THINKING HIGH AND LOW

EXPLORING PAY DISPARITIES IN SOCIETY

high pay centre

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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FRIENDS PROVIDENT Foundation

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Foreword

Deborah Hargreaves

Can we justify a business leader being paid 100 times more than someone who works for him? How about 50 times? Is there a right number?

Those at the top of the corporate sector maintain these numbers are irrelevant and that there is no connection between pay at the top and wages for everyone else. However, for me, these ratios clearly reflect the growth of inequality in our society.

As we see pay disparities growing ever wider across the business landscape, it is worth taking some time to debate the social change these numbers point to.

It is currently quite difficult to know the exact dimensions of the gap between pay at the top and the rest of the workforce. Few businesses calculate their own ratios, let alone discuss the implications of them.

Under the 2013 new remuneration regulations introduced by the coalition government in the UK, there is an obligation on company remuneration committees to set CEO pay in the context of wages and conditions in the rest of the workforce. They are required to show how they have made the comparison.

However, few choose this opportunity to disclose a pay ratio. It remains an extremely sensitive number.

This collection of essays is part of a six-month project on pay ratios by the High Pay Centre, funded by the Friends Provident Foundation. This is our attempt to introduce some ideas for discussion into the debate around pay gaps and fairness. I am delighted that we have contributions from John Lewis and Christian Aid, both of which operate a pay ratio as part of their business. Have your say online highpaycentre.org and on twitter #payratios

The economics of high pay: market forces and market power

Diane Coyle

Why do some people earn so much? Are the chief executives of banks and FTSE 100 companies worth hundreds of times more than their average or lowest paid employee? Or than me? Of course not, and the multiples can and should be reduced.

It is instructive to look at the income distribution for the UK (and the pattern is similar for other OECD countries). Would you say that a couple who are both teachers on average pay for their profession of about £30,000 a year, with two teenage children at home, and paying an average council tax bill and mortgage, are rich? Probably not.

Yet they are: they have a higher income than 82% of the population.[1] The person half way along the UK income distribution earned just over £21,000 last year.

The income distribution is not symmetric; the top tail of the distribution is very far away indeed from the main bulk. Few people appreciate just how distant the top earners are from everyday experience. Economic forces are part of the explanation for soaring top pay since the 1990s, but they are not as inexorable as the forces of physics, nor are they the whole story. And the chasm between top and ordinary pay has damaging consequences, political as well as economic. The gap in resources, opportunities and experience between the 1% and 99% is steadily undermining democracy; there is no way in which we are 'all in this together'.

The economic triggers for increased income inequality – which has occurred in all the developed economies including Scandinavia – were new technologies and globalisation. The digital technologies have spread "winner take all" or "superstar" effects. Just as the most popular movie stars earn vastly more than actors who are almost as good, the wide reach of online and increasingly global markets means the top earners in many professions have pulled far ahead of the pack. The technologies have generally increased the pay for people with certain kinds of skills, reflected in the increased wage premium for people with degrees.

While the top of the distribution was being stretched upward, the process of deindustrialisation, and the loss of well-paid jobs for large numbers of people (mainly men) in manufacturing, has pushed many people towards the bottom of the income distribution. The phenomenon of 'hollowing out' of the middle earners is universal.

However, the global and technological forces are not the end of the story. High earners have also cemented and enhanced their advantage by progressively rigging the institutions of the market in their favour. The most glaring examples occur in finance, where the deregulation of speculative trading activities and the bonus culture have vastly enriched a small number of people, while the costs of their risk-taking have been borne by the majority.

Corporate executives elsewhere have steadily adopted the same practices, including remuneration committees that ratchet up pay by all wanting their executives to be in the top quartile, and that pay asymmetric bonuses (how many top earners have repaid money to their company when profits decline?) The claim that pay needs to be performance related is distorted by defining performance in terms of share price over short periods, rather than, say, customer satisfaction over 10 years. The whole of the corporate sector has been financialised and has drifted away from its fundamental purpose of investing in goods and services that will serve customers and society.

Some of the measures needed will be long term remedies. A total rethink of education is one of them: what do schools need to do to enable young people to work alongside new technologies and share in the economic benefits of advancing technology and productivity? The answer will not be testing their powers of memory to turn them into more expensive and less effective versions of computers.

However, the institutions of the market can be addressed on a far faster timescale. Corporate law and governance codes can go a long way to tackle the excesses of top pay. Companies could be required to publish pay multiples and also to set out a policy on their internal distribution of pay. What top to bottom or top to median pay multiple will help achieve the company's strategic objectives?

It would be instructive to see executives being required to explain in detail, with reference to specific metrics, why they are worth 400 times more than their employees. Remuneration committees could be required to stop using relative measures to set "reward", ending the upward ratchet, and to disregard share price – so easily manipulated by executives – as a measure of value. Tax and pension legislation can be used to discourage the 'variable' pay, the share option and

[1] http://www.ifs.org.uk/wheredoyoufitin/welcome.php

bonus schemes, typically used to inflate top pay.

In his famous book, *Capitalism and Freedom*, the ur-free market economist Milton Friedman, argued in favour of an unequal distribution of incomes. He said different levels of pay were needed to induce people to invest years in training, or to reward those who took risky career decisions like becoming an actor or footballer or author. Some people work harder than others. Sometimes too people are lucky, and we do not begrudge someone who wins the lottery. Finally, he said inequality is needed to build up the savings that finance the investment needed for future progress. But he also argued that governments should be careful not to allow some groups of people to build up market power that would enable them to extract unfair incomes. And he wrote that the results of the market were "unlikely to be tolerated unless it is also regarded as yielding distributive justice."

The financiers and executives who are lucky enough to have that kind of market power – far beyond what Friedman could have imagined possible when he wrote in 1961 – are distorting the economy and destroying democratic consensus. Narrowing the pay gap would increase investment (no more incentive to keep up the share price by buyback schemes instead of investing in the company), improve productivity (through higher investment and greater enthusiasm among the rest of the workforce), and above all repair the catastrophic loss of trust in corporate elites that is destroying the market economy and liberal democracy.

Diane Coyle is a Professor of Economics at the University of Manchester.

