high pay centre

MAKING THE CASE FOR BUSINESS REFORM

About the High Pay Centre

The High Pay Centre is an independent non-party think tank established to monitor pay at the top of the income distribution and set out a road map towards better business and economic success.

We aim to produce high quality research and develop a greater understanding of top rewards, company accountability and business performance. We will communicate evidence for change to policymakers, companies and other interested parties to build a consensus for business renewal.

The High Pay Centre is resolutely independent and strictly non-partisan. It is increasingly clear that there has been a policy and market failure in relation to pay at the top of companies and the structures of business over a period of years under all governments. It is now essential to persuade all parties that there is a better way.

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David Cameron, Prime Minister, Leader of the Conservative Party (8th January 2012) “What I think is wrong is pay going up and up and up, when it is not commensurate with the success that companies are having. … Government shouldn’t tell people what they should be paid but where you have a market failure, and to me this is a market failure, we saw between 1998 and 2010 the average pay of FTSE executives go up four times … it is this excessive growth in payment unrelated to success that is frankly ripping off the shareholder and the customer and is crony capitalism and is wrong.”

Nick Clegg, Deputy Prime Minister, Leader of the Liberal Democrats (4th December 2011) “I think the revelation that top executives of some of our top companies were receiving up to 50 per cent pay increases even though their companies weren’t doing any better was a real slap in the face for millions of people in this country who are struggling to make ends meet. I think we now need to get tough on irresponsible and unjustifiable behaviour of top remuneration of executives in the private sector.”

Ed Miliband, Leader of the Labour Party (6th January 2012) “the way we run the economy has got to change, that is the point of my responsible capitalism agenda…. I promise you they are not going to steal a march on us in this area. If one of the big battlegrounds of British politics is going to be who is really going to take action on executive pay, I say ‘bring it on’.”

Introduction

Top executive pay and the behaviour of business are issues at the heart of the current public debate. The public is dissatisfied with the status quo and is looking for more responsible business at a time of unprecedented national austerity.

Pay affects our sense of fairness, it has an impact on the success of our companies, the public's trust in British business, the state of our economy and the reputation of our business leaders. In the current climate there is a strong public interest in the issue high pay and business reform is now at the top of the agenda.

Too often pay is seen as a rather opaque and specialised part of a company, isolated from the rest of the business. Yet it is through looking at executive remuneration that we expose the classic problems of corporate governance. Nowhere do the conflicts of interest in corporate governance lie so close to the surface. The dramatic escalation of pay at the top is a form of market failure, where rewards, and performance have become dislocated, and the rules of supply and demand seem to have no effect.

As the work of the High Pay Commission showed, over the last 30 years we have seen a dramatic shift in income distribution. Over this period there has been a redistribution to the top: in 1979 the top 0.1% of the income distribution took 1.3% of the national income. By 2007 this had risen to 6.5%.[1]

The year of work completed by the High Pay Commission started the process of understanding this shift, its causes and consequences. The final report included a 12-point plan to begin to tackle the dramatic escalation in pay at the top. The current political and economic environment make it essential to look in detail at the potential impact of any policy response from the government.

The work of the High Pay Commission also exposed large gaps in the information available, misperceptions, and indeed obfuscation around top pay. This hinders the public debate, and policy-making.

Knee jerk reactions and actions that lack a sound base in evidence run the risk of creating a plethora of unforeseen consequences and, indeed, dealing with symptoms rather than causes. This is an area where sound, high quality research too rarely reaches the public domain and policy is being made in the heat of the moment.

For these reasons a new High Pay Centre has been established: to provide the data, the research and assess the policies and their likely impact. It will look in more depth at some of the justifications for top pay such as the global market for corporate talent, the cult of the superstar chief executive and competition for top directors from private equity.

There is now a consensus among the political parties on the need for action on high pay and the behaviour and accountability of business. What they will do about it and whether it will be effective, are now the most pressing questions.

To get to grips with the issues of high pay, corporate governance and responsible business, there are five key questions that the High Pay Centre will seek to answer:

[1] High Pay Commission (2011) *Cheques with balances*

1 | Is it enough to tackle rewards for failure?

It is hard to disagree that rewards for failure are wrong in principle and in practice, or that they would occur in an effectively functioning market.

Why have we seen this?

> One explanation is the attempt to link executive pay to the interests of the shareholders and create entrepreneurial capitalists at the top of companies. While this allowed executive pay to mirror the upside experienced by entrepreneurs, there was no such equivalent downside risk. The result has been rewards for failure.

