California Fiscal Focus

A Monthly Report from State Controller Betty T. Yee

June 2018

With One Month Remaining in Fiscal Year, State Revenues Fall Short of Projections

State Controller Betty T. Yee reports California brought in less tax revenue than expected during the month of May. Total revenues of $8.25 billion were below monthly estimates in the governor's FY 2018-19 updated budget proposal by $784.2 million, or 8.7 percent.

With one month left in the 2017-18 fiscal year that began in July, total revenues of $115.38 billion are $784.2 million less than estimates in the May budget revision, but $4.52 billion higher than expected in the enacted budget. Total fiscal year-to-date revenues are $10.10 billion higher than for the same period in FY 2016-17.

For May, personal income tax (PIT) receipts of $4.82 billion were $497.4 million, or 11.5 percent, higher than estimated in the governor's May budget proposal. For the fiscal year, PIT receipts are $3.28 billion, or 4.2 percent, higher than projected in the 2017-18 Budget Act.

May corporation taxes of $570.6 million were $79.2 million, or 12.2 percent, less than forecasted in the governor's proposed budget unveiled last month. For the fiscal year to date, total corporation tax receipts are 15.9 percent above assumptions in the enacted budget.

Sales tax receipts of $2.43 billion for May were $1.11 billion, or 31.4 percent, lower than anticipated in the governor's FY 2018-19 amended budget proposal. For the fiscal year, sales tax receipts are 1.7 percent lower than expectations in the 2017-18 Budget Act.

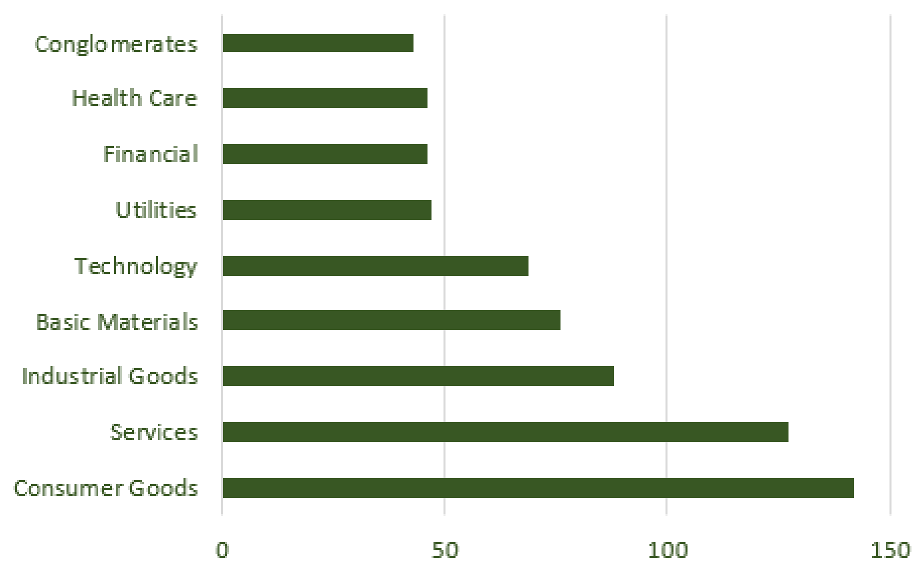
Unused borrowable resources through May exceeded amended budget projections by 13.4 percent. Outstanding loans of $5.83 billion were $1.17 billion less than the governor's May Revision expected the state would need by the end of May. The loans were financed entirely by borrowing from internal state funds. For more details, read the monthly cash report.

In this newsletter...

New Reporting Requirements Heighten Focus on Excessive CEO Pay, with Potential to Influence Consumers

Excessive executive compensation has long been a shareholder focus. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 has required public companies to give shareholders an advisory vote on their executive compensation plans. This year, shareholders will have even more information as companies publish their pay ratios.

Ratio of Russell 3000 Company CEO Pay to Median Employee Pay, by Industry Sector



Data Source: Equilar, May 2018

According to the U.S. Securities and Exchange Commission (SEC), companies only have to provide the median employee pay, CEO pay, and the CEO-to-median-employee pay ratio. Last year, the SEC offered guidance that companies may exclude up to five percent of their foreign workers and account for cost-of-living adjustments. Companies also are able to provide an additional adjusted pay ratio to account for one-time CEO bonuses and other unique circumstances. Companies can choose to report the ratio on cash compensation only or total annual CEO compensation, which includes cash and equity.

Equilar, which compiles and analyzes corporate compensation, began tracking pay ratios as companies published them in their annual proxy statements. A May 22 report showed the average pay ratio for all S&P 500 companies reported to date was 166:1, with a high of 3,101:1 for McDonald's and zero for Alphabet (Google's parent company) since the CEO is paid just $1. Russell 3000 Index companies reported a median pay ratio of 70:1. Ten of these companies had a pay ratio of zero (including Twitter and RE/MAX Holdings, Inc.). The highest pay ratio from this index was Weight Watchers International at 5,908:1, based on the CEO compensation of $35.5 million and median annual employee salary of $6,013.

While the CEOs of larger companies typically had higher compensation, the highest individual CEO pay ratio (Weight Watchers) was in the $1 billion to $5 billion market capitalization range. Median employee pay across all Russell 3000 companies was $64,024. As the number of employees increased, the median pay decreased, leading to a higher pay ratio. The consumer goods sector and services sector reported median pay ratios of 142:1 and 127:1 respectively, mainly due to low-wage, part-time employees. Utilities, financial services, health care, and conglomerate companies reported median pay ratios from 43:1 to 47:1.

