2 WHY CHAMPIONS OF FREE MARKETS SHOULD WORRY ABOUT EXECUTIVE PAY

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Concern about very high levels of executive pay is not commonly associated with proponents of unregulated markets. Many of the most prominent critics of top pay practices are animated by worries about income inequality. Free marketeers do not, in general, consider this to be such a problem in and of itself, preferring to focus solely on absolute poverty, rather than relative income differences. And many of the ways of reducing the pay gap between top executives and the wider workforce would involve the type of government intervention of which free market supporters tend to be suspicious.

Thus it has typically been socialists, social democrats and more paternalist conservatives who have generally led the condemnation of the growth in CEO pay packages that has occurred in recent years. In this chapter, however, I will argue that there are very good grounds for advocates of free markets to be worried by prevailing executive pay practices. The pay-setting process is riven with conflicts of interest, poor accountability and lax governance, ultimately leading to something of a stitch-up that enables those in powerful positions to capture sums of money that might otherwise be invested more productively.

In short, executive pay is more akin to the 'rent seeking' that free market purists condemn than to the productive enterprise they aim to foster. Many of the measures which might potentially put an end to this institutional stitch-up would involve making the 'market' for senior executives freer, more open and more efficient.

Rapid increases in pay for no reason

Public anger at executive pay levels is based around two perceptions. Firstly, that executive pay has increased at a far greater rate than the pay of ordinary workers in recent decades. Secondly, that these executive pay increases have occurred without any corresponding improvement in company performance.

Though often snobbishly dismissed as populist prejudice, these perceptions are in fact largely accurate. Over the past twenty years, the pay of the average FTSE-100 CEO has gone from around 60 times that of their average employee to nearly 150 times in 2017 (Table 1). Compared to the average worker across the UK economy as a whole, CEO pay has risen from about 70 times to nearly 200 times.

Research from the CFA Institute and Lancaster University also found that, while pay for the median FTSE-350 CEO increased by 82 per cent between 2003 and 2014, the median FTSE-350 company generated less than 1 per cent return on invested capital per year. The study concluded that (CFA Society UK 2017: 2):

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Table 1 FTSE-100 CEO to worker pay ratios

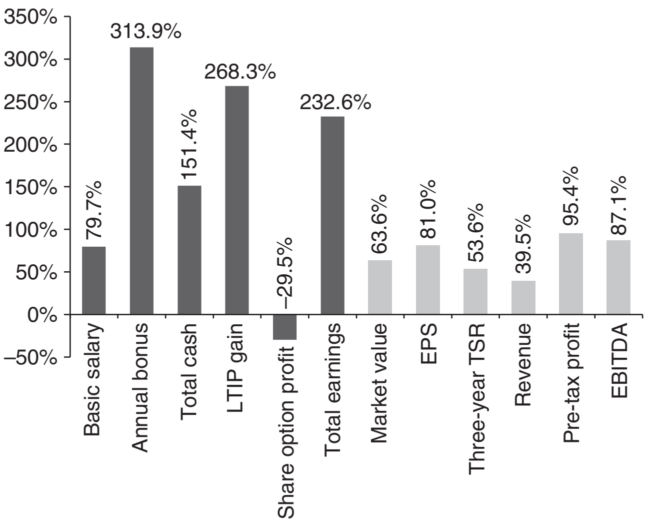
Year	*CEO pay (£m)*	*CEO/employee pay ratio*[a]	*Median UK full-time worker pay (£)*
2017	5.66	146	28,758
2016	4.58	128	28,195
2015	5.47	129	27,615
2014	4.36	125	27,215
2013	4.71	137	27,011
2012	4.57	125	26,472
2011	4.43	124	26,095/26,244
2010	4.73	138	25,882
2009	4.22	130	25,806
2008	3.96	128	25,165
2007	3.89	151	24,043
2006	3.31	107	23, 367/23, 554
2005	3.3	121	22,888
2004	3.09	119	22,011/22,056
2003	2.79	112	21,124
2002	2.6	107	20,376
2001	1.81	75	19,722
2000	1.69	70	18,848
1999	1.23	59	17,803

Sources: High Pay Centre (2015c: 48); High Pay Centre and Chartered Institute of Personnel and Development (2018: 14); Manifest/MM&K (2012: 78); and Office for National Statistics (2017).

