Institute for Policy Studies

Portland Surtax on Corporations with Extreme CEO-Worker Pay Ratios

— A Backgrounder —

Summary

On December 7, 2016, the city council in Portland, Oregon, adopted a proposal for a surtax on their local business license tax that will penalize publicly traded companies with extremely wide pay gaps. This ground-breaking new law does not set a ceiling on, or dictate in any way, how much corporations can pay their executives. But it will provide an incentive to reduce executive pay and lift up pay for workers at the bottom end, while generating revenue for public purposes. In the first two months of 2017, lawmakers have introduced similar bills in at least five state legislatures.

How will the Portland surtax work?

The city's current business license tax is 2.2 percent of adjusted net income. The surtax will be 10 percent of the business tax liability for companies with a CEO-worker pay ratio of more than 100-to-1 and 25 percent for companies with a ratio of more than 250-to-1. For example, if a large company owes the city $100,000 for its business license tax and has a pay ratio of 175-to-1, their surtax will be $10,000. To administer the tax, the city will use pay ratio data that will become available through the U.S. Securities and Exchange Commission in early 2018.

What corporations will pay the surtax?

The Portland government has identified more than 500 corporations that do enough business in the city to be affected by the surtax, including many that regularly dominate the highest-paid CEO lists, such as Oracle, Honeywell, Goldman Sachs, Wells Fargo, and General Electric. The Portland city government projects that 88 percent of revenue will come from the top 10 percent of corporate taxpayers, and 96 percent will come from the top 20 percent. They expect compliance to be 95 percent or higher.

How much revenue will this raise and what will it be used for?

Revenue from the surtax, estimated by the city to range from $2.5 million to $3.5 million per year, will be used to help pay for public services.

Why is this surtax important?

1. **The surtax addresses one of the key drivers of our country's extreme inequality: runaway CEO pay**

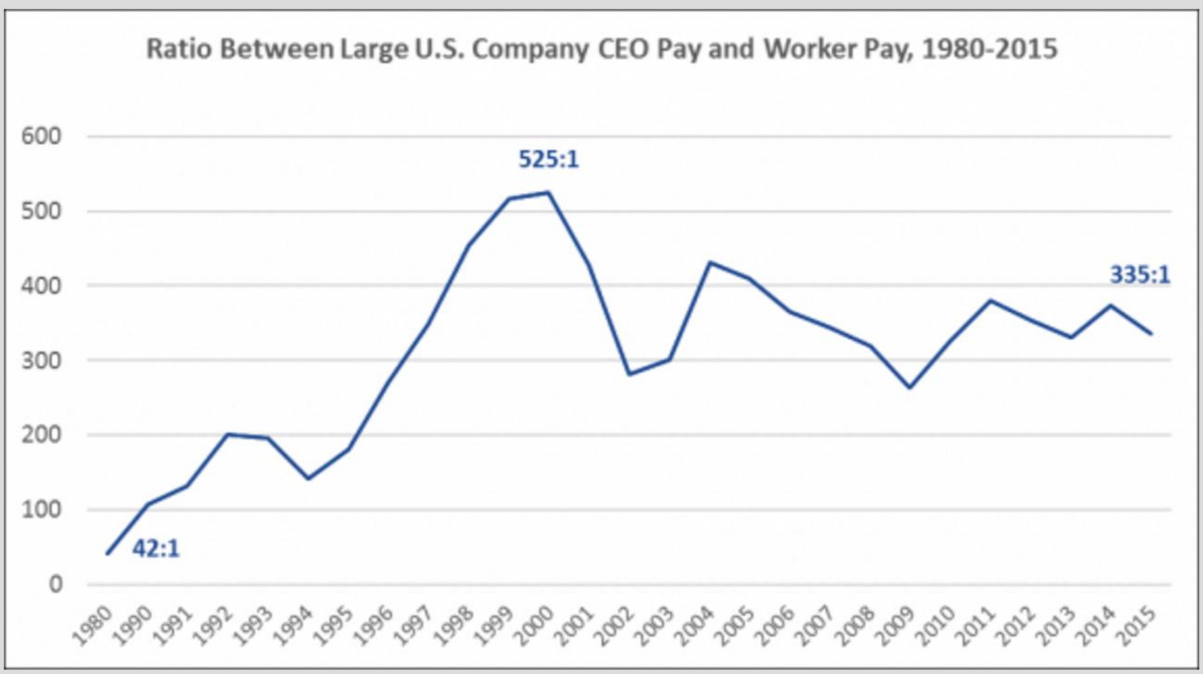
The top 1% of America's income earners have more than doubled their share of the nation's income since the middle of the 20th century. Today this elite group enjoys more than 20 percent of national income and holds nearly half the national wealth invested in stocks and mutual funds.