While she was its Vice Chair (2011-2015), the BBC Trust introduced a policy for BBC Executive pay reducing the multiple of the Director General's pay to the median BBC salary. The multiple fell to 10.7 in 2015, compared with 16.8 in 2011.

It's all relative: why we need to publish pay ratios

Ruth Sunderland

In the past few years, campaigners including the High Pay Centre have helped to bring about major improvements in the reporting of executive pay.

Annual reports now contain a 'single figure' for rewards, that brings together all the various elements such as long-term incentives, annual bonus, pension and perks.

This makes it possible to see at a glance what an executive is receiving, and to compare one boss with another.

It's a big breakthrough, considering how confusing and complex the packages are.

But more needs to be done before shareholders, taxpayers and employees can see executive pay in its full context.

This is where the pay ratio comes in. It shows in simple, broad-brush terms, how much the chief executive made in relation to an average employee.

A ratio will never paint a perfect picture, but it can give a guide to how wide the pay gulf is in particular industries or companies.

Some will see this as merely providing fuel to stoke the politics of envy.

I disagree. Only a warped version of capitalism demands uncritical support for a class of executives who are super-efficient at extracting value, but significantly less so at creating it.

This is not a hackneyed issue for old-style socialists, or shop floor workers versus the boardroom.

Executive pay has not only pulled away from low and middle income earners, but also from people who are extremely well-qualified, successful, and by any normal standards very highly paid.

The average FTSE 100 CEO took home £4.9m last year.

We have become accustomed to these figures to the point of becoming immune, but to put it in perspective, that is more than 32 times as much as someone with a taxable income of £150,000, enough to put them in the top 0.5% of taxpayers.

The sums doled out to managers of large companies are also a source of wonderment to small business owners working in the engine room of the economy and taking high personal risks without the life-changing rewards in a short space of time.

Even within Wall Street investment banks, the ratio of chief executive to analyst pay is startling: The Goldman Sachs CEO earns 218 times as much as an average analyst at the bank, according to researchers Emolument.com, and 205 times at Morgan Stanley.

If this is 'us against them', then are many more of 'us,' and far fewer of 'them'.

What we have is a small elite, becoming ever more detached financially and psychologically from the rest of humanity.

Pay ratios matter because they help gauge the gulf.

Over time, the average pay ratio has widened and now stands at 149:1 for the FTSE 100. That compares with a ratio of 'only' 47 times in 1998 and 120 times in 2009, according to figures from the High Pay Centre and Manifest.

In other words, it would take an average employee 149 years to earn as much as his or her CEO takes home in 12 months.

Or, put another way, the CEO's contribution is valued the same as 149 employees. To put this in perspective, recent research by Populus found that more than two- thirds of people in a poll of more than 4,000 supported a maximum wage so that no-one in a company could earn more than ten times the average. It also found a preference to buy from a firm that limited its chief executive's pay to no more than 50 times the average employee.

A pay gulf this wide is not good for society, for individual companies or for the economy.

The danger is that it will foster a culture of arrogance and entitlement, accompanied by a lack of respect for 'civilians' - the ordinary employees and customers who contribute to a company's success.

Genuine team work is harder to achieve when pay levels are so divisive.

Management guru Peter Drucker, back in the 1970s and 1980s, reckoned that a ratio of 20:1 or 25:1 was optimal.

Even companies such as John Lewis, which caps CEO pay at 75 times or TSB, with a ceiling of 65, have gone way beyond that.

Sacha Romanovitch, the first female chief executive at top accountant Grant Thornton, is a rare beacon of good practice. When she was appointed recently, she set a voluntary ceiling of 20 times the average salary in the firm for her pay. Admittedly the average is likely to be quite high, as most staff are highly qualified professionals, but it is a step in a healthy direction.

Too wide a pay divide is prone to foster mutual contempt. Employees may come to believe executives are driven by gross self-interest and that they are rewarded well beyond what they deserve.

Cosseted executives lose their anchor, and become un-moored from reality, which is particularly dangerous in a consumer business.

Left unchecked, the pay chasm is likely to widen further as the super-monied elite use their wealth and position to garner ever more influence over politicians and to manipulate the system for their own ends.

Democracy itself risks being undermined if power leeches away from the man on the street and the ordinary taxpayer, and is held by the corporate elite.

Look at the way the banks lobby against regulation and taxes that could curb profits and executive pay - regardless of the potential benefits this might have for society as a whole in creating a safer banking system.

And despite myriad failures and scandals, the voice of the banks still gets a disproportionate hearing: between 2010 and 2012, for example, the Chancellor had 44 one-to-one meetings with bank bosses, compared with just eight tete-a-tetes with leading manufacturers.

What to do, to stem the tide? Attempts to impose a compulsory cap on pay ratios are likely to produce flawed results and perverse effects.

Ratios will vary widely, for legitimate reasons, depending on the industry, whether a company operates in low cost overseas locations, and the nature of the work staff do. A retailer with thousands of low paid staff is likely to have a very different ratio to a software company employing mainly whizz-kids with PhDs, so a one-size-fits-all ceiling would not work.

Putting a formal cap on the ratio might even induce some firms to sack their own staff and outsource low paid jobs, in order to make themselves look better.

Insisting that companies disclose their pay ratio, as has been introduced in the US, does make sense – it would enable consumers and investors to draw their own conclusions and might even shrink the pay divide through peer pressure.

A final thought for those tempted to argue the scrutiny on pay is already too great: despite the media furore over a handful of individuals, the rewards handed to many chief executives have gone utterly unremarked.

Step forward Erik Engstrom, who received £16.2m at Reed Elsevier, now known as RELX Group, last year, Don Robert, who was paid £10.2m in 2014 by Experian, or Geoffrey Drabble, who made £7.1m at Ashtead, to name just a few. That is without even mentioning the private equity barons and hedge fund managers whose rewards are still secret.