What about large rewards for mediocrity?

- For on-target performance FTSE 100 lead executives received a bonus worth 48% of salary at the median in 2002.
- For the same level of performance in 2010, a FTSE 100 lead executive bonus was worth 90% of salary at the median.
- At the height of the crisis in 2009 83% of FTSE 350 executives received their annual bonus; indeed this increased in 2010 to 95%.[2]

Or is excessive pay in itself a problem?

"If leaders of big companies seem to occupy a different galaxy from the rest of the community, they risk being treated as aliens."

Richard Lambert, at the time director-general of the CBI

The High Pay Centre will examine the "rewards for failure" debate and ask whether it goes far enough. Beyond this, the issue of executive pay reveals the fault lines in our business model, which need to be understood and explored further.

[2] Incomes data services (2011) What are we paying for? Exploring executive pay and performance

2 | Can shareholders solve these problems?

Over the last 20 years there have been numerous reforms attempting to tackle the issue of executive pay that have focused on empowering shareholders and strengthening non-executive directors. In relation to executive pay most recently Prime Minister David Cameron has called for a binding vote for shareholders on remuneration reports.

Will this make a difference?

> On average the vote against the remuneration report was only 5.6% in companies covered in the FTSE All-Share Index in 2010. It was higher in the FTSE 100, which had an average of 8% of remuneration reports voted down in that year, up from 3.3% in 2006.[3]

Shareholders do not always exercise their current powers. They have become dispersed and holding times for shares are much shorter, giving investors less of an interest in influencing corporate behaviour. The High Pay Centre will ask to what extent shareholders are willing or able to hold the executive to account in the long term interests of the company.

Who are the shareholders?

> At the beginning of the 1980s only 3.6% of shares in publicly listed companies were held outside the UK. By 1990 this figure had increased to 11.8%, and by 2008 41.5% of UK listed shares were held by overseas investors.

[3] PIRC (2010) *Annual Stewardship Review*, Pensions Investment Research Consultants.
[4] Office for National Statistics (2010) *Share Ownership Survey*, www.ons.gov.uk/ons/guide-method/method-quality/specific/economy/share-ownership/index.html. 1 Includes investment trusts; 2 Public sector comprises local government, central government and public corporations; 3 The end-2008 survey did not identify any significant shareholdings of quoted shares owned by building societies; 4 The Share Ownership Survey has been conducted at irregular intervals since 1963, which leads to gaps in the time series shown here in tables and figures; 5 Components may not sum to the total due to rounding.

table 1 **Share ownership of UK listed companies as a percentage of total ownership, 1981–2008[4]**

	1981 (%)	1989 (%)	1994 (%)	2000 (%)	2004 (%)	2008 (%)
Rest of the world	3.6	12.8	16.3	35.7	36.3	41.5
Insurance companies	20.5	18.6	21.9	21	17.2	13.4
Pension funds	26.7	30.6	27.8	17.7	15.7	12.8
Individuals	28.2	20.6	20.3	16	14.1	10.2
Unit trust	3.6	5.9	6.8	1.1	1.4	1.8
Investment trusts		1.6	2	1.3	2.5	1.9
Other financial institutions	6.8	1.1	1.3	2.8	8.2	10
Charities etc.	2.2	2.3	1.3	1.4	1.1	0.8
Private non-financial corporations	5.1	3.8	1.1	1.5	0.6	3
Public sector	3	2	0.8		0.1	1.1
Banks	0.3	0.7	0.4	1.4	2.7	3.5
Total	100	100	100	100	100	100

3 | How much do other stakeholders matter?

The current dominant business model sees shareholders - the absolute owners - as the only stakeholders who should have a say in the decision-making of a business. Only through enhanced shareholder oversight can the business function effectively.

However, there is a growing body of evidence that challenges these assumptions.

An academic report from Cass Business school showed employee owned businesses had[5]:

> Higher rate of sales growth and job creation during the recession than shareholder owned companies.

> Created new jobs more quickly and were at least as profitable as their counterparts.

The High Pay Centre will seek to understand the role that other stakeholders can play in relation to the debate on executive pay and the wider discussion on the behaviour of businesses.

4 | Is dealing with executive pay enough?

While the political focus is on executive pay in publicly-listed companies, this is not the only area that has seen dramatic pay escalation.