Skyrocketing CEO compensation has been a major factor in fueling the growth of top 1 percent. About two-thirds of the top 1% of households are headed by a corporate executive (20% from the financial sector and 40% from the non-financial sector). And between 1979 and 2005, corporate executives accounted for 58 percent of the expansion of income for the top 1 percent of households and 67 percent of the income growth of the top 0.1 percent. Meanwhile, worker wages have largely stagnated.

Beyond the direct impacts on economic inequality, runaway CEO pay poses other dangers to our society and democracy. It drove the reckless "bonus culture" that was a major factor in the 2008 financial crisis. And it encourages a short-term mentality among business leaders that encourages other reckless behaviors that may pad executive paychecks in the short-term but cause long-term damage to the company and the country, such as slashing jobs, cutting research and development, and cooking the books.

2. By encouraging a narrowing of CEO-worker pay gaps, the surtax will help address a matter of economic fairness

While the pay ratio varies from year to year and there are various ways to measure it, in recent decades the gap has been many multiples wider than in the post-WWII period up through the early 1990s. This rising divide is the result of several factors, including a 1993 tax reform that allows unlimited corporate tax deductions for huge stock-based "performance" payouts. There is no evidence that the rise has anything to do with improved managerial performance. No one individual creates hundreds of times more to the value of a company than his or her employees. It is fundamentally unfair to have extreme pay gaps within companies. Corporations could narrow their gaps by lifting up worker pay and/or reducing CEO pay.



Source: Institute for Policy Studies and AFL-CIO analysis of Bureau of Labor Statistics average hourly earnings data and corporate proxy statements, 2016

3. The surtax will encourage a narrowing of pay differentials that will be good for business

Academic research indicates that such extreme gaps undermine worker morale, which can reduce productivity and increase turnover. A recent Glassdoor analysis of data from 1.2 million people also suggests a statistical link between high CEO pay and low CEO approval ratings among employees. Peter Drucker, widely known as the Father of Management Science, believed that the ratio of pay between worker and executive can run no higher than 20-to-1 without damaging company morale and productivity.

Why does the tax apply only to publicly traded corporations? Isn't this unfair?

The surtax will rely on pay ratio data resulting from a new SEC disclosure rule that was part of the Dodd-Frank financial reform legislation. Every year, publicly held corporations will need to disclose the ratio between their CEO and median worker pay, starting with 2017 pay data. It would be administratively impractical to extend the surtax to other firms.

It's unlikely that any small businesses would be affected by this surtax even if it did apply to them. A company with median worker pay of just $25,000 per year would have to pay their CEO at least $2.5 million to be subject to this tax. According to the Department of Labor, the average salary of chief executives in the state of Oregon as of May 2015 was $167,900. Furthermore, large, publicly held corporations set the standards for other workplaces and have an enormous impact on the health of our economy. Encouraging them to do the right thing and narrow their pay gaps will have positive ripple effects.

Won't companies just leave Portland instead of paying the tax?

The CEO pay surtax will amount to just a fraction of a percent of corporations' local profit tax. For corporations with a pay ratio above 100-1, the local business tax will increase from 2.2 percent to 2.42 percent and for corporations with pay ratios above 250-1, it will rise to 2.75 percent. Nevertheless, the company flight argument will likely continue to be raised, just as it has in the local living wage fights. And yet reports from cities that have adopted significantly higher minimum wages in recent years have not experienced layoffs or slower job growth. If there's a lesson in the living wage campaigns that are spreading like wildfire it is that reversing our nation's extreme inequality will require bold action from the base. Change needs to begin somewhere and effective federal action on CEO pay has been sorely lacking.

Won't this incentivize companies to outsource lowest-paid workers so they can narrow their internal pay gaps without having to reduce CEO pay?