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Ratios could align top bosses with workforce rather than shareholders

Simon Caulkin

Dramatically widening pay differentials inside companies faithfully mirror burgeoning inequality in society as a whole. Pay ratios clearly illustrate the trend. In the 1980s a typical top chief executive (CEO) was paid 20 times as much as the average British worker. By 2015 the ratio had reached 149 times. The US has seen a similar progression, leading to even higher multiples.[2]

Growing unease at the size of these disparities has prompted several initiatives focused on internal pay comparisons that aim at narrowing the gap, or at least opening it up to debate. The 2011 Dodd-Frank Wall Street Reform and Consumer Protection Act charged the US Securities and Exchange Commission (SEC) with drawing up rules for mandatory disclosure of pay ratios. In the UK Will Hutton's 2011 review of public-sector pay recommended tracking executive pay multiples as part of a wider Fair Pay Code. While stopping short of mandating formal disclosure of ratios, the government in 2013 reinforced reporting requirements on the relationship between employee pay and executive pay. And among other reform agenda items for debate, the High Pay Centre has advanced the idea of a maximum pay ratio barring CEOs from earning more than a certain multiple of the pay of the lowest-paid or median employee.

Alarm over seemingly uncontrollable CEO pay is real and the idea of a maximum pay ratio has wide public support. Yet so far there is little to show for such efforts. In the US, the SEC's disclosure rules took four and a half years to agree, but were finally introduced last month. In the UK, Hutton's public-sector disclosure recommendation has evoked little enthusiasm. And given that most companies have ignored existing governance requirements to explain internal pay relationships, it is hardly cynical to wonder if the 2013 reporting regulations will fare any better.

The bottom line then is – realistically, can disclosing and setting pay ratios play a useful part in improving corporate governance and making top pay less controversial? Or would they be, as opponents claim, just another stick to beat business with?

While their use is attractive in theory, in the view of Cranfield Business School's Ruth Bender there are at least three kinds of problem with practical application.

[2] See essay by Brandon Rees in this collection

The first calculating what they are. CEO pay is notoriously complex, with separate components paying off on different timescales. On the employee side, how to account (for example) for multinational corporations with a workforce distributed across both high-wage and low-wage economies, or alternatively identifying a representative sample without introducing bias, are both problematic. The implication: if disclosure is no more than a recommendation, companies will likely park it in the 'too difficult' box, as in the past.

Making it mandatory, on the other hand, as the TUC for one would like, would give the unscrupulous an incentive to manipulate or game the figure – the second issue. For example, outsourcing the lowest-paid jobs or turning them into zero-hours contracts would lower the ratio at a stroke without changing anything on the ground – the opposite result from what was intended. There could be other unintended consequences.

The third problem is that even with honest figures, there is no one 'right' ratio. A small, flat company will have a lower multiple than a traditional large one with more management layers.

'Financial and professional services firms will inevitably perform better on a ratio than retailers,' says Simon Walker, director general of the Institute of Directors (IoD), 'but does this tell you anything about whether one company is better than another?' Although supporting transparency and having nothing against companies voluntarily disclosing ratios, the IoD doubts the usefulness of a single figure. 'Ratios tell you nothing about turnover, performance or implementation of long-term strategy, all of which should be key to setting pay', adds Walker.

More granularity is needed to convey much-needed information about diversity, gender-balance and the sustainability of a company's human capital, all vitally important for investors, suggests managing director, Sarah Wilson, of Manifest, the proxy voting agency.

The overt arguments about pay ratios hide a deeper issue: they sit at the intersection point of two contrasting views of corporate governance which can't easily be reconciled, at least in the short term. In the official governance world, where top pay is increasingly composed of incentives centred on total shareholder return or earnings per share, internal pay ratios are of secondary concern. In practical fact pay aligns the CEO with shareholders, and detaches them from the rest of the firm. By definition, a company that doesn't measure pay multiples already, doesn't consider them important enough to manage. There's no mystery about the widespread failure to explain internal pay relationships under present guidelines – for most companies they simply don't enter into the calculation.

Contrast this with John Lewis. Talking to the BBC, chairman Charlie Mayfield recently described his role thus: 'I work for the partners in the Partnership. My job is to invest in them, help them work as well as they can, and if we do that we will succeed as a business.' For John Lewis, internal pay relationships are material and important – which is why the CEO's pay is limited to 75 times that of the average partner, and profit is shared equally among the workforce. Similar 'shared enterprise' reasoning is invoked by City accountancy firm Grant Thornton in its recent announcement of a 20-times cap on the salary of its new chief executive and a move to a John-Lewis-style profit share.

In the long term, of course, the conflict is a false one. Consistent investment in human capital *à la* John Lewis benefits shareholders too – in fact enduring success is unlikely to be achievable without it. The TUC is not alone in pointing to ample evidence that firms in which people genuinely feel 'we are all in this together' benefit from greater engagement, better performance and higher product quality.

Conversely, notes TUC general secretary Frances O'Grady, increasingly high pay differentials – 'we are not all in this together' – 'are bad for workforce morale, bad for productivity and bad for company performance' – impacts that should be taken into account by both remuneration committees and shareholders voting on remuneration reports.

'My guess', sums up management thinker (and unashamed capitalist) Gary Hamel, is that [company shareholders would be] better serviced if their chairman could have bragged about being aligned with employees and customers. It seems to me that a CEO's first accountability should be to those who have the greatest power to create or destroy shareholder value.'

That would take a revision of governance codes and directors' duties, as the High Pay Centre has proposed, to gain general acceptance, at which point pay ratios could take their place among a suite of different measures of corporate health. Perfection will not happen overnight, however. In the meantime, despite the imperfections, mandatory reporting would be a step towards the good, along a path already indicated – indeed required – by the codes. 'We need greater clarity on what people are being paid in the first place,' points out the TUC's O'Grady, noting that reporting on employee pay is currently so poor that it is often very difficult to work out what pay ratios actually are.

Improving that reporting would flush the fox and start a process of refinement that might well see the emergence of ratios for different sectors of the economy, generating greater understanding of different business models. It would also provoke much-needed debate about the accountabilities and incentives embedded in current corporate governance, which lie at the heart of today's problem of CEO pay.

Simon Caulkin is a business writer and former management editor of the Observer

Give bondholders more of a say on pay

David Davis MP

Pay at the top of society has risen dramatically in recent years. While wages have only just started to rise for the majority of the country, the pay of the UK's CEOs has seen double digit growth year after year. The growth of CEO and executive pay is a major factor in the increase in the top 1%'s share of Britain's wealth.

