



# ***The Fat Cat Diet***

***A progressive plan for wage fairness***

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The Centre for Labour and Social Studies (CLASS) is a leading left think tank working to ensure policy is on the side of everyday people. Originating in the trade union movement, CLASS has an authentic connection to working people and a unique insight into the challenges society faces. we combine grassroots voices with intellectually compelling analysis to show an alternative way forward. CLASS works with a coalition of academics, activists and politicians to inspire the left and cement a broad alliance of social forces to support reform, and equip our supporters with the tools to popularise a new agenda.

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# Executive Summary

Friday 4th January 2019 was Fat Cat Day. In just three working days, the typical FTSE 100 chief executive will have made more money than the typical full-time worker will earn in the entirety of 2019.

At a time when so many workers are struggling to make ends meet, with real wages lower than they were before the financial crisis, it is not right that chief executives are now taking home nearly 150 times the average UK salary. Despite public anger at these huge pay packets, little has been done to challenge and reduce these gross inequalities.

As this report will show, piecemeal reforms that rely on the good will of corporations and executive remuneration committees that are stuffed full of fellow chief executives have failed, and will continue to fail, to combat excessive pay. Naming and shaming companies with huge pay disparities has proven to be wholly ineffective.

Legislation passed at the beginning of this year, forcing companies to publish the difference between the remuneration of their CEO and their average worker, is a step in the right direction. However, this is no silver bullet.

Our companies need to be made more democratic and participatory. As such, there is a much needed role for strengthened trade unions and collective bargaining agreements that prevent ever-increasing amounts accruing to the top one percent. Removing excessive pay from being corporate tax deductible has the potential to raise over £4.6 billion annually and will act as a strong disincentive to companies who continue to pay-out high salaries.

It is overwhelmingly clear that excessive pay and the inequalities they produce do not have the support of the general public. Not only do these disparities reduce staff morale, they restrict genuine investment and innovation in our businesses and economy. Bringing an end to such fat-cattery can only benefit us all■



# Introduction

The wealth and profits of a company are the outcome of collective endeavour and, as such, the proceeds should be shared more equitably, argues Liam Kennedy.

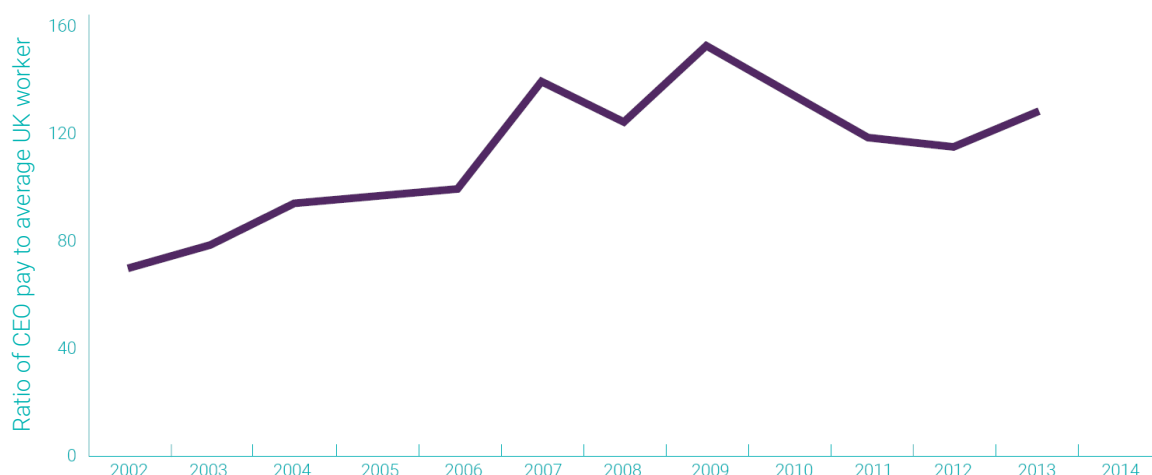
While ongoing austerity measures have inflicted needless misery and hardship on those at the bottom of the income distribution, those at the top end have been enjoying healthy pay rises. Research from the CIPD and High Pay Centre revealed that median CEO pay increased by 11 per cent in the financial year 2016-17.<sup>1</sup>

This year's Fat Cat Day – the day in which FTSE 100 CEOs will have made more money than the typical UK full-time worker will earn in the entire year – is Friday 4th January.

There is widespread support for curtailing these massive disparities. In a recent survey, British people estimated the ratio between CEO and employee pay at about 15:1. They stated that their ideal ratio would be about 5:1. The figure below only dates to 2014 but the current gap is approaching 150:1 and continues to grow.