[a]Annual change in pay ratios can be affected by changes to the composition of the FTSE-100. For example, the addition of G4S – with a very large number of low-paid employees – in 2007 caused a significant increase in 2007.

Despite relentless pressure from regulators and governance reformers over the last two decades to ensure closer alignment between executive pay and performance, evidence of more granular distinction between pay outcomes and fundamental value creation remains negligible.

Figure 1 Percentage change in median remuneration of FTSE-350 companies and selected corporate indicators 2000–2013



Source: High Pay Centre (2015a: 32).

Similarly, a study by Incomes Data Services, commissioned by the High Pay Centre (2015a), also found that increases to each of the different components of typical executive pay awards had greatly outpaced the increases

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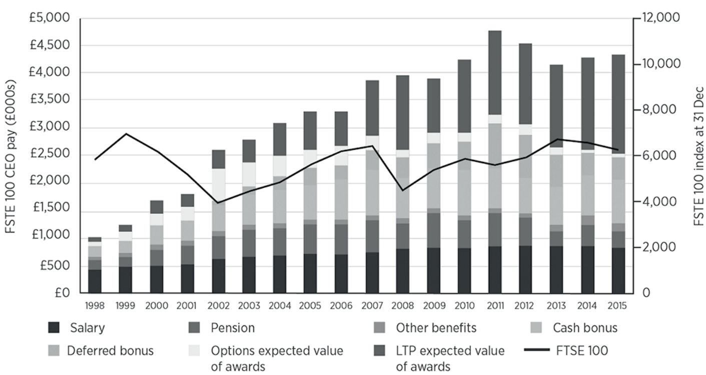
in company performance, as measured according to the performance metrics used in most executive pay packages (Figure 1).

These independent findings are also endorsed by industry and government analyses. For example, a working group convened by the Investment Association, the trade body for the asset management industry, concluded that 'rising levels of executive pay over the last 15 years have not been in line with the performance of the FTSE over the same period' (Investment Association 2016: 17).

Figure 2 FTSE-100 CEO pay and company value



Source: Minerva Analytics (formerly Manifest) Total Renumeration Survey via Department for Business, Energy and Industrial Strategy (2016: 17).

This argument is borne out by Figure 2, taken from the Department of Business, Energy and Industrial Strategy's (2016) Corporate Governance Reform Green Paper. These BEIS figures show the extent to which growth of FTSE-100 CEO pay has outpaced growth of the FTSE-100 index.

'pay' added - OK?

The data show that the increasing use of Long-Term Incentive Plans (LTIPs) in particular drove the increase in CEO pay over recent years. LTIPs usually take the form of share awards that pay out varying amounts depending on the company's performance over the coming three- or five-year period.

As Figure 2 suggests, the growth in size and prevalence of LTIPs has done little to raise the value of UK companies. Corporate governance experts have suggested their near-universal use cannot be justified. The UK Investment Association (2016: 12) working group called for more variation in executive pay structures:

> The Working Group's core recommendation is that the market needs to move away from a one-size-fits-all approach to a system where companies have more flexibility to choose the remuneration structure which is most appropriate for their business.

However, since the publication of their report, most companies continue to cling to the LTIP model. The High Pay Centre's research found that in 2017 (the most recent year for which data are available) 82 per cent of FTSE-100 firms paid an LTIP, the same number as in 2016 (High Pay Centre and Chartered Institute of Personnel and Development 2018: 9). The fact that LTIPs pay out for almost every CEO almost every year is particularly indicative of a problem, given that they are supposed to be a performance-related award, used to incentivise exceptional leadership.

The continuing use of LTIPs contributed to an increase in average pay for a FTSE-100 CEO of 24 per cent on the previous year in 2017, while the median pay rose by 11 per cent (ibid.: 14). When increases like these – for the price of a product or service – are sustained for as long as the growth in CEO pay has endured, sensible observers ought to be suspicious.

The myth of the global market and the overstated importance of CEOs

The arguments used to justify these pay increases usually focus on the importance of the decisions taken by CEOs to the performance of companies, and the (positive and negative) effect of these decisions on company value. This can dwarf the amounts paid to CEOs. Companies are supposedly paying the minimum rate necessary in a global market place to attract and retain the people who will take the best decisions

However, evidence for the existence of this 'global market' is limited. A High Pay Centre (2013) study found that fewer than 1 per cent of the world's largest companies had poached their CEO from an international rival. CEO pay is notoriously high in the US, yet it is rare for a UK business leader to be recruited by a US company.

