Shareholder activists can inadvertently raise CEO pay—here's how to help make pay rises more equal for all

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Activist investors or shareholders can be a powerful force in the corporate world, capable of driving significant change within companies. Their influence can be a force for good. It can extend beyond financial decisions to advocate that a company makes important societal, ethical and, increasingly, environmental changes.

Recently, shareholder collaboration initiatives like Say on Climate have led investors to influence companies' environmental policies and practices. But investors are also speaking out on social issues such as income inequality.

As rising CEO compensation contrasts with stagnant employee pay, the resulting CEO-to-worker pay disparities can fuel income inequality and cause employee unrest. In the US, for example, the United Auto Workers (UAW) union recently declared a strike against auto giants such as Ford and Stellantis, demanding a 40% employee pay rise after double-digit jumps in their CEOs' pay packets.

Such large pay disparities can have negative consequences including lowering morale and productivity among employees, and eroding CEO accountability to shareholders. They can also affect a company's reputation, influence customer loyalty and undermine shareholder confidence. This could impair a company's overall performance and long-term sustainability.

Companies are required to show how much their managers get paid compared to their employees in their financial reports. In the US, for instance, financial regulator the Securities and Exchange Commission mandates the reporting of the CEO-to-worker pay ratio. In the UK, a similar rule has been introduced by the Department for Business, Energy and Industrial Strategy.

Disclosing the CEO-to-worker pay gap is seen by regulators as a way to reinforce corporate accountability. It gives more information and control to shareholders over the fairness of compensation practices. But it's still not fully understood how such disclosures actually affect CEO-to-worker pay disparities.

How shareholder activism affects CEO pay

We recently investigated how shareholders affect CEO-to-worker pay ratios and their influence on CEO compensation. We studied companies listed on the Russell 3000 Index, which tracks the largest 3,000 US companies by market capitalization. We wanted to better understand how shareholders might influence pay disparities and also whether regulatory initiatives aimed at reducing them actually work.

As the pay gap between CEOs and workers gets larger, we found that shareholders are more likely to vote against the CEO's pay package. This suggests that shareholders are paying more attention to CEO pay and are concerned about the negative effects that large pay disparities can have on employees. In theory, this heightened vigilance should deter executive excess.

However, we also found that when shareholders voice their concerns about pay disparities, CEO compensation can increase. Why? The votes of shareholders may prompt remuneration committees that decide what CEOs should get paid to revisit the CEO pay package.

But instead of decreasing CEO compensation, we found that remuneration committees are inclined to change how CEOs are paid to make it more closely linked to performance. This action, in turn, could result in increased CEO compensation in cases where the CEO performs well.

And so, the remuneration committee may use shareholder dissent votes to justify paying CEOs more. But this typically only happens if CEOs meet their performance targets. This delicate balance underscores the complexity of shareholder influence on CEO pay and raises questions about whether the new rules designed to make pay more equal actually work.

What can be done about excessive CEO pay?

Of course, governments and politicians have a role to play in reducing the CEO-to-worker pay ratios. They could impose penalties on corporations with excessively large pay gaps. The city of Portland in Oregon already imposes such a tax.

At a national level, US Senator Bernie Sanders has introduced the Tax Excessive CEO Pay Act of 2021. If passed, it would set higher tax rates for corporations with disproportionate pay ratios. Non-governmental organizations (NGOs) already report pay disparities, but they could also push harder for change by advocating for reforms and championing transparency.

You can also play a role. If you work, consider joining a union to fight for fairer wages and more transparent compensation practices. Employees can use unions to collectively voice concerns about pay disparity and ensure their interests are adequately represented in compensation discussions. Collective bargaining can exert significant pressure on corporations and help reduce income inequality.

As a consumer, you could also vote with your feet. Use your purchasing power to support companies with fairer compensation practices and shun those that perpetuate income inequality.

In the ongoing battle against income inequality, enhancing shareholder engagement to reduce CEO-to-worker pay disparities is essential. It is also important to consider the unintended consequences—the effect on employee morale and productivity, for example—that may result in increased CEO compensation. These actions will help shape a more equitable and responsible corporate landscape.

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