## FTSE 100 CEO remuneration to average employee pay (ratio)

Figure 1



Source: House of Commons, Business Energy and Industrial Strategy Committee. Corporate Governance. Fourth Report of Session 2016-17



Not only do the public desire a more equitable distribution of income, recent proposals for curtailing executive remuneration have also proven popular. A 2018 survey showed that over half of those surveyed supported increasing taxes for those on higher incomes. 39 per cent of voters strongly favoured a cap of 20:1 on the ratio between an employer's highest wage and lowest-paid workers, while just eight per cent strongly opposed one.<sup>2</sup>

The Labour Party manifesto for the 2017 General Election included pledges to introduce an excessive pay levy for those on extremely high incomes (earning over £330,000) and limiting public procurement to organisations that exceeded a pay ratio of 20:1.

When Theresa May initially took office she promised to tackle the UK's "burning injustices", pledging to run a government "not driven by the interests of a privileged few." She promised workers on boards and reining in corporate excess. Unfortunately, many of the reforms and corporate governance regulations simply rely on the good will of big corporations with little or no oversight or enforcement. This is wholly insufficient.

There have been plenty of recent examples highlighting the irresponsibility and recklessness of lavish directors. The financial crisis itself was the result of 'fat cats' in the city pursuing greater profits and dividends by selling and manipulating dodgy mortgages (as argued by even the UK's Banking Standards Commission).<sup>3</sup> In the last year we have seen how underhand accountancy practices led to the demise of Carillion and the public furore surrounding the £75 million payout to Jeff Fairburn, CEO of Persimmon, who was ultimately asked to leave his role.

## Why should we care about excessive executive pay?

Excessive incomes are not the outcome of hard work or just rewards for great productivity. Instead, they represent the power of shareholders to dictate their own levels of remuneration, reinforcing their own social status, and justifying it with the claim of their 'unique' ability to do the job. They are what Thomas Piketty calls 'super-managers' and are a key driver behind growing income inequality.<sup>4</sup>

As Mariana Mazzucato has argued, neoclassical economics has conflated value with price to the extent that all income is earned income. Gone is the assessment of whether this income comes about through value creation or value extraction. In her words, "all income, according to this logic, is earned income: gone is any analysis of activities in terms of whether they are productive or unproductive."<sup>5</sup>

Take the example of Jeff Fairburn at housebuilder Persimmon, who was able to earn a ludicrously high income through the housing market and schemes such as Help to Buy. These activities do not add to the productive capacity of the economy, they instead extract value from other areas of the economy (through the rents of tenants or the increase in land value around new builds) enabling chief executives to enrich themselves.

A similar example that highlights this disconnect is the former chief executive of Goldman Sachs, Lloyd Blankfein, who in 2009 claimed that "the people of Goldman Sachs are among the most productive in the world." Yet, just the year previously, Goldman Sachs had been an integral player in the largest economic crisis in almost a century, bankrupting the US state and driving millions of people into unemployment.

Very clearly, this definition of productivity and justification for high pay has no basis in reality. The Incomes Data Services has shown that there is practically no relationship between directors' pay and a company's performance.<sup>6</sup> Similar conclusions have been reached by the Lancaster University Management School<sup>7</sup> and The High Pay Commission.<sup>8</sup> Even the Investment Association, which is a trade body that represents UK investment managers, concluded in a 2016 report that "rising levels of executive pay over the last 15 years have not been in line with the performance of the FTSE over the same period."<sup>9</sup>

Furthermore, growing disparities between those at the top of the firms and ordinary workers are bad for business. This is true not just at a macro-level where share buybacks and the reckless pursuit of profits inhibit investment and innovation but also within firms where greater inequalities in pay lead to poor company performance and low staff morale.

### So what is to be done?

In the UK economy, too many workers are stuck in low-skill and low-wage jobs. Stagnant wages and a rising cost of living has led to a situation where four million workers are currently living in poverty, while the Low Pay Commission estimate that three million workers will still be paid the National Minimum Wage in 2020. With so many struggling to get by, tackling excessive pay at the top of the income distribution remains ever more urgent. There needs to be a recognition that the wealth and profits of a company are the outcome of collective endeavour and, as such, the proceeds should be more equitably shared.

The following essays discuss a variety of measures that would help to tackle excessive pay and combat inequality in the UK. In the first section, Luke Hildyard of the High Pay Centre details the inadequacies of current corporate governance measures and the imbalance of power in the labour market. In the second, Professor Richard Murphy proposes a plan to tackle excessive pay through rewriting corporation tax exemptions. Thereafter, Sarah Anderson writes about potential lessons and comparisons that can be made with the United States, the true home of excessive pay. The last section of the report concludes and brings together CLASS's recommendations ■



# How Did We Get Here? Corporate Governance and Power Imbalances

Radical reform is needed to tackle excessive pay, writes Luke Hildyard, Director of the High Pay Centre.