This would not be a problem if these pay rises were the result of extraordinary performance. But CEO pay has massively outpaced anything with which it can even remotely be correlated, whether it be revenue, profits or share price. Not only that, but in many cases those at the top have garnered gargantuan rewards for gross failure.

Everyone will remember Sir Fred Goodwin, who received £4.19m in the year before RBS collapsed and had to be bailed out by the Government. If anything, the problem is worse in the US. Kenneth Lay received a $140m package in 2000, the year before Enron, the energy company that he led, collapsed after one of the biggest accounting scandals in history. Richard Fuld was paid $466m in the eight years prior to Lehman Brothers becoming the largest bankruptcy in US corporate history.

This growing chasm between achievement and reward is particularly evident in the banking sector. The economist Thomas Philippon's research on the US financial services industry indicates that despite its fast computers and credit derivatives, the current financial system is no better at transferring funds from savers to borrowers than the financial system at the start of the 20th century. And yet the compensation of 'financial intermediaries' as a fraction of GDP is at an all-time high, around 9% of GDP.

So while bankers are being paid more than ever, they are providing no more or a service than they did a century ago.

Despite this, I would not support a system of maximum ratios to cap pay at the top of society. A cap is simply too crude a measure, which would achieve little and be too easy to avoid. The last thing we need are further regulations that serve only to enrich lawyers and accountants. And a maximum pay ratio would also ignore the crucial difference between income and wealth, and would likely have significant unforeseen consequences.

A prime example of such consequences is the crackdown on bankers' bonuses. By legislating to restrict the amount of variable pay in the banking sector, the government managed to make bankers' pay even less dictated by performance. There is also evidence to suggest that deferred pay is not having the desired effect due to the extent to which executives devalue deferred pay.

But the biggest problem with a cap, or maximum ratio, is that such a measure would also unnecessarily punish those who genuinely deserve huge rewards.

There are some people who, through their ingenuity and innovation, are capable of creativity and enterprise that are of exceptional benefit to society. The James Dyson's, Bill Gates's and Steve Jobs's of the world, whose inventions dramatically improve our lives, deserve the exceptional wealth that they acquire as a result.

No one would complain should the inventor of a highly effective new cancer treatment, or the creator of a room-temperature superconductor, become fantastically wealthy as a result.

The fact is that high pay is not in itself inherently bad. After all, the best way to earn more in a competitive modern economy is to provide more of the goods and services that people actually want. High rewards encourage the entrepreneurial activity that improves all our lives through better and cheaper products.

And no one is complaining about the excessive pay of pop stars, film actors or footballers, who arguably contribute even less to society than those at the top of the financial services industry.

Of course, the financial industry may be an exception. Pay dependent on high relative rates of return provides strong incentives to invest in highly leveraged risky assets. Unfortunately engaging in such high risk activities in the financial sector can cause considerable systemic risk, causing wider damage to the economy.

But overall, the criticism of high pay comes down to the question of fairness. People tend to criticise high pay when there is a perception that people are getting something for nothing, or are even being rewarded for failure. There are very few reasonable objections when people benefit from the sweat of their brow, or receive their 'just deserts'.

Unfortunately, ensuring that people only receive their 'just deserts' has proven difficult to put into practice. But there is much that can be done.

Increasing competition lessens the opportunity for rent-seeking behaviour and more closely aligns reward with achievement.

Greater shareholder accountability will also help to put pressure on high pay. Vast pay packets come out of the profits, and dividends, that are the shareholders' property. Indeed, following the so-called 'Shareholder Spring' protests in 2012 a number of companies have amended their remuneration practices.

For a number of years now Sir Martin Sorrell, chief executive of WPP, has faced shareholder rebellions over his pay (£187m over the last 11 years). These rebellions have not stopped the rise in his pay, but they do get coverage and send a message to remuneration committees.

I also think that we should extend leverage over a company's pay policy to others whose investment may be at risk. There is some academic evidence that corporate bondholders are more often involved in the dismissal of chief executives than the relatively passive shareholders. Why not mandate them a place – or places – on the remuneration committee? That might slow the bankers down somewhat.

The key is to create a remuneration regime that rewards success, punishes failure and does not throw the baby out with the bathwater. We do not want to put a cap on success or ambition. These are what drive the innovation and entrepreneurial activity on which our economic growth is founded.

David Davis is the Conservative MP for Haltemprice and Howden

What should CEOs be paid? Views from around the world

Michael Norton

2,000 to 1 or 1,000 to 1, or 300 to 1.

For sports fanatics, these ratios – applied to one's own team – all signal staggeringly low odds of winning. But these ratios actually refer to another staggering set of ratios: the ratios of CEO compensation to the pay of average workers at some of the most recognisable global corporations.

Take Walt Disney. In 2014, Robert Iger was compensated to the tune of more than $40m, while Disney's median worker was paid just under $20,000. Do the maths… and you'll find a ratio of 2,000 to 1. A similar story unfolded at Microsoft, where Satya Nadella took home more than $80m while median workers received just over $40,000. Again, a ratio of 2,000 to 1. Of course, not all companies were this extreme. The ratio of Howard Schultz's pay at Starbucks was 1,000 times higher than the typical barista, and Rupert Murdoch at 21st Century Fox came in at 340 times his median employee (Morgensen, 2015).

These ratios beg a simple question: How much more than the average worker *should* CEOs make? There are some hints that the high pay ratios above may be too high for many people. For example, the management guru Peter Drucker suggested a cap on the ratio of CEO to average worker salary of 25 to 1 in the 1970s, believing that greater disparity would harm job satisfaction and company performance (McGregor 2013). In 2013, the Swiss electorate voted against a referendum to cap bosses' pay to 12 times that of their lowest-paid staff – such that executives could not earn more in one month than their lowest-paid workers earned in one year – though nearly 35% voted yes.