The risk of losing supposedly rare talent by reducing executive pay is much lower than often suggested: 80 per cent of companies in our study had promoted their lead executive from within. Far from needing to pay significant sums of money to convince an external candidate to 'jump ship', most CEO appointments involve companies taking a chance on a more junior executive and offering them a significant increase in terms of profile, status and responsibility.

Whether ambitious candidates also require vast pay incentives for promotions to more senior roles is questionable. In addition, the preference for internal appointments suggests that familiarity with the particular leadership team, culture, strategy, markets and stakeholders of a company is a key, non-transferable attribute for a CEO. It also implies that the need to use pay increases to retain the services of good executives is overstated – if a company does find themselves in that position, it reflects poorly on the quality of their own training and development programmes.

Furthermore, even if it were the case that reducing pay for UK CEOs would result in losing them to international rivals, it is debatable whether this would have much impact on company performance.

Quite apart from the fact that the evidence highlighted in Figure 2 suggests that UK CEOs *haven't* been taking decisions that have greatly increased the value of their companies, the notion that they are the key determinants of company success is hotly contested.

And, as the prominent business leader Philip Hampton notes, the impact of executives at more complex businesses with larger market capitalisation, more internationalised operations and larger workforces may actually be less pronounced than at smaller companies (High Pay Centre 2015a: 10):

> The bigger the system, the more the system counts rather than the person at the top of it. … Sometimes you just get lucky. Perhaps you joined an industry at the right time, maybe you were promoted at the right time, and then the circumstances of your industry suddenly become favourable. Even if you are a half-wit, you are going to do quite well in this situation. So many financial incentives rely on luck, the evolution of markets, rather than on people's contribution.

In other words, the executives of larger companies are only able to personally oversee a much smaller proportion of the business's workings and thus are more dependent on those to whom they delegate. Therefore, it is hard to argue that the business would struggle to cope without them. In fact, the demand for and importance of executives has been greatly exaggerated in order to justify vast pay inflation.

This is particularly true in the case of long-established businesses – most of the publicly listed companies in the UK whose pay is the source of most controversy in this country have histories stretching back many decades and are led by managers and bureaucrats who have worked their way up through the firm and inherited oversight of its existing infrastructures, rather than built them up themselves. They are not entrepreneurs on whom the companies' existences are dependent.

Indeed, free market advocates should be particularly concerned by the extent to which these companies have historically enjoyed and continue to enjoy support from the UK state. The nexus between government and industry is a critical engine of the dominant sectors in the UK listed market. For example, UK mining and oil and gas companies' extensive global operations have been established with significant support from the UK government, and, even in recent years, stories abound relating to UK lobbying of African and South American governments regarding legal issues and exploration permits facing companies including BP, Shell and Rio Tinto.[1]

Similarly, UK defence and manufacturing firms operate almost in partnership with the UK state. The former Foreign Secretary Robin Cook noted that the Chairman of BAE Systems 'appeared to have the key to the garden door to number 10 (Downing Street)' during his tenure.[2] BAE famously benefited from UK government pressure on the Serious Fraud Office to drop an investigation into alleged bribes paid by Saudi Arabia, while more recently it was revealed that they had seconded staff to the Ministry of Defence and a UK government body promoting defence exports.[3] Recent corruption allegations against BAE's competitor Rolls-Royce have also brought into the spotlight

1 Tory ministers lobbied Brazil on behalf of Shell and BP, Government accidentally reveals, *The Independent*, 20 November 2017 (https://www.independent.co.uk/news/uk/politics/tory-ministers-liam-fox-greg-hands-international-trade-lobbied-brazil-bp-shell-oil-environment-a8066236.html); Documents reveal extent of Shell and Rio Tinto lobbying in human rights case, *The Guardian*, 6 April 2014 (https://www.theguardian.com/business/2014/apr/06/shell-rio-tinto-human-rights-nigeria-kiobel).

2 Why is government is so close to BAE Systems, Open Democracy, 24 April 2016 (https://www.opendemocracy.net/uk/andrew-smith/why-is-government-so-close-to-bae-systems).