## Lavish Pay Awards Undermine Trust

Huge pay awards lavished on the chief executives of major UK companies have undermined public and stakeholder confidence in business. Polls consistently show the scale of public disapproval of very high executive pay packages.

In recent years:

- A poll for the Legatum Institute think tank found that, when presented with two competing statements, survey respondents were significantly more likely to agree that senior executive pay should be capped than they were to say that businesses should be free to pay what they like.<sup>1</sup>
- 80 per cent of respondents to a poll commissioned by the High Pay Centre agreed with the proposition that gaps between high earners and those on low and middle incomes are too high and should be reduced.<sup>2</sup>

The Edelman Trust Barometer put trust in business at 43 per cent in 2018, higher than trust in government or the media but lower than that for NGOs and two percentage points lower than levels recorded in 2017.<sup>3</sup> Executive pay was the most commonly cited factor for a lack of trust in business, identified by 58 per cent of respondents.<sup>4</sup>

This state of affairs is clearly unsustainable and unnecessary. The median pay for a FTSE 100 CEO is £3.9 million. One could easily cut pay levels by 80 or 90 per cent and still be able to afford a lifestyle beyond the wildest dreams of most ordinary workers.



Still, advocates of CEO pay might argue that public anger simply reflects the politics of envy, and that what private companies pay their executives should be a private matter. This latter point is misguided on a number of grounds – major UK companies benefit from government support in multiple ways, including direct subsidies and tax breaks. They also benefit from implicit bail-out guarantees and individual policy changes made as a result of the regular access that business leaders have to UK ministers. Therefore, it is entirely reasonable for the public to expect the government set certain expectations in terms of the way that these businesses conduct themselves in return.

## Inequality Is Bad For All Workers

On pay specifically, executive pay awards do not exist in a vacuum and are not drawn from a pot of infinite wealth. Though headline executive pay awards represent sums of money that are non-material to major companies, this doesn't tell the full story of the costs of rising top pay. The trend towards higher CEO pay, with bigger bonuses and more generous share awards made through long-term incentive plans (LTIPs), has also been reflected in the pay packages for other top earners.

Data from the World Inequality Database shows that the top one per cent of earners account for 14 percent of total earnings across the UK today. In the late 1970s, this was just six percent. The share going to the top 0.1 per cent has risen from three per cent in 1990 to six per cent today.

If the increased share of income going to these top earners across the economy as a whole reflects a pattern occurring at individual companies, this represents a substantial cost to business. The difference between spending, for example, 14 per cent and six per cent of the wage budget on the top one percent of earners has a significant impact on how much is left over for the remaining workers.

Similarly, it could affect how much is available for research and development or investment in new technologies. Advocates of high executive pay might counter that higher pay for those at the top enables the company to attract better managers and thus produce higher revenue. But this is a contestable assertion. There is a strong argument that redistributing from the highly paid to middle and lower earners or other forms of business investment would be beneficial to business.

## Corporate Governance and Imbalances of Power

The share of income going to the top one per cent in the UK has risen in almost inverse proportion to the decline in trade union membership. Similarly, the countries across Europe with highest levels of collective bargaining also see the lowest shares of total incomes accruing to the richest one per cent. This stands to reason – if collectively empowered with trade union support, low and middle income workers are in a much stronger position to demand a fairer share of company pay and profits for themselves. Therefore, an expansion of trade union rights, improving workers' understanding of the benefits of union membership, and giving union organisers better access to low-paid workers, will be critical to achieving fairer pay distribution.

In terms of corporate governance reform, workers' representation on company boards would go a long way to injecting a dose of real world perspective into deliberations on pay. Boards and the remuneration committees that determine executive pay are currently populated almost entirely by other senior business leaders who see nothing unusual about pay awards hundreds of times the size of those experienced by ordinary workers, and who are greatly compromised by the fact that they themselves benefit, or have benefited from, a culture of very high top pay.

The current approach of naming and shaming directors where more than 20 per cent of shareholders vote against a company's pay proposals has proved to be completely ineffective. The number of such instances doubled between 2017 and 2018 yet there has been no accompanying decline in executive pay. In recently privatised Royal Mail, for instance, 70 per cent of shareholders rejected the executive remuneration policy but it made no difference to the amount of money collected by the board.<sup>11</sup>

The High Pay Centre's forthcoming report with the Chartered Institute for Personnel and Development argues that a committee focused solely on the pay of one or two top executives is in itself a reflection of warped priorities and should be replaced by a committee looking at people and culture more generally.

Workers on boards and 'people and culture committees' would be able to accomplish a great deal more if directors' legal duties were amended to recognise that business is not simply about pursuit of profit at all costs, but the more complex balance of priorities and stakeholder interests that companies should seek to manage.

