400 and 500,
- 5 points when the CEO pay ratio is greater than 500.

Almost all S&P 500 companies would be affected by such a tax because around 80% of S&P 500 companies posted a CEO pay ratio greater than 100 in 2018 (on average, this ratio was 278). According to calculations by Bernie Sanders' campaign team, this surcharge would have cost the bank JP Morgan nearly $ 1 billion in 2018 (CEO pay ratio of 381 for the 2018 fiscal year) and nearly $ 800 million to Walmart (CEO pay ratio of 1,188 for fiscal year 2018).

Even if it is unlikely that this surcharge will be applied quickly at the federal level[6], this illustrates that this type of taxation focusing on intra-company income inequalities could develop in Western political platforms.



Source: CPR AM, companies' financial documents

In addition, this type of measure is taking off at the local level. For example, the city of Portland (650,000 inhabitants) adopted in 2016 and implemented in 2018 an increase when paying the business tax license (local corporate tax) for listed companies with high CEO pay ratios: 10% increase for companies with a CEO pay ratio between 100 and 250 and 25% for companies with a CEO pay ratio greater than 250. This surcharge, which was presented as the first "inequality tax", has allowed the city to raise $ 3.5 million in total in the first year, which is relatively small. But other cities may follow. The

---

[7] Currently 10.84% for financial companies and 8.84% for others.

[8] Larcker D., N. Donatiello et B. Tayan, 2016, « Americans and CEO pay: 2016 public perception survey on CEO compensation", Stanford Business. https://www.gsb.stanford.edu/faculty-research/publications/americans-ceo-pay-2016-public-perception-survey-ceo-compensation

All comments and analyses reflect CPR AM's view of market conditions and its evolution, according to information known at the time. As a result of the simplified nature of the information contained in this document, that information is necessarily partial and incomplete and shall not be considered as having any contractual value.

cpr

city of San Francisco spoke of adopting a similar measure before postponing it. The State of California could follow: the bill SB37, discussed in the Senate of the State of California plans to increase the state's corporate tax rate of companies[7] and to adjust it according to the CEO pay ratio. Under this bill, companies whose CEO pay ratio exceeds 300 would pay 4 points more than those whose ratio is below 50. This is significant from a financial point of view.

By the way, it would be a mistake to think that income inequality is only the concern of Democrats in the United States: more than half of Republican voters think that the remuneration of business leaders should be limited in some way[8], even if it is not on the agendas of the Trump administration or of the Republican Congress members.

Finally, the display of a high CEO pay ratio can also spark controversy and pose reputational risk. In April 2019, the comments of Abigail Disney, granddaughter of the founder of the Disney group, were widely reported in the press: she explained that the compensation of the Disney CEO Bob Iger ($ 65.6 million in 2018, this which represented 1424 times the median compensation of the group) was "insane" and that the fact that this level of pay "had a corrosive effect on society". Several studies have shown that consumers avoid buying products from companies with high CEO pay ratios[9] and that this can also affect employee perception[10][11].

In conclusion, it is becoming increasingly clear that large companies in which the pay gap is high incur long-term financial risk. In the United States, the entry into force of the publication of the CEO pay ratio for listed companies provides political authorities with a tool to target companies with high pay differentials. It is also one of the stakes of the 2020 US presidential election.

Date of publication : 13 February 2020

Information:
All comments and analyses reflect CPR AM's view of market conditions and its evolution, according to information known at the time. As a result of the simplified nature of the information contained in this document, that information is necessarily partial and incomplete and shall not be considered as having any contractual value.

This document has not been drafted in compliance with the regulatory requirements aiming at promoting the independence of financial analysis or investment research. CPRAM is therefore not bound by the prohibition to conclude transactions of the financial instruments mentioned in this document. Any projections, valuations and statistical analyses herein are provided to assist the recipient in the evaluation of the matters described herein. Such projections, valuations and analyses may be based on subjective assessments and assumptions and may use one among alternative methodologies that produce different results. Accordingly, such projections, valuations and statistical analyses should not be viewed as facts and should not be relied upon as an accurate prediction of future events.

About CPR Asset Management:
CPR AM is an investment management company certified by the French Financial Markets Authority, an autonomous and wholly owned subsidiary of Amundi Group. CPR AM works exclusively in third-party investment management (for institutional, corporate, insurance, private banking, fund management, and wealth management clients). CPR AM covers the main asset classes, including equities, convertibles, diversified investments, interest rates and credit).

CPR AM in figures (End December 2019)
– More than €52 billion in AuM
– More than 100 employees, more than one third of whom are involved in investment management.

CPR ASSET MANAGEMENT, limited company with a capital of € 53 445 705 - Portfolio management company authorized by the AMF n° GP 01-056 - 90 boulevard Pasteur, 75015 Paris - France – 399 392 141 RCS Paris.

cpr-am.com @CPR _AM cpr-asset-management

---

[9] Mohan B., T. Schlager, R. Deshpandé et M. Norton, 2018, "Consumers avoid buying from firms with higher CEO-to-worker pay ratios", *Journal of Consumer Psychology*.
[10] Benedetti A. et S. Chen, 2018, "High CEO-to-worker pay ratios negatively impact consumer and employee perceptions of companies", *Journal of Experimental Social Psychology*.
[11] Green C. et D. Zhou, 2019, "Pay inequality, job satisfaction, and Firm Performance".