In recent research with my colleague Sorapop Kiatpongsan, we set out to explore what regular folks all around the world – in countries ranging from the United Kingdom and Venezuela to Bulgaria and South Africa – thought the gap between CEOs and median workers actually was, and most importantly, what they thought it should be. We used data from the latest International Social Survey Programme (ISSP) Social Inequality IV (International Social Survey Programme, 2009). In all, more than 55,000 respondents from 40 countries completed the survey.

They were asked two sets of simple questions. First:

How much income do you think the average chairman of a large national corporation makes each year?

How much income do you think the average unskilled worker makes each year?

These two numbers allowed us to calculate the estimated pay ratio between CEOs and average workers. Across the entire sample, respondents believed that the ratio was 10 to 1 – that CEOs made 10 times as much as the average unskilled worker. In the UK, respondents estimated the actual ratio to be 13.5 to 1.

The second set of questions asked respondents not to estimate the current state of the world, but to report their ideal state of the world. If up to them, what would CEOs and average workers be paid?

How much income do you think the average chairman of a large national corporation ***should*** *make each year?*

How much income do you think the average unskilled worker ***should*** *make each year?*

Across the full sample, respondents' ideal ratio of CEO to average worker pay was 4.6 to 1; in the UK, the ideal was 5.3 to 1.

You may have noticed something. In both the whole sample and in the UK, ideals (4.6 and 5.3) were far more equal than the estimated ratios (10.0 and 13.5). In fact, this trend was true in every one of the 40 countries surveyed. Estimated pay ratios of CEOs to unskilled workers ranged from 3.7 (in Denmark) to 41.7 (in South Korea), and ideal ratios ranged from 2.0 (in Denmark) to 20.0 (in Taiwan), but in every country, respondents reported ideal pay ratios that were more equal than what they believed them to be (Figure 1).

Moreover, when we delved deeper into the data, we found striking consensus in these ideals across rich and poor respondents and respondents to the left and the right of the political spectrum, and across gender, age, and education levels. In every subgroup, respondents reported ideal ratios more equal than their estimates.

But how do these estimates and ideals compare to reality? It could be the case that people's ideals are perfectly in line with the current state of affairs, such that their ideals are already evident in practice. For 16 of the 40 countries, we were able to obtain the *actual* ratio of CEO pay to the pay of average workers. As can be seen in Figure 2, it is readily apparent that actual ratios are far more unequal than respondents' estimates and ideals. In the UK, for example, the actual ratio is 84 to 1, far higher than the estimate of 13.5 or the ideal of 5.3.

In sum, these results suggest a powerful – and global – consensus. People all over the world, with different political views and levels of wealth, appear to desire a more equitable distribution of pay between bosses and their employees.

Michael Norton is a Professor at Harvard Business School and coauthor of *Happy Money: The Science of Happier Spending*

figure 01 **In each of 40 countries, respondents' ideal CEO-worker pay ratios (in grey) are more equal than their estimated pay ratios (in red)**