Mainstream media have focused on pay ratios and increasing income inequality in recent months. As reported in the *New York Times,* Walmart employees would have to work nearly 3,000 years at the median pay of $24,406 to earn the $22.2 million their CEO was paid in 2017. Such increased reporting may lead to a change in customer

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State Pension Funds Employ Many Tools to Improve Corporate Governance

The corporate governance teams at the California Public Employees' Retirement System (CalPERS) and California State Teachers' Retirement System (CalSTRS) exercise shareholder votes each year to protect the long-term value of the public companies in which they invest. The process includes analyzing companies' annual statements and then voting on the proposals put forth by management and other shareholders. In addition, the funds often partner with like-minded investors to file and solicit support for shareowner proposals such as strengthening a company's governance structure, increasing board diversity, reining in excessive executive compensation, or calling for greater disclosure on sustainability issues.

In 2017, CalPERS voted at 11,379 shareholder meetings on a total of 107,941 resolutions, while CalSTRS voted at 8,042 meetings on 79,229 proposals. Over the same time period, CalPERS partnered with other shareowners on 33 solicitation campaigns. The corporate governance team targeted 71 companies for proxy access, which allows longstanding shareowners to place a set number of alternative board candidates on a company's ballot card at the annual shareowner meeting. The majority – 52 out of 71 – agreed to the request, leaving just 19 proxy solicitation campaigns. The CalPERS team also targeted 15 climate risk reporting engagements, received one settlement, and helped solicit support for the remaining 14 shareowner proposals.

This year, CalPERS targeted 47 companies on the proxy access issue and settled 31, leaving shareowner proposals at 16 companies. Climate risk two-degree disclosure shareowner campaigns were launched at 20 public companies, six of whom settled, leaving 14 pending proxy solicitations. Majority vote for director elections was targeted at 50 companies, 26 of which settled, leaving 24 active proxy solicitations.

In 2015, CalPERS began partnering with other shareowners to support proxy access campaigns. Approximately 60 percent of S&P 500 companies have adopted proxy access bylaws, up from one percent in 2014. Over 150 other publicly listed U.S. companies also have adopted proxy access. Over the past three years, CalPERS has focused on 50 public companies annually.

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In order to increase board diversity, CalPERS also is focused on majority vote initiatives, which require a director to be elected by a majority of the shareholder votes at the meeting, as opposed to the plurality voting model that allows a director to be elected with a single vote, regardless of the number of shareholder votes withheld. Of the 500 companies CalPERS has engaged since 2010, 385 have either adopted or committed to adopt majority vote for director elections. CalSTRS also engaged more than 580 companies since 2010 and won majority voting at 97 percent of them. This year, CalPERS is engaging 100 companies on this topic. Half of these companies will include a diversity and inclusion initiative to ensure corporations look for diverse board director candidates as openings arise.

This proxy season, CalSTRS will vote against directors on nominating and corporate governance committees — and possibly entire boards — if they do not act to address the level of board diversity following engagement. CalSTRS has identified about 25 companies for focus based on lack of action following prior engagement. Other top issues include executive compensation, increases in authorized common stock, and environmental issues. Sustainability risk management will continue to be a focus for CalSTRS, with an emphasis on energy efficiency, water risk management, and methane emissions management. Tying these issues together during engagement stresses the importance of incorporating climate-related considerations and disclosure into company practices.

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behavior. Dr. Bhayva Mohan of University of San Francisco and Dr. Michael I. Norton of Harvard University recently published a *Wall Street Journal* article exploring the impacts on customer behavior. They found that while most Americans think the average pay ratio is 30:1, they believe it should be 7:1. The professors also cite a 2009 study of Swiss citizens that found sales fell at Swiss companies with higher published pay ratios. This should concern companies and shareholders alike.

The increased attention to executive compensation also has led to a greater focus on whether companies that benefited from the recent federal tax law changes shared any of the windfall with workers in the form of higher wages. Although Walmart and a few other high-profile companies announced wage increases, most companies did not. In fact, shortly after the tax reform law went into effect, companies announced plans for $178 billion in share buybacks this year – the largest amount announced in a first quarter historically – as companies race to return short-term revenue to shareholders instead of investing in their workforce, research and development, or capital investments.

This presents a challenge for long-term investors like the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS). Both funds have a history of actively engaging with companies on executive pay. In the current climate, it is more crucial than ever to safeguard their ownership in these companies. CalPERS recently updated its policy to vote against an executive compensation plan when it includes negative pay practices or is rated D or F by the global proxy advisory service Glass Lewis. In 2017, CalPERS voted against 18 percent of executive pay packages. CalSTRS bases its analysis on whether a company's executive compensation plan is aligned with pay for performance, including the use of discretionary compensation. In 2017, CalSTRS voted against 17 percent of CEO compensation plans. At Controller Yee's request, CalPERS and CalSTRS recently updated their policies to ensure companies have a clawback policy for repayment of executive compensation made as a result of negligent or fraudulent activities that affected revenues or reputation.

Emerging best practices centered on the reporting and comparison of executive pay ratios hold great promise. In order for them to be truly effective, shareholders will have to engage with companies to ensure the disclosed pay ratios allow for easy comparison. This will help determine the correlation between pay ratio and company performance. As long-term shareowners, public pension funds owe it to their members and California taxpayers to ensure companies are not overpaying executives with funds that should be invested in the company and its workers to improve returns.

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