Corporate Law and Economic Inequality: A Beginner’s Guide

SPRING 2020
Studium Generale

Sean McGinty, Associate Professor
Nagoya University Graduate School of Law

Today’s Idea

- Corporations and corporate law are making societies more economically unequal.
- Why?
  - Corporations are organizations where decisions about how wealth is distributed are made.
  - The way they make these decisions today overwhelmingly direct wealth to those who are already wealthy and away from those who are not.

Content

- What is the current state of economic inequality?
- What are Corporations and corporate law?
- How do they contribute to economic inequality?

Vocabulary

- Economic Inequality
  - Wealth inequality
  - Income inequality
- Corporation
- Corporate Law

Economic Inequality

The current state

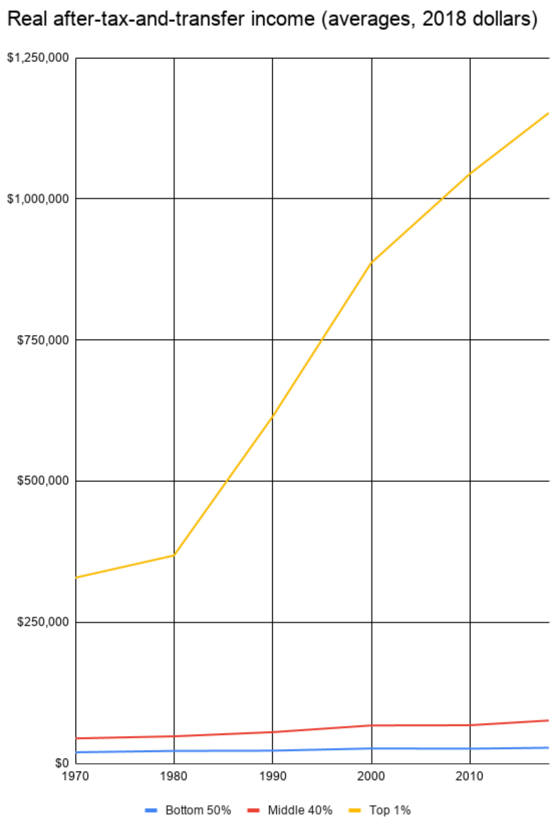
Why is economic inequality something you should care about?

Part 1: Economic Inequality

- How much economic inequality is too much? How much is too little?

Income Inequality Today

Source: Greg Sargent, *The Massive Triumph of the Rich, Illustrated by Stunning New Data* Washington Post December 9, 2019 (available at: https://www.washingtonpost.com/opinions/2019/12/09/massive-triumph-rich-illustrated-by-stunning-new-data/ accessed 10 June 2020)



Wealth Inequality Globally

P. Espinoza Revollo (2020). Time to Care: Methodology note. Oxfam. https://dx.doi.org/10.21201/2020.5419 (accessed 10 June 2020)

2,153 people have

- 8.8 Trillion Dollars in wealth

4,600,000,000 other people have

- 8.2 Trillion Dollars in wealth

Many Factors Influence Economic Inequality

- Globalization
- Technological Change
- Changes in tax policies
- Corporate decision making – Lets look at this one a bit closer!

The Corporation and Corporate Law

What are they, and how do they influence economic inequality?

The Corporation

- An entity created by a "corporate law" which provides a standard form of organization for business.
  - In Japan, the Companies Act
- Owned by shareholders, who can freely buy and sell shares.
- Run by a board of directors which is elected by the shareholders. The board appoints executives to run the corporation day by day.

The Corporation’s Stakeholders

- Corporations have many “stakeholders” who are affected by corporate decisions:
  - Shareholders
  - Executives
  - Employees
  - Creditors
  - Communities in which they operate
  - Society as a whole

How The Corporation Exacerbates Economic Inequality

- Basically, corporations exist to earn a profit. They have to decide how they will split that profit among various stakeholders. The way they make that decision (in the aggregate) is feeding economic inequality.
- At the Top End:
  - **Executive** Compensation
  - Payouts to **Shareholders**
- At the Bottom End:
  - **Employee** Compensation

Executive Compensation

- In 2019 average CEO pay of companies listed on S & P 500 was $14.5 million. Compared to $47,000 for the median worker in the US.
- In contrast, in 1965 the CEO-to worker pay ratio in the US was closer to 20:1.
- In the US, the increase in pay going to top corporate executives is a major contributor to the outsized increase in pay at the top of the income spectrum (the "1%"), thus this has a direct impact on overall income inequality across society.
- There is a vast divergence between countries, however. In Japan for example the pay of corporate executives is much lower than it is in the United States.

Payouts to Shareholders

- Payouts to shareholders can generally take two forms:
  - Dividends
  - Share Buybacks
- Over 90% of net profits at Standard & Poors 500 companies go towards these two.

Employee Compensation

- As noted above, the ratio of CEO to employee pay has rapidly increased in recent decades in the US and many other developed countries.
- Generally wages for workers have not increased in line with increases in productivity since the 1970s in the US and many other developed countries.

How Corporate Law Affects This

Executive Pay

- Pay of top executives is set in a contract.
- Corporate law rules put three types of constraints on these contracts:
  - Compensation Committees in Boards of Directors to approve them;
  - Director fiduciary duties to the corporation;
  - Say on Pay Rules for shareholders
- In practice these rules put the decision into the hands of people (executives or shareholders) who favor higher pay for executives.

Shareholder payouts

- Decision to make payouts to shareholders rests in the hands of the board of directors, who put it to the shareholders to vote on.
- The shareholders also have extensive oversight powers over the board – including the right to elect the directors and also to remove them.

Employee Compensation

- Like executives, is subject to a contract.
- Corporate law itself is largely silent on employee pay. Generally the decision falls under the general business decision making powers of the board, which can be delegated.
- This generally puts decision making on employment compensation in the hands of stakeholders who favor paying less.

Summing up the Problem...

- Corporate decision makers (the board and officers) generally exercise their decision making power with two interests in mind:
  - Their own, and
  - That of the shareholders
- Corporate Law:
  - Does a poor job of discouraging them from the former,
  - Requires them to cater to the latter, and
  - Doesn’t care about everyone else.
- The end result is that decisions on how to distribute the corporate surplus are tilted overwhelmingly in favor of two stakeholder groups that are already quite wealthy and away from the only one whose membership is mainly not.

Concluding Questions

- How might we resolve this? Is it a good idea to:
  - Alter the corporate law rules to realign distributive decisions?
  - Leave corporate law alone and instead pursue other reforms (such as tax or employment law)?
  - Something else?

References

- William Lazonick, *Profits without Prosperity* Harvard Business Review September 2014
- Douglas McGaughey, Do Corporations Increase Inequality? Transnational Law Institute Think! Paper 32/2016 (2016) available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2697188 (accessed 2 July 2020)