The 2006 Companies Act makes a vague reference to a duty to have regard for stakeholders including workers, customers and suppliers (a provision that is widely ignored) but still elevates shareholders interests above all others. A re-writing of this law would help achieve a vital change in corporate culture over time. Instead of mandating Directors to act in the way most likely to promote the success of the company in the interest of its members (shareholders), company law should simply outline a responsibility to act in the long-term interest of their company. Guidance could make clear that this involves balancing the different impacts the company has on different stakeholder groups (without elevating shareholders to a priority status) as well as wider society and the environment.

These proposals may sound shocking to the people who benefit from a culture of excessive executive pay. However, to the ordinary man or woman in the street they are likely to prove much less provocative than the increase in FTSE 100 CEO pay from roughly 60 times the average UK worker in the late 1990s to nearly 150 times today. It is clear that radical reform is needed, and these changes to employment rights and corporate governance regulations would be a useful start ■



**“ Corporate  
governance  
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corporations ”**



# Tackling high pay through the tax code

Who pays tax, and how can we design a system where the rich pay their fair share? Richard Murphy proposes some solutions.

## A New Proposal

As this report has already made clear, it is now widely accepted that there is a problem with the growing pay disparity within UK business. Unfortunately, efforts to tackle this issue have, to date, largely failed. Corporate governance regulations should not rely on the good will of corporations and new proposals for taxation need to be robust in order to counteract the levels of tax avoidance so common at the upper end of the distribution.

The proposal made in this section does, then, rely upon changes to the corporation tax system to impose an additional tax charge on those employers making payments to employees in excess of 10 times UK median pay in the year. This is at present a sum of £300,000 per annum (if we define high pay to be a sum approximately ten times UK median pay, which according to the UK Office for National Statistics, was £29,588 in 2018).

The proposal is that the cost of all pay to an employee, director or other officer of a company that exceeds £300,000 per annum should be disallowed as an expense when calculating the taxable profits of a company or other entity subject to UK corporation tax.

The stated objectives of this proposal are to:

1. Increase the tax payments due as a result of the payment of high salaries;
2. Bring pressure to bear to reduce such salaries, and so income inequality as a result.

A range of anti-avoidance measures are discussed in the proposal. The consequences are that this charge will fall very heavily on employers, and so on the owners of capital who will, as a result, have an incentive to reduce income inequality.

The effect of disallowing an expense for corporation tax purposes is to increase the taxable profits of a company. As a result, if that company does declare taxable profits an

additional sum equivalent to the amount of high pay expenditure disallowed will be subject to corporation tax. The UK corporation tax rate for all companies is 19 per cent at the time of writing in 2018.

If no change in behaviour takes place as a result of this charge it is suggested that a sum of corporation tax of in excess of £4.6 billion per annum would be collected as a result of this proposal. For reasons noted, significant behavioural change is not anticipated.

## A Brief Example

This is a simple example of how the scheme might work. Suppose a company has taxable profits of £1,000,000 and pays one of its employees £500,000 a year. Under the new proposal, only £300,000 of this employee's wage is tax deductible with the remaining £200,000 reclassified as profits and taxable at the rate of corporation tax, which is currently 19 per cent.

Profits would increase as a result to £1,200,000. The tax bill payable by the company, which would have been £190,000 (i.e. 19 per cent of £1,000,000) before the adjustment will increase by £38,000 as a result of the adjustment being made (19 per cent of £200,000). This additional sum would now be payable by the company taking its total corporation tax bill to £228,000.

It should be noted that the employee pays no additional tax as a result of this arrangement. It should also be noted that the company would still have to pay all the PAYE and national insurance that would have been due whether or not the sum of £200,000 was disallowed in its tax computation. In other words, the change is only to the employer's tax bill. Absolutely all other tax bills remain unchanged as a result of this high pay expenditure adjustment which only impacts corporation tax owing.

## Anti-avoidance measures

There are many ways in which such a simple tax adjustment might be avoided unless steps are taken to prevent such abuse. There may also be many tax advisers more than willing to assist such avoidance arrangements. As such anti-avoidance measures would have to be put in place to make such that this scheme would work to deliver the intended effect.

Those avoidance arrangements that we anticipate might be taken, and which will as a result need to be addressed, are as follows:

- Employers might try to reward their employees through benefits in kind e.g. the provision of pension contributions; the supply of rent free accommodation; the settlement of personal liabilities; the provision of assets for personal use, and so on to avoid this charge. There are bases already available for the valuation of all of these payments for tax purposes and they should be used to value them for inclusion as part of the employee's pay package. The cost should be added to any salary paid to calculate the tax disallowance. Although pension contributions are not normally considered



part of pay for these purposes they should be when calculating this disallowance;

- The employer may loan the employee money to avoid the charge;
- The employer might be tempted to set up a share scheme that resulted in the payment of dividends and not salary to employees who might be subject to this disallowance;
- The employee might ask that a relation or associate be paid instead of them to disguise the benefit of the payment made. An associate could include a company of which they had control or from which they might benefit.