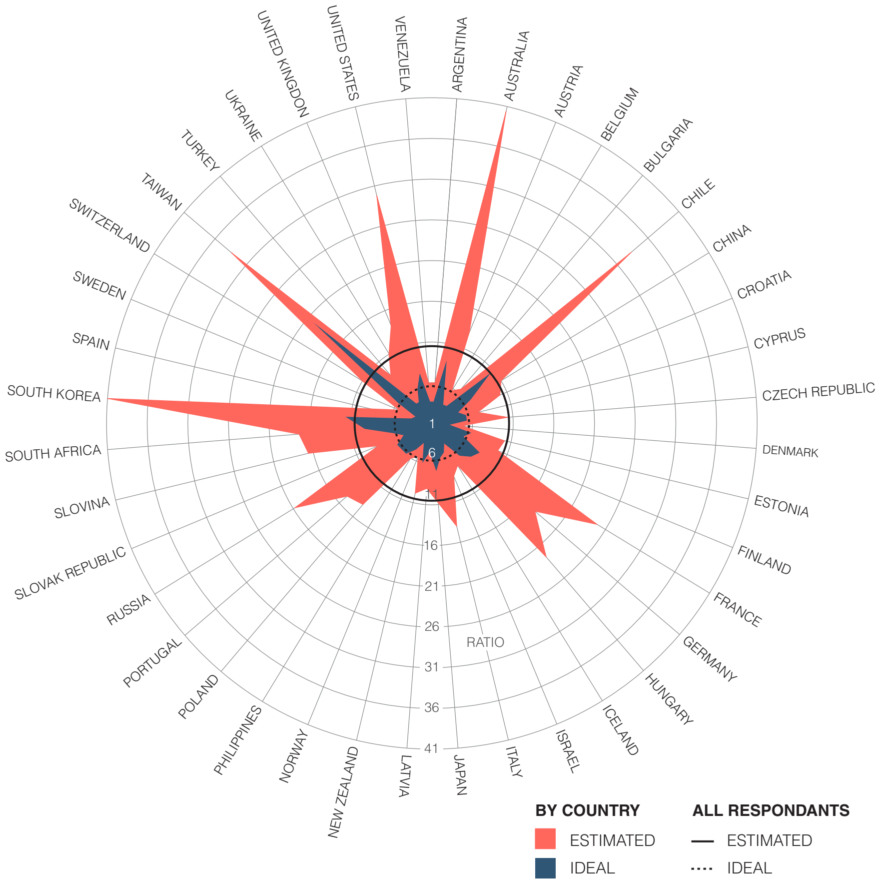

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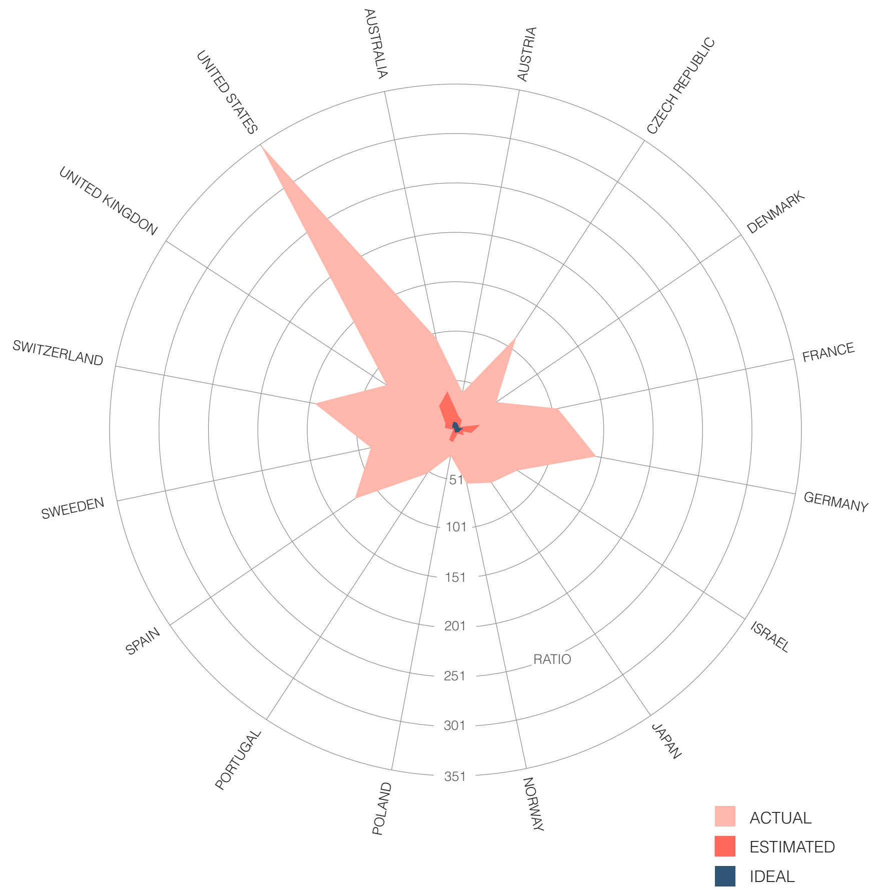
figure 02 **In each of 16 countries, respondents' estimated (red) and ideal (blue) ratios are more equal than the actual current ratio of CEO to average worker pay**



Christian Aid and pay ratios – a case of practising what you preach?

Duncan Brown

'Well of course *they* would!' was how my executive compensation consultant colleague responded on hearing that Christian Aid, the major international aid charity with the mission of "fighting for a world free of poverty and injustice", operated a pay ratio policy. The response also implies that the approach was far from suitable for more 'normal' organisations. The egalitarian biblical vineyard owner Mathew who describes paying those workers he hired late in the day the same one denarius wage as those he hired at 9am, would surely defy the hourly and performance-based pay systems and sense of fairness prevailing in most contemporary employers.

Yet Christian Aid is far from being in some type of isolated, antiquated, low pay paradise. The staff are highly committed to their cause of eradicating poverty. But the charity also operates in some highly competitive labour markets for international aid specialists and is subject to intense fundraising and cost pressures. Nor have they and the other international aid charities been shielded from the critical media spotlight currently falling on executive pay. *The Daily Telegraph's* front pages in the summer of 2013 included Christian Aid under the headline 'Thirty Charity chiefs paid more than £100,000', prompting a parliamentary enquiry and new guidelines on executive pay from the National Council for Voluntary Organisations (NCVO).

Loretta Minghella, Christian Aid's chief executive, who was formerly the head of the Financial Services Compensation Scheme, earned £126,206 last year, well below the sector average for larger charities. This was for managing an organisation with an income of over £100m and around 900 staff based in the UK and spread across some of the poorest parts of the world.

Loretta's earnings are capped by the policy operated by the Remuneration Committee (on which I sit) which limits the pay of their highest paid executive to four times the median pay of the organisation's UK employees.

Christian Aid has operated a maximum internal pay ratio for more than a decade, and according to Director of Strategy and People, Martin Kyndt, it is "aligned with and underpins the strong values of the organisation" including fairness, stewardship and transparency. The NCVO guidelines recommend that other major charities follow their example. So what have been Christian Aid's experiences with the policy and can other types of employer learn anything from them?

Maximum pay ratios, even much higher ones than Christian Aid's, are often rejected in the private sector on the ground that they don't allow enough flexibility to recruit at senior levels. Yet Christian Aid introduced the policy as part of reforms to its pay structures in 2004, which were stimulated by growth and the need to recruit and compete more effectively for professional and specialist staff, as well as provide a clearer and more differentiated structure for career progression. As Martin Kyndt says, unlike the vineyard owner, "we can't pay everyone the same as we are in a competitive market for talent".

But as he says, it was an "easy", "obvious" decision to introduce the ratio –"we are using charitable funds and we need to steward those carefully; we don't want a situation where people at the top end are paid vastly differently from those at the other levels". Their pay policy "recognises the important responsibility we have to the poor communities we work with, our donors and the public to ensure we are open and transparent" and ensure value for money, while also being able to "attract, motivate and retain capable staff to implement the work we do".

As well as the ratio, other pay principles include paying at or below the median in relevant markets, fair and consistent decision making, and providing an attractive total rewards package incorporating personal choice and flexibility. Annual pay reviews are driven by affordability and the external cost of living, and reflecting on the difficult economic environment for the major charities in recent years, no cost of living award was made to staff in Britain and Ireland in 2014/15.

The ratio was originally six times the lowest paid person in the organisation, and the current chief executive was recruited successfully with that in place, though on a lower salary than in her prior post. Two years ago it was shifted to four times the median pay, not interestingly to reflect escalating differentials at senior level in the external market, but rather to provide more flexibility at the lower end to recruit more apprentices and trainees.

Like the vineyard owner (who was paying all the labourers at the level of a Roman centurion), Christian Aid pays comparatively well for lower skilled roles and is an accredited Living Wage employer.

The change also followed the report of the Hutton Review of Fair Pay in the public sector in 2011 which recommended this as the most appropriate measure. Avoiding the definitional problems and complexity which have bedevilled the attempts in the US to introduce pay ratio reporting in quoted companies, Christian Aid excludes its overseas staff from the calculation. It also omits any valuation of pension benefits on the 'keep it simple' principle.

The pay ratio policy also reflects Christian Aid's leading position in the sector on remuneration disclosure. The NCVO guidelines point to the variety of charitable organisations as a reason for not adopting a target ratio in the sector. But they do recommend publication of the figure as "there's a great story to tell here: our sector is much fairer than most" and trustees should be "mindful of pay comparisons within the organisation" as well as externally when making their decisions.

