



Mythbusters

from nef and the Tax Justice Network

“Huge executive salaries are vital to UK competitiveness”

Luke Hildyard

We're encouraged to believe that company executives are talented wealth creators, worthy of extreme pay packages which supposedly drive them to work hard to the benefit of society. In this Mythbuster, Luke Hildyard of the High Pay Centre exposes the truth behind the myth, and explains the benefits of reining in high pay.

The myth

Between 1998 and 2011, the pay of the average FTSE 100 Chief Executive rose around £1 million to £4.8 million.¹ At the same time, average pay for a full time worker in the UK has risen from around £22,000 in 1998 to £26,000 in 2011.²

So CEO pay has increased by about 500% in little more than a decade, while pay for ordinary workers gone up by 20%. The pay ratio between the average FTSE 100 CEO and the average UK worker has risen from 45:1 in 1998 to 185:1 at the latest estimate. This has not gone unnoticed. There has been substantial media coverage relating to the issue of executive pay particularly in the wake of individual pay-outs considered to be exceptionally egregious, such as those awarded to disgraced bankers at Barclays and RBS. However, this has often been depicted as misplaced populist outrage, despite the fact that executive pay growth is reflective of significant wider trends.

The share of the national income controlled by the richest 0.1% of households has risen from 1% in 1978 up to 5% in 2009.³ The top 1% took a 14% share of income, up from 6% in 1978.⁴ Research from the TUC estimates that the average worker would be £7,000 a year better off, if incomes were distributed as equally as they were in 1979.⁵ It is hardly surprising, then, that a widespread public perception has taken hold that a tiny wealthy elite have rigged the economy in their own favour, enabling them to secure enormous pay packages vastly disproportionate to their efforts or their talents, and that this situation is completely unfair.

Polling for the High Pay Commission shows that 73% of people now think differences in income in Britain are too large (8% disagree), and 57% think it is the responsibility of government to reduce the differences between high and low incomes (20% disagree).

The Government response

The Government response to the executive pay debate has been weak. David Cameron has claimed that "some people are worth £2 million because they've added masses of jobs, masses of investment, masses of growth... it's the excessive growth in payment unrelated to success that's frankly ripping off the shareholder and the customer and is crony capitalism and is wrong."⁶

His comments clearly reflect a view that high pay and rampant inequality per se are not a problem; they fail to examine whether individual company leaders are solely responsible for all the jobs, investment and growth created by their organisation; and they suggest that shareholders are the critical constituency in the executive pay debate.

This is reflected in Government policy. New 'say on pay' regulations empower shareholders to veto company pay policy, but it is doubtful whether they will use these new powers.

The average length of shareholding in the UK is now just seven months, while foreign investors account for nearly half UK shareholdings.⁷ Short-term traders who buy and sell company shares on a regular basis, and international investors with a portfolio of investments all over the world have little attachment to the companies in which they invest, or the communities where they operate. Therefore, they are unlikely to engage with remuneration policy or care what executives are paid. Under the advisory shareholder vote that currently exists, only the most extreme pay awards have failed to win a majority of shareholder votes.

Further proposals to address excess pay, such as the publication of the pay ratio between the company's highest and lowest paid employees, or worker representation on the remuneration committees that set executive pay, have been dismissed in the face of intense corporate lobbying.

A number of arguments have been emphasised repeatedly to justify the lack of action:

- the risk of driving talented executives overseas;
- the unique talent of top executives;
- the importance of ensuring that executives' interests are aligned with shareholders;
- and the right of companies to operate free from Government interference.

However, each of these claims has become increasingly undermined by the evidence base.

The Reality

The global marketplace for executives does not exist

"In a global marketplace, UK-based firms need to pay a competitive rate in order to retain internationally mobile staff – or equally crucially attract new, talented individuals."⁸