3 Ibid.

financial support for the company from the government agency the Export Credit Guarantee Department for deals worth $400 million.[4]

Other instances of so-called crony capitalism include pharmaceuticals companies selling drugs developed from publicly funded research or housebuilders' sales rocketing following the introduction of government subsidies for homebuyers in 2013, enabling Persimmon Chief Executive Jeff Fairburn to bank over £100 million from an incentive payment linked to the company's share price.[5] Bail-outs for banks and the support that implicit guarantees of bail-outs provide for their stock market value are a further well-known example.

All told, there is scarcely a major UK company that doesn't significantly benefit in some way from government lobbying, subsidies, public research funding or underwritten guarantees. That is not to say each individual example of state support for private companies is (necessarily) a bad thing. However, it does suggest that paying UK executives as if they were genuine wealth creators and risk takers who had started their companies from scratch, as opposed to bureaucrats operating at the nexus of corporations and the state, is inappropriate.

4 Rolls-Royce faces fresh bribery case, *The Times*, 7 February 2017 (https://www.thetimes.co.uk/article/old-deals-land-rolls-royce-in-hot-water-2bslft95d).

5 NHS pays pharmaceutical companies millions for drugs developed with taxpayers' money, *The Independent*, 22 October 2017; *The Times*, Taxpayers help to buy £100m bonus for Persimmon boss Jeff Fairburn, 27 November 2017 (https://www.thetimes.co.uk/article/taxpayers-help-to-buy-100m-bonus-for-persimmon-boss-jefffairburn-s55xmz3v8).

So what are the market failures that have allowed this to happen?

The ultimate providers of capital want action on pay

Under the UK's shareholder-policed corporate governance system, the company boards and remuneration committees which set pay are supposed to be accountable to shareholders. These shareholders are expected to exercise effective stewardship, ensuring that governance standards and management practices, including pay, are sufficient to deliver good outcomes.

The money for investment in company shares very often ultimately comes from ordinary people with a pension or savings plan. But, in practice, shareholdings are usually managed by asset managers acting on behalf of individual and institutional investors, who engage with investee companies and vote at their annual general meeting.

The complicated array of intermediaries separating companies, as the ultimate recipient of investment, from the individuals who provide the capital and are the intended beneficiaries of any return, can also include, for example, financial advisers, institutional investment consultants and the different governance, trading and portfolio managers within the asset management firms. This means that the beneficiaries have little influence over the behaviour of the investee companies, which in turn has profound consequences in terms of executive pay.

There can be little doubt that ordinary pension savers would like to see the intermediaries managing their money do more to address excessive top pay in their investee companies. Public opinion surveys consistently show the scale of public disapproval of very high executive pay packages. In recent years polls have shown that two-thirds of the public think it inappropriate for CEOs to be paid over £1 million (just 7 per cent took the opposing view in 2012).[6] Similarly, in 2015, 80 per cent of survey respondents felt that gaps between high earners and those on low and middle incomes are too high and should be reduced.[7] More recently, 57 per cent supported (versus 30 per cent who opposed) Jeremy Corbyn's plan to cap executive pay at twenty times the level of the lowest-paid worker.[8]

The merits of capping pay and reducing intra-company pay differences are usually debated in relation to their economic and social impact. However, executive pay also relates on principle to issues of governance, accountability and even morality. The rights associated with share ownership ought to be asserted in accordance with the wishes and values of the ultimate providers of capital – very often,

6 Public 'want top pay reined in', BBC News, 29 January 2012 (https://www.bbc.co.uk/news/uk-16778264).

7 Briefing 46: Most people think that differences in pay between high and low earners are unfair, Inequality Briefing, 3 October 2014 (http://inequalitybriefing.org/brief/briefing-46-most-people-think-that-differences-in-pay-between-high-and-low).

8 Majority of public support Jeremy Corbyn's plans to cap bosses' salaries, poll suggests, *The Independent*, 14 January 2017 (https://www.independent.co.uk/news/uk/politics/majority-of-public-support-jeremy-corbyn-s-plans-to-cap-bosses-salaries-poll-finds-a7527381.html).

working people with pension plans, insurance policies or savings accounts. There is a very high likelihood that these people share the views of the majority of the cited survey respondents.

However, weak accountability between the different links in the investment chain prevents the providers of capital from exercising due influence over the recipients, including over practices such as executive pay.

Investment beneficiaries lack capacity to influence pay

It is not enough to suggest that because those members of the public that are in some way invested in companies are not beating down the door of their financial adviser or pension fund trustee to do more to challenge executive pay practices, they therefore must find the status quo acceptable. Levels of financial literacy are such that it is likely that all but the most engaged savers (with the most time on their hands) have very little idea how and why their savings are linked to levels of executive pay.