The issues relating to payments as benefits in kind can be relatively straightforwardly addressed since none is, in itself, previously unknown in income tax abuse. In effect our proposal is that the amount of any payments of this type should be added to the amount of PAYE remuneration that the high paid employee receives for the purposes of estimating this tax disallowance. To elaborate this we make the following suggestions:

- For the sake of the example in this proposal the net sum of dividends paid is considered the sum to be added to pay;
- If a loan is made then all net new sums loaned to persons who might be subject to this disallowance should be added to their pay for the purpose of calculating the disallowance. Repayments would be a negative sum in that case;
- If a payment was made to a person related to the employee for the purpose of avoiding this charge then that payment should be included in the pay of the person subject to the disallowance calculation. It will be for the company to disclose to HM Revenue & Customs all payments to persons related to someone actually or potentially subject to this charge and to prove that the payment made to a related person was not for tax avoidance purposes.

To ensure that the disallowance is effective strict ordering of what constitutes the top part of pay is necessary, as follows:

- Those sums included in pay for this purpose that may not otherwise be directly taxable e.g. loans to an employee, will form the first part of pay;
- Dividends and similar payments will form the second part of pay;
- Payments to related persons would form the third part of pay;

- Benefits in kind, including pension contributions would constitute the fourth tier of pay;
- The top part of income will always be the salary paid that is subject to PAYE.

As example, if a company make a dividend payment of £100,000 to an employee; loans them £70,000; employs their spouse without apparent good reason for £30,000; pays £50,000 into their pension and then pays a salary of £200,000 the income will be tiered as follows:

Tier	Description	£
1	Loan	70,000
2	Dividend	100,000
3	Payment to related person	30,000
4	Benefits in kind (inc pension cont.)	50,000
5	Declared salary	200,000
<b>Total pay</b>		<b>450,000</b>
Allowed high pay		(300,000)
<b>Part of salary subject to tax disallowance</b>		<b>150,000</b>
<b>Additional corporation tax due at 19%</b>		<b>28,500</b>

The net effect is to render attempts at avoidance largely redundant. It should be noted that dividends and loans are provided out of already taxed income i.e. 19 per cent tax will have already been paid by the company on funds used for this purpose.

## Who is paying the tax?

It is always reasonable to ask who is actually likely to bear the cost of any additional tax charge. In our opinion by far the largest part of the incidence for this tax charge will initially fall on the owners of the company who decide to make the payment of a high salary. There are several reasons for saying so.

Firstly, the only people with complete control over the way in which their remuneration is packaged are likely to be the owners / directors of their own entrepreneurial enterprises. Few of these people are likely to be paying themselves salaries of £300,000 a year. This is because existing national insurance rules strongly encourage them to reward themselves by way of dividends. Dividends will not be capped under this scheme as they are not tax deductible for corporation tax purposes. This scheme is unlikely to impact such people in that case. This, however, means that few others will shift their earnings entirely into dividends as a result, so removing some, most or all tax deductible pay from the cap arrangement. In that case the incidence will fall on the employer.

Secondly, those who are genuinely employees are unlikely to agree to a fall in their pay because their employer's tax charge for engaging them has increased. Therefore pay will not fall. At least initially then the charge will be paid by employers, and so in turn the owners of capital on whom the primary incidence of corporation tax falls.

Thirdly, there will, of course, be a behavioural consequence. This is very unlikely to be a resort to avoidance because of the suggested design of the charge.

Fourthly, the likely outcome of the charge is, then, an eventual fall in high pay, or at least in its rate of acceleration. This will not be matched by a decline in effort, a shortfall of available talent or a reduction in effort on the part of those impacted. The suggestion that there is a relationship between the rate of pay of those impacted by this potential charge and their effort has already been disproved in the introduction to this report.

## Revenue Raising Potential

The latest reliable data available from HM Revenue & Customs on payments in employment relates to the tax year 2015/16. Conveniently, the data is calibrated at £300,000 of income. The data<sup>1</sup> is as follows:

Lower band of income from employment	Number of employees in this band	Total tax paid by those in this bracket (£'m)
£300,000	38,000	5,650
£500,000	18,000	5,070
£1,000,000	9,000	7,940
<b>Totals</b>	<b>65,000</b>	<b>18,660</b>

These are not the only likely people who are going to be impacted by this charge. Some on lower pay who also receive dividends and significant benefits in kind as well as loans from their companies and might also be impacted, but for the sake of prudence no estimate of their numbers has been made.