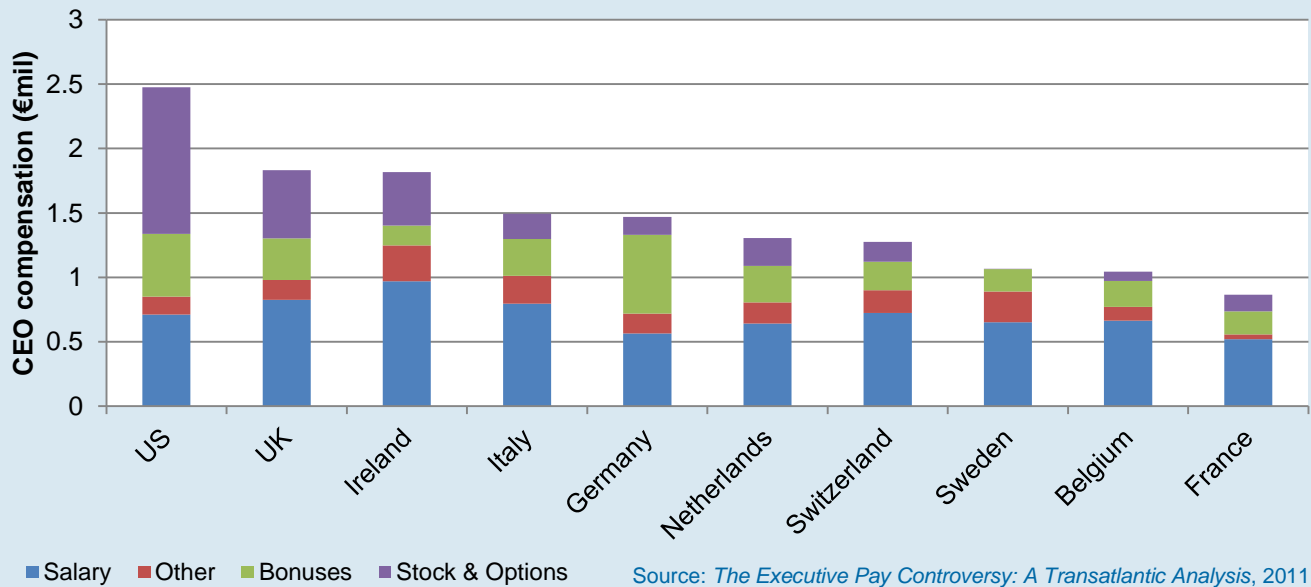
– Mark Boleat, City of London Corporation

The supposed risk of driving talented executives overseas is perhaps the most commonly cited reason to do nothing about the massive increase in executive pay. The idea is that the dynamism of the UK economy depends on a small pool of footloose talent, who could easily go and work anywhere else in the world, if they had the opportunity to earn more in other countries. This argument does not stand up to scrutiny.

Firstly, it is generally accepted that UK executives receive higher pay than their counterparts in most other countries. A study for Cornell University in 2011 comparing companies with €1 billion in revenue found that UK CEOs were the second-highest paid out of 10 advanced economies, behind only the United States (see Figure 1).⁹

So UK executives already receive very generous levels of pay, and any reduction would only bring them closer to parity with most international comparators.

Figure 1. CEO pay in advanced economies



Secondly, even if this were not the case, research from the High Pay Centre shows that most major corporations prefer to promote from within, rather than recruiting internationally. The ‘global marketplace’ referred to by Mark Boleat simply doesn’t exist.

Of the ‘Fortune 500’ list of the world’s biggest companies, only 4 out of 489 CEOs were ‘poached’ while CEO of another company in a foreign country (see Figure 2).¹⁰ Just one was recruited while working as CEO on another continent.¹¹ Over 80% of CEOs at these companies were internal promotions.¹²

This stands to reason. Major corporations have their own distinct identities deriving from very particular brands, products, markets, challenges, key personalities and relationships with governments, suppliers, competitors and civil society. It represents a significant gamble to transplant a new executive unfamiliar with the corporate culture, into the leading role at the company.

Executives are not uniquely talented, nor are they irreplaceable

‘When you get to these very senior levels, the pool of people who can do these jobs is quite small’¹³

– Margaret Doyle, Reuters

One of the most patronising aspects of the ‘global market’ myth is the implication that superstar executives are the only people capable of doing their jobs, and that our leading companies would fall apart without them. The UK’s prosperity supposedly depends on this select pool of people, and they need to be incentivised and rewarded. The myth of the superstar CEO is perhaps a reflection of a celebrity culture, and results from the profile that leading executives now enjoy. The internet and rolling 24 hour news channels mean that media coverage of major companies is greater than ever. At the same time, companies have become synonymous with key individuals, for example Bill Gates (Microsoft); Steve Jobs (Apple); or Richard Branson (Virgin). A visit to any bookshop demonstrates the extent to which the cult of the CEO has taken hold – there is an entire cottage industry dedicated to biographies and autobiographies of these and other business leaders.