This is borne out by research for the NEST pension provider, finding that many pension savers struggled to understand and explain fairly basic financial concepts such as a 'stock', a 'bond' or an 'interest rate' leading them to conclude that 'a lot of people across all levels of education and achievement don't understand what investment is or how it works' (NEST Corporation 2017: 12).

It is unrealistic to expect these people collectively to assert their share ownership rights in relation to executive pay. This is the crux of the top pay problem, from a free market perspective. In theory, one would expect the investors in a company to retain cost discipline in relation to top pay, and to ensure that the company's wider pay practices are fair and proportionate.

However, most savers lack the understanding or the information to engage with their asset manager (or with the relevant intermediary, such as a pension fund) to create pressure on them to exercise proper stewardship over investee companies in relation to pay (and potentially other issues as well).

Institutional asset owners lack the expertise or engagement to influence asset managers

This market failure could be mitigated if the institutional investors, principally the pension funds through which pension savings are managed, took more of an interest in their asset managers' stewardship on their members' behalf.

However, this is not currently the case. The Financial Conduct Authority (FCA) identifies over 44,000 pension schemes in the UK, but few have signed the Financial Reporting Council's Stewardship Code, committing them to holding their asset managers to account over their stewardship practices. The Code sets out a series of principles on which signatories can state their policy, including monitoring of and engaging with investee companies, and reporting on stewardship practices. For asset managers, this covers their direct engagement with companies. For asset owners – such as pension funds – it involves setting out expectations in this respect of asset managers.

That so few pension funds have signed up to the code suggests that they are not interested in using the influence they have over the companies in which they are invested, regardless of the views of their members.

The fragmented nature of UK pension funds has also had an important impact on their ability to influence their asset managers. The FCA's Asset Management Market study notes that the large number of smaller schemes reduces the capacity of scheme governance in two ways (Financial Conduct Authority 2016: 70):

- *investment expertise and resources to spend helping them make investment decisions* – a larger number of schemes means a larger number of governance roles to fill, and fewer resources for each scheme with which to attract appropriately skilled individuals.
- *greater bargaining power and ability to benefit from economies of scale* – larger investors that form a larger part of the asset manager's client base are better positioned to influence its activities.

The FCA relates the lack of scale to pension funds' inability to secure better value from asset management costs. However, the same problems – a lack of governance body members with the time and expertise to scrutinise their managers and insufficient investment funds to influence them – also bedevil pension funds' efforts to shape stewardship practices on issues such as executive pay.

Pension funds account for around 44 per cent of the £6.9 trillion worth of assets under management by members of the UK Investment Association (Investment Association 2017). Therefore, they would represent a significant bloc exerting downward pressure on pay – as shareholders and bondholders – if lines of accountability were operating effectively.

Asset managers and remuneration committees are biased and conflicted on pay

Without pressure from their individual clients or from their institutional investors, the asset managers who engage directly with companies and decide how to vote on pay resolutions at AGMs are at best too apathetic and at worst too conflicted to act over top pay of their own accord.

There is evidence to support this hypothesis in numerous studies. The Kay Review (2012: 10) of UK equity markets and long-term decision-making noted the shorter and shorter periods over which shares in companies are traded, making engagement between investment managers and investee companies much less common.

The UK's share ownership market is also increasingly fragmented, meaning that shareholdings are much smaller and more geographically widespread. Just 16 per cent of UK shares were held by overseas investors in 1994, but 54 per cent in the most recent figures.[9] The fragmenta-

9 Ownership of UK quoted shares: 2016, Office for National Statistics, 29 November 2017 (https://www.ons.gov.uk/economy/investmentspensionsandtrusts/bulletins/ownershipofukquotedshares/2016).

tion makes it harder for those investors that want to assert their stewardship rights to do so with enough weight to influence the company.

Kay also questioned whether the interposition of intermediaries, with their own business objectives, which are not necessarily aligned with companies and beneficiaries (the people who are providing the money for investment), might conflict with the underlying interest of the companies and their beneficiaries (Kay Review 2012: 41).

