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Pay Ratios and Pay Inequality

Kevin F. Hallock
University of Richmond, president@richmond.edu

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Sen. Christopher Dodd (D-Conn.) and Rep. Barney Frank (D-Mass.) — as in the Dodd-Frank Wall Street Reform and Consumer Protection Act — were not the first to be interested in the ratio of CEO pay to regular worker pay.

Cornell University
ILR School
Institute for Compensation Studies

Kevin F. Hallock
Chair and Professor,
Department of Labor Economics,
Cornell University

Professor,
Department of HR Studies,
Cornell University

Director,
Institute for Compensation Studies,
Cornell University

Member,
2010-2011 WorldatWork
Board of Directors

The increase in CEO pay relative to the typical worker's pay that began in the early 1990s is now raising some public rancor about what should be done about it. But, following on the heels of some corporate pay disasters, the global financial crisis and ensuing Great Recession gave opportunity to reformists advocating for requiring publicly traded firms to disclose the ratio of the pay of the CEO to the pay of the median-paid employee. Since lots of new disclosure requirements were being legislated, some argue why not require just one more number? Namely, the government should require reporting of the ratio of the CEO's pay to that of the middle worker in the organization.

A simple statistic, but what are the merits of and potential problems with reporting such a ratio? Are there similar ratios that may also be informative? What are some simple yet powerful characteristics of the wage distribution in the United States that are perhaps underpinning the focus on this one simple statistic?

CEO Pay Ratios

Some argue that reporting the ratio of CEO pay to that of the median-compensated worker in the organization is useful since it highlights the sometimes large discrepancy between the pay of an average worker and that of corporate

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executives. Others counter that there are several problems with this sort of ratio.

One argument against reporting the ratio of CEO pay to median worker pay is that this is much more difficult to calculate in practice than in theory. In fact, for some large multinational organizations it is sometimes difficult to accurately count the number of employees in the organization, nevermind the median level of pay. Also, details about what is meant by "pay" matter. For example, and as I have discussed in a previous column, wage and salary income can be quite substantially different than total compensation. Should health insurance be included in the "pay" amount? Probably should. Is the pay of the median worker defined at a certain point in time? Should it include at-risk bonus, etc? And should U.S. regulators concern themselves with the ratio of CEO pay to the median of the company's global workforce or only those employees in the United States?

Finally, there is also the issue of how organizations could manipulate the ratio of CEO to median employee pay through reorganization. Imagine an organization with a CEO who is paid $1 million and 101 other employees, 50 of whom are paid $100,000 and 51 of whom are paid $20,000. The ratio of the CEO pay to the median paid worker is $1 million: $20,000 = 50. But if the organization spins off the 51 lower-paid jobs into a different company or simply by outsourcing, it is left with 50 workers, each of whom is paid $100,000. The organization reports a ratio of $1 million: $100,000 = 10. Is this a better organization? And, does it mean that, in the case of a spinoff, there is now a new company born that could have the same or lower or even higher ratio as the original firm, depending on what it pays its CEO?

It's hard to deny that the push for disclosure of the CEO to median employee pay ratio is motivated by many Americans feeling that CEOs may be paid too much. But too much relative to whom? As a specialist in compensation, what do you know about what has happened to the actual distribution of pay for American workers and the CEO pay ratio? Following are three simple facts.

The Earnings Distribution and Earnings Ratios

1. Hourly earnings of workers at the bottom have been incredibly flat for the last generation.

Figure 1 illustrates earnings in the United States during the past 30 years. Using data on full-time workers from the *United States Current Population Survey* (CPS), I have computed points along the distribution of earnings per hour by year, adjusting for inflation to 2009 dollars.

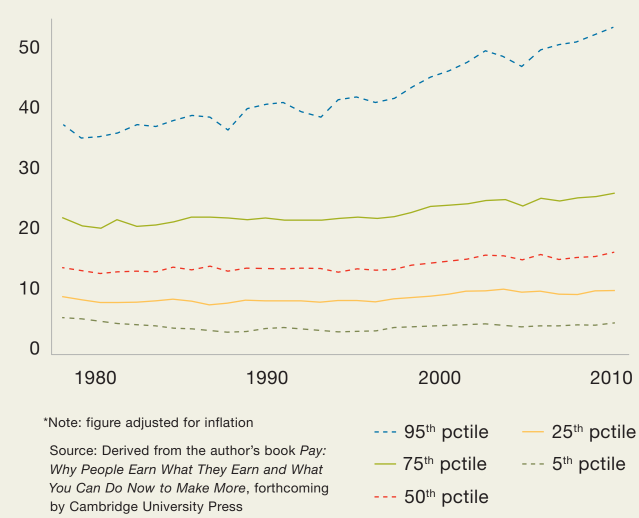
For example, in 2009, workers who earned at the 25th percentile (three-quarters of U.S. workers earned more and only one-quarter earned less) earned about $8 per hour. Those who earned at the 95th percentile (only 5 percent of U.S. workers earned more) made about $48 per hour.