Gates, Jobs and Branson are all entrepreneurs who founded their own companies from scratch, while most leading executives are managers/bureaucrats appointed to well-established organisations. However the characterisation of the superstar CEO pays little heed to this important distinction.

Political discourse around the executive pay debate and related policy areas, such as taxation and inequality, applies terms such as ‘wealth creators’ to entrepreneurs and bureaucrats alike. This kind of language implies that the economy is dependent on a small pool of god-like executives who bestow prosperity on the rest of us. It gives legitimacy to pay demands of company executives that would otherwise seem outrageous. But it is based on very little evidence.

Research from the University of Delaware drawing together numerous academic studies comparing the performance of CEOs promoted internally versus those recruited from competitors shows that the internal hires performed significantly better than the external recruits.¹⁴ The findings suggest that it is not innate leadership qualities that make for a successful CEO, but a good understanding of the company, its culture and its strength and weaknesses. This results from nurture and experience, rather than inherent talent. It is also important to note that a leader is only as strong as their followers – it is much easier to predict how successfully an

existing colleague will work with key staff than a new recruit transplanted from an external organisation.

Furthermore, it is a very narrow, subjective view of businesses to suggest that they are shaped solely by the skills and wisdom of a handful of executives, directing success from the top down. At a major corporation with hundreds of thousands of employees and operations on multiple continents, it is simply impossible for success to result from one or two individuals. Instead, wealth is created collectively by the efforts of an engaged and motivated workforce, from the bottom upwards.

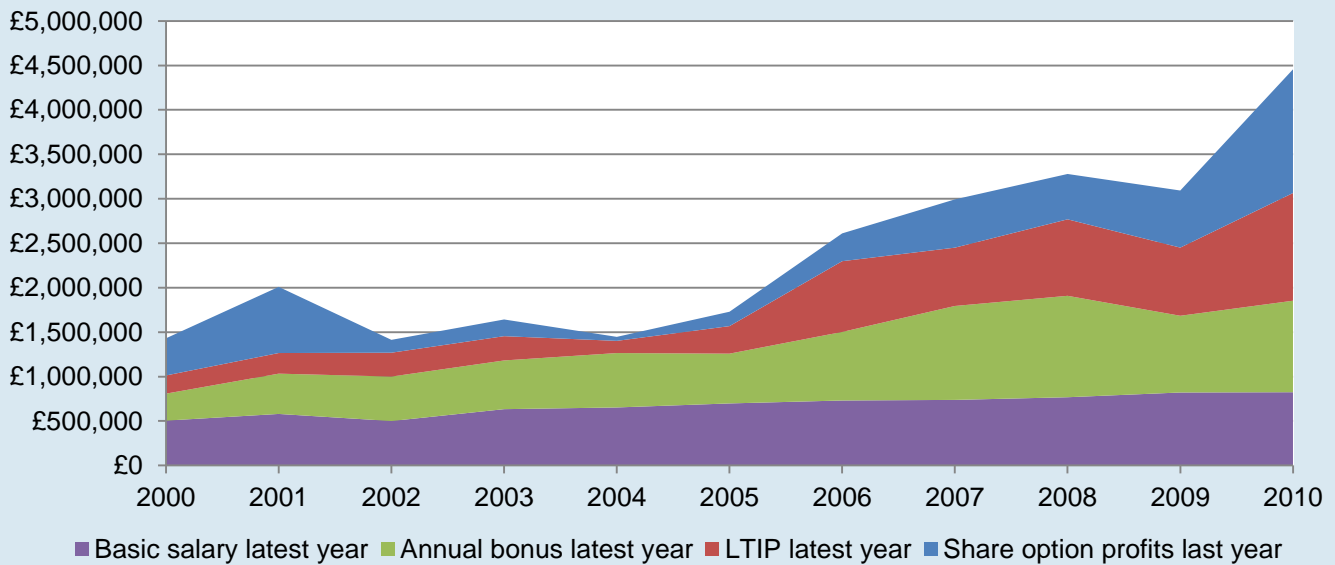
More innovative pay structures recognise this. The John Lewis Partnership, where bonuses are distributed across all staff, is frequently heralded as a model UK company. At US tech companies, where CEOs such as Steve Jobs or Facebook’s Mark Zuckerberg are amongst the most famous in the world, the practice of share awards across all company employees is commonplace.¹⁵