Reflecting on their experiences, Martin Kyndt recognises that pay ratios are not a 'magic bullet' solution for a challenging pay environment. Pay freezes and public criticism of anyone earning over £100, 000 in the sector, however low this level is in absolute and ratio terms compared to the private sector, have been challenging to deal with, particularly in terms of staff motivation.

And the London market in particularly is rapidly becoming more competitive again for their staff based there. He believes that while an organisation should never adopt an impractical ratio which acts as a strait-jacket and has to be responsive to the market, for Kyndt the ratio "gives us a clear and transparent position on how we do that, which directly reflects our values and sits well with our charitable values".

Given that post the financial crash and scandals many organisations are now asserting the importance of and espousing a values-based business philosophy (see for example http://www.business2community.com/strategy/the-importance-of-company-values-0530401); and given that a pay strategy is a very tangible way in which an employer puts its 'money where its mouth is' and 'practices what it preaches', then Christian Aid's operation of and experiences with its pay ratio policy have potential appeal and application to many other types of UK employer.

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US CEO-to-Worker Pay Ratio Disclosure will change how much business leaders are paid

Brandon Rees

In 2014, CEOs of the S&P 500 Index companies received, on average, US $13.5 million in total compensation.[3] In other words, these CEOs received 373 times the average annual pay of rank-and-file workers in the US.[3] These high levels of CEO pay and stagnant worker wages are fuelling economic inequality in the United States.[5]

There are many reasons why US worker pay has not increased with economic growth in recent decades. These include the decline in trade union membership, fewer manufacturing jobs as a result of globalisation, the growth in part-time and contingent jobs, and the erosion of worker protections such as the minimum wage.[6]

It hasn't always been this way. After World War II until the 1970s, US worker wages increased in line with productivity growth.[7] CEO-to-worker pay disparities were modest during this period of broad-based economic prosperity.[8] The typical CEO of a large US company made just 42 times ordinary worker's pay in 1980.[9]

Since that time, CEO pay levels have increased dramatically. One major reason for CEO pay inflation is that boards of directors use a flawed process to set CEO pay targets. For the vast majority of public companies, the targeted dollar amount of CEO pay is set based on a peer group analysis of what other company CEOs have received.

While this process sounds like it is based on market forces, in reality it is a rigged game. Some companies have explicitly set their CEO's target pay at the 75th percentile. Others cherry-pick higher paid CEOs for their peer group analysis. This leads to an inevitable spiralling up of CEO pay because not every CEO can be above average.[10]

To fix this flawed system, boards of directors need to look beyond peer groups to also consider the reasonableness of CEO pay levels for their company. This means examining their own company's internal compensation structures and salary ladders, as well as evaluating the company's overall compensation philosophy.

To encourage this realignment, the Dodd-Frank Wall Street Reform and Consumer Protection Act requires public companies to disclose the ratio of their CEO's

[3] Executive Paywatch, AFL-CIO, http://www.paywatch.org. AFL-CIO analysis of company proxy statements available as of May 13, 2015 for 472 companies in the S&P 500.
[4] Current Employment Statistics Survey, U.S. Bureau of Labor Statistics, Average weekly earnings of production and nonsupervisory employees on private nonfarm payrolls (multiplied by 52).
[5] Alyssa Davis and Lawrence Mishel, "CEO Pay Continues to Rise as Typical Workers Are Paid Less," Economic Policy Institute, June 12, 2014. Available at http://www.epi.org/publication/ceo-pay-continues-to-rise/.
[6] Lawrence Mishel, "Causes of Wage Stagnation," Economic Policy Institute, January 6, 2015. Available at http://www.epi.org/publication/causes-of-wage-stagnation/.
[7] Lawrence Mishel et. al., "Wage Stagnation in Nine Charts," Economic Policy Institute, January 6, 2015. Available at http://www.epi.org/publication/charting-wage-stagnation/.
[8] Lawrence Mishel and Alyssa Davis, "Top CEOs Make 300 Times More than Typical Workers," Economic Policy Institute, June 21, 2015. Available at http://www.epi.org/publication/ceo-pay-continues-to-rise/.
[9] "Executive Pay: The Party Ain't Over Yet," BusinessWeek, April 25, 1993. Available at http://www.bloomberg.com/bw/stories/1993-04-25/executive-pay-the-party-aint-over-yet.

annual pay to that of their median employee.[11] When these new rules take effect, boards of directors and investors will be able to better evaluate pay disparities within companies.

Organisational performance suffers when CEOs are paid disproportionately more than other executives.[12] When the lion's share of pay goes to the CEO, employee turnover increases.[13] High CEO pay levels also undermine teamwork and collaboration.[14] These negative impacts of high CEO pay extend from the executive suite to the shop floor.[15]

Rank-and-file employees are keenly aware of their CEO's total compensation. Employee productivity, morale and loyalty suffer when workers see that the CEO is taking more while those same workers do more for less. In contrast, a reasonable pay ratio sends a positive message that the contributions of all employees are valued.

For these reasons, a company's internal pay ratio is an important financial metric for investors to monitor and evaluate.[16] Higher levels of employee pay may indicate that a company is investing in a high productivity workforce. Disclosure will permit investors to compare employee pay structures of companies over time and to their competitors.

The ideal ratio of CEO-to-worker pay remains to be determined. Different companies and industries necessarily will have different ratios. But once this information is disclosed, investors will be able to consider the impact of CEO pay levels on other employees when voting on "say-on-pay" votes and other executive pay matters.

Perhaps not surprisingly, CEOs have vigorously lobbied to delay and repeal this disclosure requirement.[17] In an effort to understate CEO-to-worker pay ratios, they also sought to exclude international and part-time employees. As a result, the US Securities and Exchange Commission (SEC) repeatedly delayed implementation of the final rule.

The SEC adopted its final pay ratio disclosure rule in August 2015.[18] Companies will start disclosing their pay ratios in 2018, eight years after passage of the Dodd-Frank Act in 2010. Regrettably, companies can exclude up to 5 percent of their employees from the calculation and only have to calculate median employee pay every three years. The SEC said the rule was one of the most controversial it had been required to undertake.