Those earning between £300,000 and £500,000 pay an average of a little over £148,000 each in tax. Assuming an average overall effective tax rate of 40 per cent for these people (allowing for lower rates, the withdrawal of the personal allowance and the 45 per cent rate) this implies an average salary for this group of around £370,000. This has been used for the purposes of calculation. Note, the proposed disallowance calculation takes benefits in kind, including pension contributions into account. Also note that this estimate of earnings does not allow for all such contributions and this will result in the tax disallowance being prudently understated.

Those earning between £500,000 and £1 million pay an average of about £282,000 in tax each. Assuming a tax rate of 42 per cent, because the 45 per cent higher rate will have great impact in this band, the implied average salary is £670,000, which will be used for estimation purposes.

Those earning above £1 million pays an average of £882,000 in tax. At an expected rate of 44 per cent this implies an average salary of £2,005,000. £2 million has been used for estimation purposes.

The calculation of tax owing is as follows:

High Pay Calculations					
HMRC lower income band	Number of employees	Average salary as noted in text	Average corporation tax disallowance	Additional corporation tax due at 19% per person impacted	Total additional revenue
£		£	£	£	£
300,000	38,000	370,000	70,000	13,300	505,400,000
500,000	18,000	670,000	370,000	70,300	1,265,400,000
1,000,000	9,000	2,000,000	1,700,000	323,000	2,907,000,000
TOTAL					4,677,800,000

It is suggested that an additional sum of at least £4.6 billion of corporation tax would be collected a year if this proposal was adopted. It is stressed that this is believed to be a cautious estimate. As such the estimate offered is considered as robust as any estimate of tax yield can be, largely because it has considered likely behavioural consequences of the proposal■



**“ We would  
do well to  
present taxes  
as just one  
more form of  
responsible  
regulation on  
corporate  
behaviour ”**





# Examples and Lessons from the US

Linking a corporation's tax bill to the CEO-worker pay ratio is growing in popularity, writes Sarah Anderson.

## Mind the gap

If you think British CEOs get fat paychecks, check out their U.S. counterparts. In 2017, the chief executives of S&P 500 companies received, on average, \$13.9 million<sup>1</sup> in total compensation (£10.9 million). That's 361 times as much as average U.S. worker pay.

U.S. executives' obscenely inflated pay levels have sparked outrage across the political spectrum. A Stanford University poll, for example, found that 74 per cent of Americans see CEOs as overpaid relative to their workers.<sup>2</sup>

How can we best pop the CEO pay bubble? As in the UK, the idea of using tax policy to moderate executive compensation has been gaining ground in the United States.

In 2017, the U.S. Congress made some progress towards limiting the tax deductibility of executive compensation, somewhat along the lines of the proposal analysed above. Buried in an otherwise horribly regressive Republican tax reform, legislators moved to close a loophole in a 1993 tax law that put a cap on corporate tax deductions for executive compensation to no more than \$1 million per executive – but with a huge exception for stock options and other “performance” pay. For more than two decades, this loophole encouraged corporate boards to hand out massive bonuses that dramatically widened the pay gaps within U.S. corporations.

The Republican tax reform of 2017 closed this bonus loophole, but only for compensation going to the CEO, CFO, and the three other highest-paid employees. Performance pay above \$1 million going to Wall Street traders, celebrities, and other highly paid non-executives remains fully deductible.<sup>3</sup> Fair pay advocates are continuing to press for the closure of this loophole for all employees, which congressional experts estimate would generate approximately \$5 billion per year.

In the United States there is also growing support for proposals to tie a corporation's tax rate to the size of their CEO-worker pay gap. The bigger the gap, the bigger the corporate tax bill.

A new U.S. regulation makes pay gap taxes along this line easy to administer. Starting in 2018, publicly traded U.S. corporations must annually report the ratio between their CEO and median worker compensation.

The first year's numbers have turned out to be nothing short of staggering. Toymaker Mattel had the largest gap, with a CEO making nearly 5,000 times as much as the median employee. At McDonald's, the ratio came in at over 3,000:1. At Walmart, the ratio topped out above 1,000:1.

The British Conservative Party has also developed a CEO-worker pay ratio disclosure regulation,<sup>4</sup> with the first reports expected in 2020. This counts as a welcome development, even though methodological differences will likely prevent apples-to-apples comparisons. The two main differences:

1. The UK regulation bases median worker pay only on UK employees. U.S. corporations have to report their global medians, although some have voluntarily reported their U.S. median as well.
2. The UK regulation allows firms to convert part-time workers' pay into full-time equivalents. U.S. corporations fought for a similar approach, but regulators refused, arguing<sup>5</sup> that actual pay figures more accurately reflect a company's employment and compensation practices.