Figure 2. Global CEO appointments

	Number of companies in study	Internal hire	Domestic external hire (not CEO elsewhere when appointed)	Domestic external hire (CEO elsewhere when appointed)	External hire from abroad (not CEO elsewhere when appointed)	External hire from abroad (CEO elsewhere when appointed)
North America	142	124	13	5	0	0
Western Europe	153	110	16	12	11	4
China	61	40	13	7	1	0
Japan	69	68	0	1	0	0
Rest of Asia	33	29	3	0	1	0
Eastern Europe	9	5	4	0	0	0
Latin America	13	10	2	1	0	0
Australia	9	6	0	2	1	0
Total	489	392	51	28	14	4

Source: High Pay Centre, *Global CEO Appointments: A very domestic issue, 2013*

Figure 3. Weighted average salary and actual incentive payments received by FTSE 100 lead executives 2000 to 2010



Source: High Pay Centre, *What are we paying for? Exploring executive pay and performance*, 2012

Conversely, the case of UK CEO Marc Bolland demonstrates the myth of the superstar CEO. When he quit after a successful spell as CEO of Morrisons to take up a post at Marks and Spencer in 2009, he was nicknamed the billion dollar man, after a drop in Morrisons' share price and a rise in the value of M&S of around £600 million.¹⁶ At the time, Bolland's reputation was so stratospherically high that M&S paid him a £7.5 million 'golden hello' in order to compensate him for loyalty bonuses he would have received at Morrisons.¹⁷ Bolland was unable to replicate his success, however, and media speculation suggests that consistently poor sales figures threaten his position as M&S CEO.¹⁸

The experience of Bolland highlights the absurdity of elevating CEOs to the heights implied by pay packages nearly two hundred times those received by ordinary workers. As the journalist Anthony Hilton puts it "Executives have skill which comes from training and experience, but which can be learnt and applied by most intelligent people with the right personality. Executive skill is neither unique nor special."¹⁹

Large bonuses and performance incentives at best have no effect on executive performances, and at worst actively harm companies

"Compensation needs to be tied to the long-term performance of companies."²⁰

– Policy Exchange

The theory that executive compensation needs to be aligned with company performance, in the form of performance-related pay packages worth many times base salary, is a key factor in the recent increase in executive pay awards. Annual bonuses are usually worth around 200% of salary, though can be considerably more, while so-called 'Long-Term Incentive Plans' (LTIPs), which are generally deferred for three years, with payment contingent on the fulfilment of certain performance targets, can be worth up to 700%.²¹

As part of the drive to link executive pay to performance, the average bonus awarded to FTSE 100 CEOs increased from around £300,000 in 2000 to £1 million in 2010, while LTIPs increased from £200,000 to £1.4 million over the same time period.²² Just 16% of FTSE 350 companies awarded an LTIP in 2000, rising to over 50% in 2010 (see Figure 3).²³

The increase in performance-related pay is meant to incentivise executives – looking at company remuneration reports, there is near-universal agreement that pay policy should, as the remuneration report for Imperial Tobacco states, “attract, retain and motivate a high quality pool of talented employees at all levels who are incentivised to deliver our corporate strategy through clear links between reward and performance.”²⁴

In other words, levels of executive pay should depend on company performance (nearly always measured in terms of profits, dividends and share price movements), in order to encourage executives to achieve the best possible results for the company.