By the same logic, the personal objectives and biases of the individuals working as investment intermediaries are also potentially distortive of the concerns and interests of their beneficiaries, particularly in relation to executive pay. As Kay notes, pay for investment intermediaries is very high. Surveys have put the pay for a typical portfolio manager – who oversees an asset manager's individual investments – at over £200,000.[10] Other research suggests that average pay at some asset management firms has passed the £1 million mark.[11] Asset managers' pay is subject to many of the same criticisms as executive remuneration.

Despite their generous pay packages (paid for from the costs ultimately accruing to ordinary savers) the majority of investment managers usually fail to 'beat the market'. A study by S&P recently concluded that 86 per cent of 'actively managed' funds failed to achieve better returns than the

10 Best and worst paying jobs in finance, Emolument blog (https://www.emolument.com/career_advice/best_and_worst_paying_jobs_finance).

11 Has fund manager pay gone too far? *Portfolio Adviser*, 18 June 2018 (https://portfolio-adviser.com/has-fund-manager-pay-gone-too-far/).

FTSE All-Share index in 2016.[12] Over the previous decade, 74 per cent underperformed the market.

Similarly, asset managers are themselves major companies with very highly paid executives. Any move that the asset managers make, as investors, to exert discipline or downward pressure on executive pay is likely to have negative ramifications for the pay of their own executive team.

It is not excessively suspicious to think that the explicit self-interest, as well as the unconscious biases, of asset managers who benefit from a culture of high pay means that their approach to this issue in investee companies does not represent a functional, transparent, efficient market in action. If people working for asset managers justify their own very generous pay packages on the basis of their unique skillset, the value they generate and the need to attract, retain and incentivise key staff, it is highly likely that they would be sympathetic to similar claims made in relation to company executives, however dubious these claims may be, and however they may contravene the views and expectation of their clients.

With the intermediaries in the investment chain unwilling and/or incapable of holding companies to account over their pay practices, the pay-setting process is dependent on the remuneration committee to deliver appropriate outcomes. Unfortunately, such committees are typically riddled with similar biases and conflicts of interest to those of the asset managers that hold them to account.

12 Nine in ten popular Isa funds fail to beat the stock market, *Daily Telegraph*, 26 October 2016 (https://www.telegraph.co.uk/investing/funds/90pc-of-popular-isa-funds-fail-to-beat-the-market/).

Like the asset management industry professionals, the business leaders and financiers who populate remuneration committees benefit from a culture of very high top pay. Research from the Trades Union Congress (2015) found that over a third of FTSE-100 companies have executive directors from other companies sitting on their remuneration committee, while 246 out of 383 FTSE-100 remuneration committee members held additional board positions at other companies. Average pay for a remuneration committee member (from all their various positions) was £441,000 (about sixteen times the national average).

This implies that those setting executive pay are personally incentivised to maintain a high market rate for executive roles and are instinctively sympathetic to arguments that also justify their own high pay packages. The fact that executive pay has continued to climb with no obvious justification, the very rare instances in which remuneration committees exercise discretion to revise pay downwards, and the continuing and near universal use of LTIPs as part of CEO pay structures despite extensive expert criticism all suggest that remuneration committees are insufficiently sceptical of prevailing executive pay levels and structures. There are good grounds for thinking that overt self-interest and unconscious bias are at least part of the reason for this.

It is in this aspect of the executive pay-setting process that the charge of rent-seeking most readily applies. Remuneration committees are appointed by and accountable to serving or former executives and other leading professionals from similar backgrounds in major businesses or finance and investment firms. Executives as a group are able to extract disproportionate pay awards from company funds through their dominance of this process, rather than through their productive contribution and enterprise.

Remuneration committees are also typically advised by consultants, who provide market information on the levels and structures of CEO pay, and help to design pay policies. Again, though, this process is blighted by conflicts of interest. It is in the interest of consultants to devise ever more complex pay structures in order to justify their own existence. There is much less work involved (and therefore less need for consultants) in developing a pay package consisting of a basic salary and perhaps some form of share award or profit-sharing arrangement than for a policy involving multiple different incentive plans covering different time periods and 10–12 performance metrics.

The ultimate result of this growing complexity – bolting additional components onto CEO pay awards, with increases in the value of performance-related components to compensate for the fact that executives are likely to apply a discount rate to conditional payments made over a period of years – has been the increases in executive pay discussed in the opening section of this chapter. Any benefits to businesses, their stakeholders or the wider economy are harder to discern.

Why does this matter and what should be done?