> 1997 and 2007/8 income for the top 0.1% of the population grew by 64.2% while the income of a person in the 50th percentile only grew by 7.2% over the same period.[6]

> If these trends continue, earnings for those in the top 0.1% will almost double to nearly £1 million by 2020, while wages of a person in the 50th percentile will increase from £17,100 to just £18,700.[7]

Who is in the top 0.1%?

There are other areas in the economy where we have seen incomes at the top grow, some such as private equity, are extremely secretive and data is hard to come by. The High Pay Centre will explore what has happened to top pay outside the boardroom and will ask whether it should be tackled.

[5] J.Lampel., Aj. Bhalla & P. Jha (2010) Model Growth: Do employee-owned businesses deliver sustainable performance?
[6] High Pay Commission (2011) More For Less: what has happened to pay at the top and does it matter?
[7] Ibid.
[8] Based on IFS Report *Racing Away Rich: All data are presented at the adult level and for Great Britain only. IFS calculations based on SPI 2004/5.*

table 2 **Where 'high-income' individuals worked 2004/5[8]**

	All taxpayers	Top 10–1%	Top 1–0.1%	Top 0.1%
Company directors	3.40%	9.70%	24.20%	34.60%
Proportion working in the following industries				
Financial intermediation	4.30%	7.20%	16%	30.20%
Real estate, renting and other business activity	15.60%	21.50%	30.50%	38.50%
Public administration and defence	5.50%	7.20%	1%	0.30%
Education	10.70%	11.10%	1.80%	0.30%
Health and social work	10.20%	6.80%	15.50%	3.60%

5 | What are the real effects of excessive pay at the top?

Business

Trust in business has clearly eroded and needs to be reconstructed. It's very dangerous if a country doesn't trust the private sector.

Andrew Witty, CEO of GlaxoSmithKline[9]

Business leaders are seen as being on a par with estate agents in the degree of public trust they inspire. John Cridland, Director General of the CBI, the business lobby, states that this 'is not a good space to be in'.[10]

> The credibility of the CEO as a 'trusted spokesperson' is at an all-time low of 29% globally and 20% in the UK.[11]

Impact on businesses of high wage disparity:

> In a survey of executives globally, 84% of respondents said that 'disengaged employees' were one of the three biggest threats facing their business.[12]

> Lower-echelon employees who feel disadvantaged are less supportive of the goals of the over-rewarded group.[13]

> Individuals who believe they are treated fairly have a stronger identification with their company, so they internalise the goals promoted by managers.[14]

Economy

Entrepreneurialism

> Studies have shown there is a relationship between patents per head of population and equality, suggesting that entrepreneurship and innovation may be higher in more equal countries.[15]

Growth

This inequality is destabilizing and undermines the ability of the economy to grow sustainably and efficiently… [Income inequality] is anathema to the social progress that is part and parcel of such growth.

Sarah Bloom Raskin, Board of Governors of the Federal Reserve System

Society

Both intra and intergenerational mobility appear to be affected by inequality. Intergenerational mobility has been declining in Britain over the same period as the gap between the top and the bottom has widened.[16] Further countries with higher levels of inequality also have lower levels of social mobility.[17]

The High Pay Centre will seek to understand the wider economic, business and social implications of dramatic shift in income distribution witnessed in the last 30 years.

[9] Andrew Witty in an interview for the High Pay Commission
[10] L. Elliott (2011) 'CBI's John Cridland: "There is a sense of urgency about making Plan A work"' Guardian, 15 April, www.guardian.co.uk/business/2011/apr/15/john-cridland-sense-of-urgency-plan-a-work.
[11] Edelman Trust Barometer
[12] Economist Intelligence Unit (2010) *Re-engaging With Engagement: views from the boardroom on employee engagement*, www.businessresearch.eiu.com/sites/businessresearch.eiu.com/files/LON%20-%20PL%20-%20Hay%20report_WEB.pdf.
[13] E. Hatfield and S. Sprecher (1984) 'Equity theory and behavior in organizations', in S. B. Bacharach and E. J. Lawler (eds), *Research in the Sociology of Organizations 3*, JAI Press, 95–124.
[14] C. O'Reilly and J. Chatman (1986) 'Organizational commitment and psychological attachment: the effects of compliance, identification and internalization on prosocial behavior', *Journal of Applied Psychology* 71: 492–99.
[15] Wilkinson and Pickett, *The Spirit Level.*
[16] J. Bladen, P. Gregg and S. Machin (2005) *Intergenerational Mobility in Europe and North America, London Centre for Economic Performance*, London School of Economics.
[17] Wilkinson and Pickett, *The Spirit Level.*