## Ratio-based legislation

The U.S. disclosure regulation has sparked a flurry of legislative proposals to raise taxes on corporations with extreme pay gaps. One federal bill<sup>6</sup> would impose tax rate increases on companies with large gaps, from 0.5 percent for firms that pay their CEO more than 100 times their median employee to 3 per cent for firms with pay gaps of more than 400:1.

At the Institute for Policy Studies, we looked at 2017 tax, profit, and pay ratio data for S&P 500 firms to get a rough revenue estimate for this type of tax. We found that these very large firms alone would have to pay about \$8.7 billion (£6.8 billion) per year in extra taxes — unless, of course, they narrowed their pay gaps.

Legislators in five U.S. states have introduced similar legislation.<sup>7</sup> And in one city — Portland, Oregon — corporations already began paying such a tax this year. Portland has a local 2.2 per cent profit tax for all companies doing significant business in the city. The new surtax<sup>8</sup> increases this tax liability by 10 per cent for companies with CEO-worker pay ratios of more than 100:1 and 25 per cent for companies with ratios of more than 250:1. In other words, a large company that owes the city \$100,000 in profits tax and has a pay ratio of 175:1 would pay an additional \$10,000.

The Portland surtax applies to more than 500 corporations<sup>9</sup> that do business in the city — not just firms headquartered there. The companies include many that regularly appear on lists of America's highest-paid CEOs, corporate and banking giants that range from Goldman Sachs and Oracle to Walmart and GE. We'll soon learn how much the city raised in revenue from this new tax. Portland officials plan to use the tax dollars raised for expanding homeless services.

Some U.S. officials are also looking to incorporate the pay ratio indicator in contracting and subsidy reforms. In the state of Rhode Island, a Senate bill<sup>10</sup> would give preferential treatment in government contracting to corporations that pay their CEOs no more than 25 times their median worker pay. This is similar to the UK Labour Party's proposal<sup>11</sup> to deny public contracts to companies that pay their CEO more than 20 times the pay of their lowest-paid worker.

Trump budget director Mick Mulvaney actually authored an amendment<sup>12</sup> in this vein back when he was serving in Congress. If that amendment had passed, companies with pay gaps of more than 100:1 would not have been able to receive federal export subsidies.

Pay ratio-related reforms, be they focused on taxes or contracting and subsidies, encourage corporations to narrow their gaps by lowering the top and lifting up the bottom of their pay scale, giving workers a more direct stake in the reform. Research<sup>13</sup> also indicates that narrower gaps help business as well. Extreme pay divides undermine worker morale, and that lower morale,<sup>14</sup> in turn, reduces productivity<sup>15</sup> and increases turnover.<sup>16</sup>

Peter Drucker, widely known as the father of modern management science, believed<sup>17</sup> that the ratio of pay between worker and executive can run no higher than 20:1 without undermining business effectiveness. In 2017, when the Trump administration attempted to block the pay ratio disclosure regulation, institutional investors<sup>18</sup> weighed in forcefully to defend it. More than 280,000<sup>19</sup> individual Americans also wrote letters supporting the disclosure.

U.S. CEO pay critics are also exploring tax penalties on excessive compensation, regardless of the size of the company's pay gap. Former CEO and corporate board veteran Steven Clifford<sup>20</sup> is calling for a 100 per cent tax<sup>21</sup> on any executive pay above \$6 million. A growing number of business leaders like Clifford feel the current U.S. executive pay system has become badly broken. Current practices harm executive performance, Clifford explains, "by narrowing vision, limiting creativity and innovation, and focusing exclusively on short-term results."

Whatever form an excessive compensation tax might take, corporate lobbyists will inevitably cry foul. In the United States, they have long argued that to limit an individual's earning potential would be downright "un-American." And yet, in our era of extreme inequality, ordinary Americans are increasingly questioning this view. One poll found that even a majority of Republicans<sup>22</sup> would favor a strict cap on CEO pay, relative to worker pay — no matter how well a firm might be performing.

S&P 500 Corporations With Pay Gaps Above 1,000 to 1			
Company	CEO Pay (\$)	Median Worker Pay	Pay Ratio
Mattel	31,275,289	6,271	4,987:1
McDonald's Corporation	21,761,052	7,017	3,101:1
Gap	15,587,186	5,375	2,900:1
Aptiv PLC	13,800,347	5,464	2,526:1
Hanesbrands	9,581,986	5,237	1,830:1
TJX Companies	16,880,171	11,243	1,501:1
Yum! Brands	12,368,607	9,111	1,358:1
V.F. Corporation	13,736,655	10,151	1,353:1
Ross Stores	12,400,574	9,437	1,314:1
Kohl's Corporation	11,339,206	8,975	1,264:1
Walmart	22,791,276	19,177	1,188:1
Ralph Lauren Corporation	23,792,036	22,913	1,111:1
PVH	17,217,565	16,520	1,042:1

Source: AFL-CIO Paywatch

In both countries, we would do well to present such taxes as just one more form of responsible regulation on corporate behavior. Few would question the need for governments to limit the pollution corporations can spew out, the chemicals they can put into their products, or the hours they can force employees to labor.