It is very clear from this figure that workers holding jobs at the bottom of the hourly earnings distribution have experienced incredibly flat pay for the last generation. (Note: these are not necessarily the same workers in these jobs across the 30 years.) In fact, even workers at the middle (median) of the hourly earnings distribution (where half the workers earn more and half earn less) have had flat hourly pay over the past three decades, after adjusting for inflation.

2. Only the top 5 percent have seen large gains over time; for CEOs, the gains are substantial.

While Figure 1 shows that those at the 95th percentile of all U.S. workers in terms of hourly earnings have seen large gains in pay over time, Figure 2 (see page 16) shows this to be even more true for CEOs. Compiled for the same period

Figure 1 | U.S. Wage Percentiles by Year*

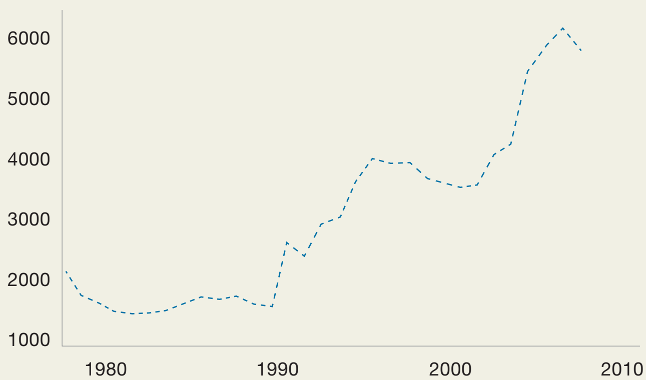


*Note: figure adjusted for inflation

Source: Derived from the author's book *Pay: Why People Earn What They Earn and What You Can Do Now to Make More*, forthcoming by Cambridge University Press using a variety of sources, the hourly pay for the middle (median) paid CEOs, as charted here, roughly tripled over this period, even after adjusting for inflation.

So, for most parts of the earnings distribution, pay gains have been practically nonexistent. For the highest-earning 5 percent, there have been some notable gains. And for those at the top of corporate America, there have been substantial gains. (The issue of others who are at the top of their heaps — such as some athletes, entertainers and hedge fund managers — is left for another column.)

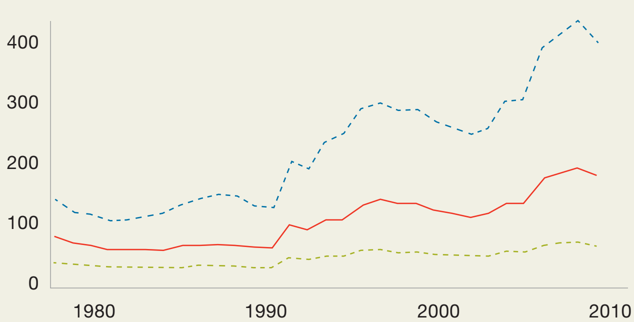
Figure 2 | **Median Total U.S. CEO Pay in Thousands by Year***



*Note: figure adjusted for inflation

The data are compiled using a variety of sources and capture (roughly) the largest 800 companies publicly traded in the U.S. each year over the sample period. All data are reported in company proxies.

Figure 3 | **Median Total U.S. CEO Pay to Worker Pay***



*Note: figure adjusted for inflation

Source: Derived from the author's book *Pay: Why People Earn What They Earn and What You Can Do Now to Make More*, forthcoming by Cambridge University Press

3. Multiple of CEO pay to median of top 5 percent of earners has doubled.

It should be no surprise, given the information in Figure 1 and Figure 2, that the median CEO to median worker hourly earnings ratio increased over time — we know the numerator (median CEO pay) has increased much and the denominator (median worker pay) has been relatively flat. This ratio, charted in the red line in Figure 3, has in fact increased from about 75 in 1980 to about 180 today. But notice the other two lines in this figure.

The blue and very steep line is the ratio of CEO pay to those in jobs at the bottom (5th percentile) of the earnings distribution. This ratio increases dramatically from about 150 to about 400 over the past 30 years. This is the ratio we often see publicized in the media.

The third and flattest line (green) in Figure 3 is the ratio of median CEO pay to those in jobs at the top (the 95th percentile) of the hourly earnings distribution — these folks earn more than all but 5 percent of other workers, earning about $48 per hour or about $100,000 per year for full-time workers. Since these workers are also likely, on average, to be in professional jobs requiring high levels of education and skill, this seems like a more even comparison. The ratio of CEO pay to the 95th percentile worker has doubled from about 30 in 1980 to about 60 today — not nearly as much as the other two ratios.

As those thinking deeply about compensation, using the United States as a case study, we should be also be thinking deeply about why 1) hourly earnings of workers at the bottom have been incredibly flat for the last generation, 2) only the top 5 percent of workers have seen large earning gains over time, and 3) even against just these highly talented folks, the CEO pay ratio has doubled. But, more importantly, we should be thinking about what or whether these numbers forecast about future regulatory pressures and economic sustainability in the United States and other free-market economies of interest. ws