Using outsourcing of low-wage workers as a strategy to avoid the pay ratio tax without reducing CEO pay would be mathematically extremely challenging. The average CEO compensation in 2015 for S&P 500 firms was $12.4 million, while average worker pay was around $40,000. Under the Portland surtax, companies would face a tax penalty if their pay ratio is more than 100-to-1. And so, for example, to avoid the tax while keeping CEO pay at the average level of $12.4 million, median worker pay would need to be raised to $124,000. If a CEO makes only half the S&P 500 average ($6.2 million), the median would need to be raised to $62,000. In an era when outsourcing is already widespread, it's hard to imagine that many firms would be able to shed enough of their low-level workers in a cost-effective way for this strategy to work.

Isn't CEO pay a shareholder issue? Why should government get involved?

Lawmakers mandate limits on corporate behavior all the time. They limit how much pollution corporations can spew out. They limit the chemicals companies can put into their products. They limit the hours they can force employees to labor. They set these limits because they recognize that irresponsible corporate behaviors threaten our communities. Excessive executive pay, the Wall Street meltdown has demonstrated ever so vividly, endangers our public well-being as surely as any pollutants. Jackpots have become so huge that executives will do just about anything to hit them. They'll even destroy our economy. Thus, particularly when corporations are benefiting from government assistance — and virtually all of them do, whether through subsidies, contracts, or tax breaks — it is responsible policy to set limits on executive pay.

What other states and cities are considering a Portland-style policy on wide CEO-worker pay gaps?

Minnesota (HF 65) and **Rhode Island** (H. 5141) are considering surtaxes similar to Portland's pay ratio surtax.

Illinois (HB3335) is considering a flat annual fee on publicly traded companies based on the SEC's pay ratio disclosure rule: $1,500 if the pay ratio is more than 100:1 and $2,500 if the pay ratio is more than 250:1.

Connecticut (HB 6373) would replace the state's current 9 percent corporate income tax with graduated rates, based on pay ratio:

- 5 percent if the pay ratio is equal to or less than 25:1;
- 7.5 percent if the pay ratio is more than 25:1, but equal to or less than 100:1;
- 10 percent if the pay ratio is more than 100:1, but equal to or less than 250:1; and
- 25 percent if the pay ratio is more than 250:1.

Massachusetts (S. 1555) proposes a 2 percent surtax on publicly traded companies with a pay ratio more than 100:1.

What is happening at the federal level?

Federal CEO Accountability and Responsibility Act: In 2014, a California Senate Bill (SB 1372) sought to raise the state corporate income tax from 8.84 to 13 percent for firms that pay their top execs over 400 times what their median workers are making and lower the tax rate to 7 percent on companies with a top executive-worker pay divide less than 25-to-1. The measure received a state Senate majority but not the two-thirds super-majority required to pass tax-related legislation in California. One of the champions of the California bill, Mark DeSaulnier, was elected to the U.S. Congress in 2014. In October 2016, he co-sponsored a similar bill with another member of the House Oversight and Government Reform Committee, Bonnie Watson Coleman of New Jersey that would link corporations' federal tax rate to their pay ratio level. The CEO Accountability and Responsibility Act (H.R. 6242) would increase rates on companies with larger than a 100-to-1 ratio, while giving a slight tax rate break to companies whose CEO to worker ratio fell below 50-to-1.

What other ways are there to encourage narrower CEO-worker pay gaps?

Some policymakers have proposed using the power of the public purse by tying CEO-worker pay ratios to procurement and subsidy policies.

Rhode Island state senate bill: In 2014, the Rhode Island Senate passed a bill to establish preferences in the awarding of state contracts for businesses whose highest-paid executive receives compensation/salary equal to or less than 32 times that amount paid to its lowest paid full-time employee. In 2015, the bill was re-introduced with a slight revision to make the ratio calculation consistent with the new federal disclosure rule. The Rhode Island Senate Finance Committee held a hearing on the bill on May 26, 2015. However, because of concerns over whether there would be time to bring up the bill for a vote in the house chamber, they did not push for a vote in the state senate in 2015. Bill champions aim to make a renewed push in the current session.

Export-Import Bank proposed amendment: In November 2015, then Republican congressman Mick Mulvaney from South Carolina authored an amendment designed to prevent the U.S. Export-Import Bank from subsidizing any U.S. company whose annual CEO pay runs over 100 times median worker pay. Mulvaney is currently director of the Office of Management and Budget.

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