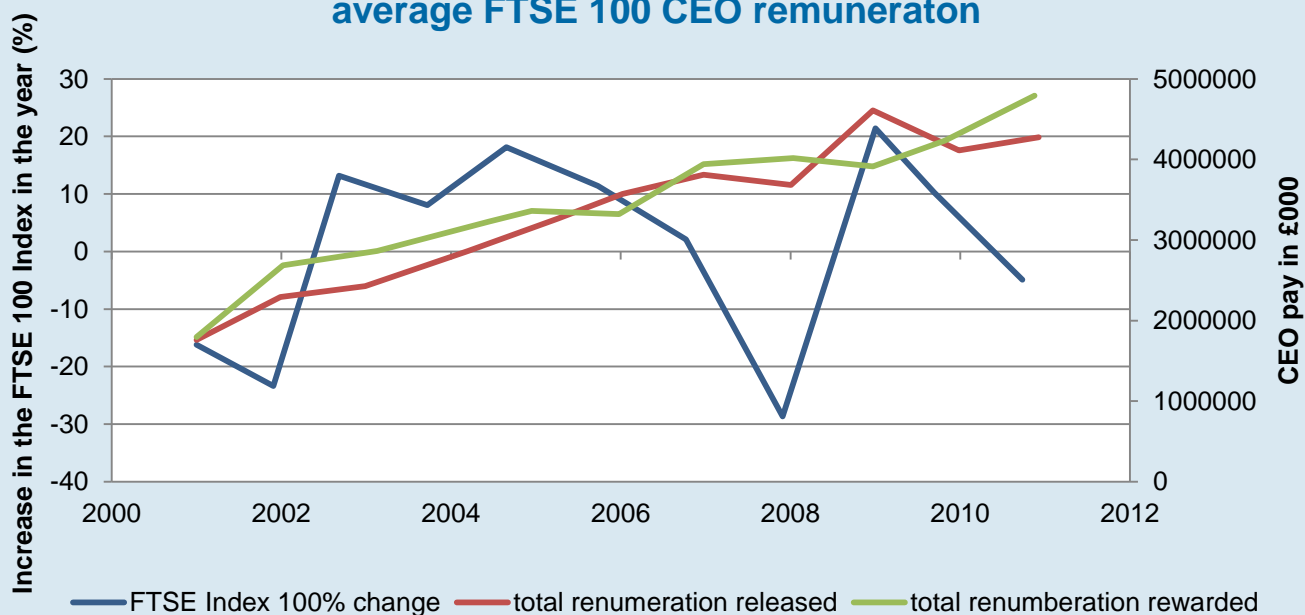
If this principle were to be applied properly, one would expect basic salaries to decline, albeit with the possibility of higher bonus or LTIP payments in the event of company success. However fixed pay has also risen in recent years, from around £500,000 in 2000 to £800,000 in 2010.²⁵ Bonuses and LTIPs are supposed to encourage executives to strive harder on behalf of the company, but they are already guaranteed significant increases on their historic salaries before variable pay is even considered.

In any case, performance-related pay is almost always structured in such a way as to ensure that poor performers get their bonus and LTIP payments anyway, thanks to undemanding criteria and relative comparisons with other companies, meaning that targets can be met even if returns are down, provided that comparator companies did even worse. Figure 4 shows how the value of the FTSE100 Index fell in most years over the past decade, while executive pay increased consistently over the same period. Performance has dipped, while performance-related pay has rocketed.

This is unsurprising, given the limited evidence to suggest that financial incentives have any sort of positive effect on performance. US Academic Tim Judge, drawing on 92 studies over 120 years, featuring over 15,000 individuals looking at the effect of pay on job satisfaction, found minimal overlap between the two.²⁶

Similarly, a survey of executives conducted by PricewaterhouseCooper’s found that pay is a far less significant motivator for executives than other factors such as responsibility, status, and mastery of a complex task.²⁷ Any importance attributed to pay was largely as a proxy for recognition, particularly in relation to peers, rather than in

Figure 4. Comparison of FTSE 100 Index performance and average FTSE 100 CEO remuneration



Source: High Pay Centre, State of Pay, 2012

terms of absolute financial value. Again, this is not especially revelatory – Abraham Maslow's 'hierarchy of needs', first proposed in 1943 and one of the most well-known theories of motivation in economics suggested that higher the level of status and responsibility an individual achieves, the less they become dependent on or motivated by material or financial considerations.

This suggests that huge pay packages with enormous performance incentives are unnecessary. But worse still, there is substantial evidence that they are actively damaging. The Salz report into the corporate culture at Barclays concluded that high pay was a key factor LIBOR manipulation scandal that cost the Bank nearly £300 million in fines and £4.6 billion in lost share price value.