Policymakers set these limits because they recognize that irresponsible corporate behavior threatens all of us. Excessive executive pay also endangers our public well-being. It encourages the reckless behavior that led to the 2008 financial crisis and undermines our democracy. We have waited too long for corporations to take action to rein in runaway compensation voluntarily. The time has come for a much more responsible policy■





***“An excessive pay  
gap harms  
workplace  
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and stifles  
innovation”***





## Conclusions

As this report has outlined, excessive pay at the top of the income distribution harms workplace morale, hinders investment and, consequently, stifles innovation and the economy.

The continuing and ever-growing gap between average workers and their CEOs does not have public support and attempts to cut corporate excess to-date have largely failed.

Yet, there is no silver bullet to tackling excessive pay; a combination of measures is needed. Firstly, as multiple sources have shown, and as Luke Hildyard points in his chapter, deunionisation is a key cause of growing inequality. Reigning-in top incomes requires much stronger rights for trade unions and stronger collective bargaining agreements. Trade unions ensure that the proceeds from work are collectively shared and not disproportionately dished out to a select few at the top.

Further corporate governance reforms are also increasingly necessary. This requires a complete rethink and overhaul of executive remuneration committees, as the High Pay Centre and CIPD have called for, but also a recognition that current approach to naming and shaming companies that have excessive pay has not worked.

If a more equitable distribution of income can not be achieved through these measures, there is a role for the tax system. As Richard Murphy has shown, excluding excessive pay (10 times the median) from corporation tax deductibility has the potential to raise £4.6 billion annually and would act as a strong deterrent to continuing with excessive remuneration packages. Such a move is not without precedent and if designed correctly would avoid many of the loopholes that plagued its introduction in the U.S.<sup>1</sup>

Finally, as Sarah Anderson has noted, ratio-based legislation has the potential to expand upon new measures introduced in the UK which forces companies to publish and justify the gap between their workers and the CEO. Anderson discusses examples of U.S. states enforcing a pay ratio. Other international ideas are also worthy of consideration, such as legislation passed in Australia, known as the 'two-strike rule', which sees the entire board of directors removed if pay packages are voted down by more than 25 per cent of shareholders.

In light of the findings in this essay series, as well as what has been tried to date, CLASS recommends a combination of policy proposals that will tackle the imbalance in power which means that there is very little accountability as well as much needed tax changes:

### **1. Reform corporate governance through a redefined Companies Act 2006 and repurposed executive remuneration committees.**

We need a re-writing of this law, in particular the duty that asks for regard for stakeholders including workers, customers and suppliers. Such a change will help achieve a vital change in corporate culture over time.

A CLASS report<sup>1</sup> exploring the role of workers on boards found that not only were they able to impact pay and conditions for fellow workers, but influence pay decisions for senior managers. This could be a crucial first step to changing a culture of pay that sees workers struggling to make ends meet while top bosses earn the average UK salary in three working days. Our research also underlined the essential role of trade unions in making workers on boards work for workers - without trade union involvement, the role risks becoming tokenistic and the role holder ill-equipped to challenge decision making at the top – and the importance of putting checks in place to protect workers on boards from conflicts of interest, including introducing whistleblowing protections.

### **2. Remove executive pay (more than £300,000) from corporation tax deductibility.**

This proposal from Richard Murphy builds on CLASS's previous work on an Excessive Pay Levy, that aims to tackle the problem directly. It is a tax paid by the employer rather than the employee that acts as a disincentive for companies to pay over £300,000 and can help to raise vital public funds.

### **3. Strengthen trade union rights and collective governance structures through the implementation of the Institute for Employment Rights's Manifesto for Labour Law.<sup>2</sup>**

Fat cat pay is a symptom of deeper problems in the labour market. With the labour share of GDP falling and real wages stagnant, there is an urgent need to end the hostile environment towards trade unions. As the Institute of Employment Rights has advocated in their 'Manifesto for Labour Law', the re-introduction of sectoral collective bargaining through a new Ministry of Labour would provide a valuable conduit to assess and address the needs of the UK's 31 million working people. Sectoral collective bargaining would mean workers' pay and conditions are negotiated through trade unions and employers at the sectoral level.

A combination of the above proposals would help to combat excessive high pay, distributing the proceeds more equitably throughout the workforce and providing money for public services through increased tax revenues. Bringing an end to such massive pay disparities within our companies is one step on the path to tackling inequality elsewhere in the UK economy and society ■

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