I have argued that executive pay has increased without any justification. The ultimate providers of capital – those who own shareholdings in companies and to whom the companies' leadership should be accountable – lack the understanding, information and resources to engage with where their money is invested. Those entrusted with managing their investment are compromised by biases and conflicts of interest. This has resulted in a situation where executive pay is unnecessarily, disproportionately and undeservedly high.

But why should this be important for free market advocates? There are three key reasons. First, the unsatisfactory outcomes resulting from the executive pay-setting process and their high profile will help to create a perception that free markets deliver unsatisfactory outcomes more generally. This is likely to result in anti–free market policies in other policy areas. Second, though headline executive pay awards represent sums of money that are often immaterial to major companies, this does not tell the full story of the costs of rising top pay. The trend of higher CEO pay, with bigger bonuses and more generous share awards made through LTIPs, has probably been reflected in the pay packages for other senior managers across companies.

Since the late 1970s, the share of incomes taken by top earners in the UK has increased from around 6 per cent to about 14 per cent according to the most recent figures.[13] The share going to the top 0.1 per cent has risen from 3 per cent in 1990 to 6 per cent.

A similar increase within companies would represent a substantial shift in spending that could otherwise be

13 World Inequality Database, 2014 (https://wid.world/).

used for pay across the wider workforce, for investment in research and innovation or as returns to shareholders. The opportunity costs of rising executive pay have perhaps not been sufficiently discussed or analysed.

Finally, free market advocates should be concerned about CEO pay as a 'canary in the coal mine.' The sensible and sustainable management of UK companies depends on responsible stewardship by investment managers and rigorous accountability between the different intermediaries that form the investment chain.

Executive pay inflation highlights the inadequacies of current stewardship practices and levels of accountability. It raises concerns that negligent and/or self-serving boards and shareholders are not properly holding their companies' management to account – and potentially on other issues as well as pay. This has worrying implications for the productivity and sustainability of the UK's biggest companies and the wider UK economy.

So what is to be done? The High Pay Centre has historically advocated worker representation on boards and remuneration committees as a means of introducing a more challenging, less conflicted perspective into the pay-setting and oversight process. Free market proponents have traditionally been sceptical of stakeholder voices in corporate governance structures, arguing that it could subvert market forces, by making companies accountable to a separate vested interest, as opposed to their customers, or the shareholders who have 'skin in the game' through their investments. There are occasions when it could be in the company's long-term interests to take decisions that would be painful for the workforce, such as making redundancies or reducing expenditure on training and development, and worker directors may make tough but necessary decisions more difficult.

However, worker directors would not have a controlling say, so ought not to be able to prevent such decisions when they are justified by a business case. Furthermore, as we have seen, shareholder oversight of corporate governance is also very often shaped by the vested interests of investment intermediaries. Company workers' interests are closely aligned with the long-term success of the company in that their jobs depend on it.

It should perhaps also be noted that while stakeholder-oriented governance structures with worker participation, as commonly found in continental Europe, are not associated with free markets, there is no reason in principle why they are inconsistent with the low-tax, low-regulation economy that is the long-standing objective of most free market proponents. Indeed, changes to the governance framework under which businesses operate that bring about more equal market-based outcomes are likely to lead to a reduction in taxation and in the regulatory interventions that are traditionally anathema to free marketeers.

Greater transparency is a further measure that could bring about changes in respect of high pay via market mechanisms – the government has recently required companies to publish the pay ratio between their CEO and their median UK employee. More detailed disclosures on pay distribution – showing, for example the amount spent on the pay of the top 1 per cent of earners within the company

– might encourage investors to recognise the opportunity cost of high pay, and exert better stewardship and more effective downward pressure.

Finally, the stewardship process could be made more accountable and democratic by requiring institutional investors to offer some form of voting on company AGM resolutions to their ultimate beneficiaries. The disengagement of savers and low levels of understanding of investment processes mean that this would not be instantly transformative. But it would remind investors of their duties to their underlying clients, and could also engender efforts to better engage consumers with their savings and investment.

These measures are all potential constraints on the unjustifiable executive pay increases that have become too common across UK companies, and are consistent with a pragmatic free market approach to governance and stewardship. The diversion of company resources from already generous executive pay packages to more productive investment would represent the positive economic outcome that free market proponents desire.

By enacting them, the government could ensure that an economic system based largely on free market principles maintains popular support at a time when it is being seriously questioned for the first time in a generation.