The large sums of money awarded to Barclays staff caused bankers to think they were "above ordinary rules... losing all sense of proportion and humility."²⁸ The type of person attracted to a role at Barclays tended to be motivated purely by personal compensation, with less interest in contributing to long-term corporate success. These individuals pursued their personal short-term financial targets, with no regard for ethical or regulatory constraints, at the expense of the Bank's wider reputation in the eyes of customers and the general public. When their manipulation of the LIBOR became apparent, the consequences were disastrous for Barclays. Salz's analysis reflects wider criticism of performance-related pay. It is difficult to imagine the competitive and determined individuals who reach executive positions moderating their efforts according to their pay level – as the Shell Chief Executive Jeroen Van der Veer has said, 'if I if I had been paid 50% more, I would not have done it better. If I had been paid 50% less, then I would not have done it worse.'²⁹

Indeed the psychologist, Edward Deci argues that financial motivation risks crowding out intrinsic motivation, encouraging short-cuts, and a focus on the reward, rather than the task itself, with negative consequences for performance. In the case of Barclays, traders prioritised returns from their investments that would maximise their bonus

payments, at the expense of the bank's need to adhere to regulations and protect its reputation.³⁰ Their experience demonstrates the fallacy that pay packages hundreds of times the national average, comprised of complex bonuses and incentives structures, are at all helpful in terms of improving company performance.

Executive pay has damaging effects on society

"Executive pay is between us and the shareholders. It has nothing to do with the public"³¹

– Gareth Baines, Siemens UK

Multi-million pound pay packages at taxpayer-supported banks such as RBS and LloydsHBOS demonstrate an obvious public interest in the question of high pay. Beyond these companies, though, the most extreme cases of high executive pay have occurred in the private sector. In which case, do governments, pressure groups or members of the public have any business telling these private companies how much they should pay their executives?

Those who say that the state and civil society should keep out are making a philosophical argument based on a fundamental belief in the so-called 'free' market, rather than one that seeks to engage in the practical consequences of such high levels of executive pay and the ensuing income disparities between rich and poor. They argue that corporations are private property, and action to address executive pay represents an interference in private property relations anathema to liberal democracy.

In response, it is important to note that decisions on executive pay have repercussions for people beyond the executives themselves and their company. As the Church of England investment committee has observed, executive pay has become so excessive it is a risk to a harmonious society.³² Only a society in which everyone receives a fair and proportionate reward for their economic contribution is sustainable, and it is therefore vital that Government ensures an economy that delivers this.

Tensions arising from wild variations in standards of living result in higher levels of mental health problems, obesity, drug abuse, violence and teenage pregnancy, plus lower levels of trust and social mobility, in more unequal countries, such as the US and the UK, compared to more equal societies, like Norway or Germany.³³

Bristol University Academic Stewart Lansley also notes that the increasing concentration of wealth amongst a tiny super-rich elite is economically destructive. The super-rich are unable to spend the entirety of their income in the productive economy (i.e. consumer goods and services that create jobs) instead concentrating it in non-productive investments (for example, property or shares).³⁴ By contrast, an increase in incomes for low to middle income earners is likely to result in an increase in consumption, with attendant benefits in terms of employment and growth. The public would expect the Government to address these kinds of social and economic problems. Tackling the levels of inequality created by the rapid increase in executive pay would be an effective way of doing so.

This is the practical argument for government intervention on executive pay. There is also a powerful moral argument. Companies do not exist in a vacuum. They depend on a reliable transport infrastructure, the rule of law defended by a trained and well-equipped police force and a justice system that has the confidence of the public; and an educated employee and customer base. Government also provides around one third of all R&D spending in the UK, from which private companies are able to profit.³⁵ Though companies may contribute to Government revenues through taxes, the contribution that an individual company makes to public spending is minimal, compared to the value they derive from the kind of investment outlined above. The endeavours of individual taxpayers create a social and economic infrastructure within which private companies and their executives can make money. Wealth is created collectively – and when it accrues to a small number of executives who are paid far in excess of what might be considered fair or proportionate, this represents the exploitation of other taxpayers.

Conclusion

When the Chartered Market Institute published the findings of their research into executive pay in April 2013, they noted that the growth of top pay in comparison to average earnings "isn't just a short term boost for executives. It's a big long-term trend in society."³⁶

For most of the 20th century, reducing the gap between rich and poor was seen as a hallmark of progress. Since 1979, however, the unconstrained growth of executive pay has helped to re-open the gap, with inequality prophesied to reach Victorian levels by 2035 if current trends continue.³⁷ This should not be the price of economic progress. A more equal society where people's talents and endeavours are fairly and proportionately rewarded is possible.

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