In contrast, the Indian Ministry of Corporate Affairs adopted a similar regulation for public companies in India just seven months after pay ratio disclosure was enacted into law as part of India's 2013 Companies Act.[19] India's pay ratio disclosure rule does not include any of the loopholes contained in the US regulation.

Once pay ratio disclosure goes into effect, investors will have for the first time the information needed to consider the reasonableness of CEO pay levels relative to other employees. Investors have been clamouring for this information as shown by more than 285,000 individuals who wrote the SEC in support of pay ratio disclosure.[20]

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[10] Charles Elson and Craig Ferrere, "Executive Superstars, Peer Groups and Overcompensation: Cause, Effect and Solution," Journal of Corporation Law, Spring 2013. Available at http://www.irrcinstitute.org/projects.php?project=60.
[11] Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).
[12] Lucian Bebchuk et. al., "The CEO Pay Slice," Journal of Financial Economics, Volume 102, Issue 1, October 2011.
[13] James Wade et. al., "Overpaid CEOs and Underpaid Managers: Fairness and Executive Compensation," Organization Science, Vol. 17, No. 5, September–October 2006. Matt Bloom and John Michel, "The Relationships Among Organizational Context, Pay Dispersion, and Managerial Turnover," Academy of Management Journal, (2002).
[14] Phyllis Siegel and Donald Hambrick, "Pay Disparities Within Top Management Groups: Evidence of Harmful Effects on Performance of High-Technology Firms," Organization Science, Vol. 16 (2005).
[15] Douglas Cowherd and David Levine, "Product Quality and Pay Equity Between Lower-Level Employees and Top Management," Administrative Science Quarterly, Vol. 37 (1992).
[16] James Cotton, "Toward Fairness in Compensation of Management and Labor: Compensation Ratios, A Proposal for Disclosure," Northern Illinois University Law Review, Volume 18, 1997.

[17] See e.g., Business Roundtable letter to the U.S. Securities and Exchange Commission, December 2, 2013, available at http://businessroundtable.org/sites/default/files/legacy/uploads/hearings-letters/downloads/12213_SEC_Pay_Ratio_Letter.pdf.
[18] U.S. Securities and Exchange Commission, Pay Ratio Disclosure, Release Nos. 33-9877, 34-75610, File No. S7-07-13, available at http://www.sec.gov/rules/final/2015/33-9877.pdf.
[19] India Ministry of Corporate Affairs, Companies (Appointment and Remuneration of Managerial Personnel) Rules,
[20] 2014, Chapter 13 (5), March 31, 2014. India Companies Act, 2013, Section 197 (12), August 29th, 2013.
[21] U.S. Securities and Exchange Commission, Comments on Pay Ratio Disclosure, Release Nos. 33-9452, 34-70443, File No. S7-07-13, https://www.sec.gov/comments/s7-07-13/s70713.shtml.

Linking success: do pay ratios help or hinder commercial performance?

Jane Burgess

In recent years, the question of income inequality has dominated the political narrative in the UK and the US. Hillary Clinton, in the early salvos of her campaign to become the next US President, spoke of the need to create an 'inclusive society' and an 'economy that works for every American', and, on both sides of the Atlantic, many point to pay ratios as a route to addressing income inequality in the workplace.

Research suggests that the gap between the lowest and highest paid in a community plays a key role in shaping satisfaction and happiness: the smaller the gap the more content people are in their lives. And beyond the moral view, there is a commercial debate regarding whether pay ratios help or hinder strong commercial performance.

For businesses, public and voluntary sector organisations, creating a diverse talent-pool with the best qualified people is core to their success. And this is particularly the case for senior management roles, where candidates with strong interpersonal skills and technical expertise are in high-demand and can often command high salaries. The extension of this rationale can often lead to escalating pay for specialist roles as organisations seek to attract and retain top talent.

The John Lewis Partnership has employed a pay ratio for over 50 years and, with its strong commercial focus, the business is no exception to this desire to attract the brightest and the best. The Partnership is also wholly owned by its employees (or as we call them, 'Partners'), and the pay ratio plays an important role in acting as a check and balance on remuneration across the organisation.

Since the business's pay ratio was formalised in the early 1950s the measure has changed significantly. It was first established as a 'maximum wage', defined as the lower of two calculations: 25 times the wage of a London selling assistant with four children, or the equivalent of £5,000 a year in 1900. Now, spurred in part by the need for simplicity, the Partnership's pay ratio sets out that the highest-paid Partner can earn no more than 75 times the average pay of non-management Partners.

By extension, this has an impact on pay rates across senior leadership positions. And whilst the pay ratio may narrow the pool of candidates at the senior level, it guarantees that those who join the Partnership share a stronger motivation than personal reward: they share the values of the business. In the Partnership's case, this goes beyond profit, to the creation of a successful business in which the 'worthwhile and satisfying employment' of its members is the principal aim.

By and large, this creates a culture wherein Partners in leadership positions are motivated by creating and shaping a business that thrives, not just for current Partners, but for Partners in the future.

The introduction of a pay ratio is by no means a 'silver bullet'. Setting the ratio isn't an exact science: it relies on discretion and judgment, and there are challenges to transposing a ratio across businesses and sectors. Similarly, there is no definitive view on the 'correct' measure and the pay ratio employed by the Partnership benefits from ongoing scrutiny. It is also important to recognise that changing the pay ratio is not in the gift of the executive alone: it has to have agreement of Partners, thereby providing an important counterbalance.

Creating a link between remuneration at different levels does not automatically lift rates at the bottom of the scale, but it does drive a continuing focus on pay across the business, creating a much better understanding of reward for all employees. In the Partnership's case, this means that we're placing a concerted focus on improving pay and productivity for those at the lower end of the income distribution.

The use of pay ratios does not in itself guarantee a more 'responsible' form of capitalism. But, in my experience, ratios can be an important part of promoting practices that focus on creating long-term value, visibility and transparency in pay. This supports fair reward for effort for all employees, and helps drive greater commercial success.

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