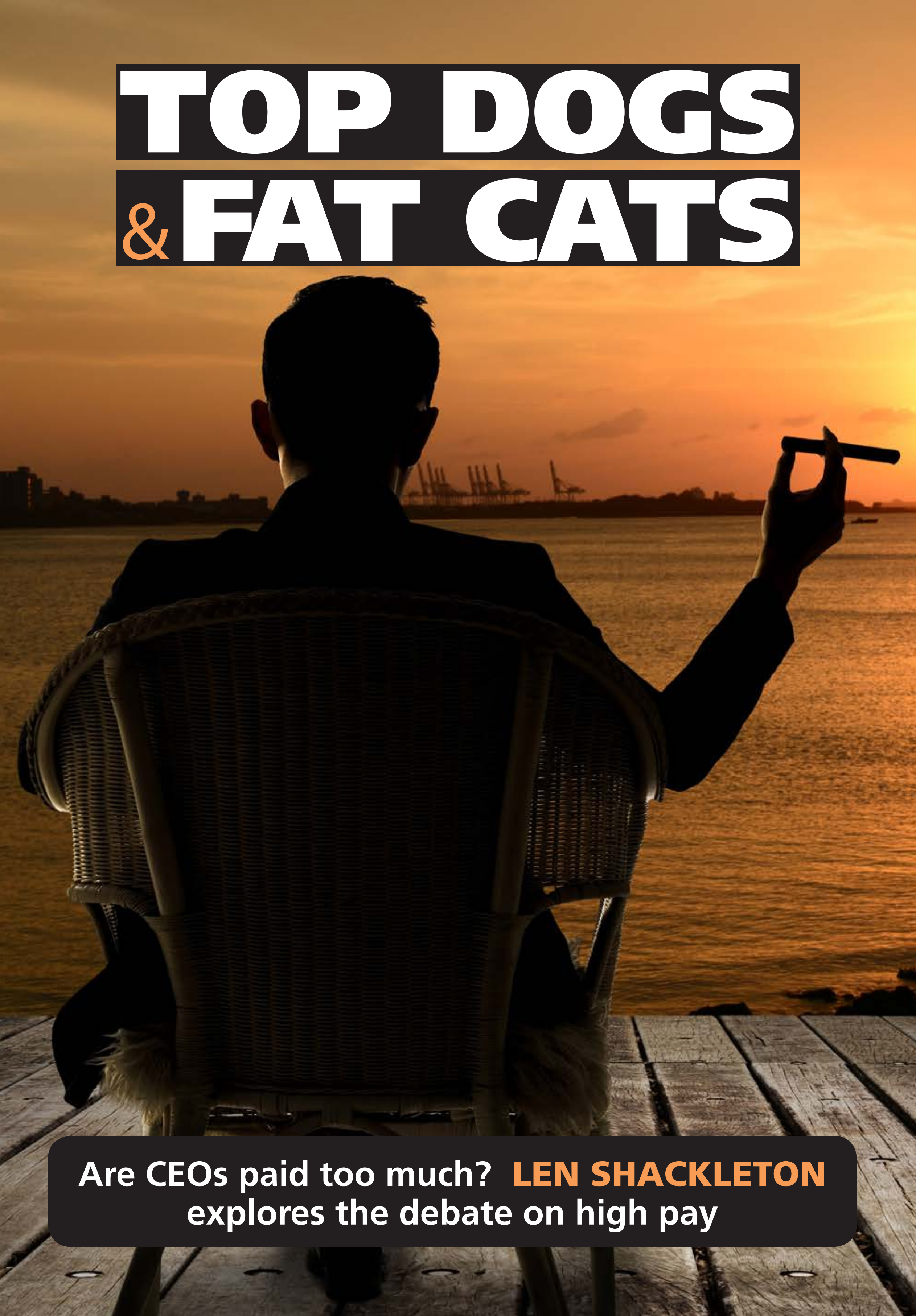
TOP DOGS & FAT CATS



Are CEOs paid too much? **LEN SHACKLETON** explores the debate on high pay

The apparent excesses of some company pay structures have fuelled intense political debate recently.

Over the last twenty years, top pay has risen much faster than average levels of pay, share prices and other key indicators, as the chart below illustrates.

Why is this, and is there some sort of "market failure" requiring government action?

According to Luke Hildyard of the High Pay Centre (a pressure group for reform), although rising pay for Chief Executives (CEOs) may partly be the result of increasing global competition for top talent, it may also be a result of rigged markets.

We may be experiencing what critics call "crony capitalism" – where business and government are too close, allowing company bosses to gain favourable access to contracts and get an easy ride from regulators, protecting them from competition and unfairly boosting profits.

Hildyard also argues that the ultimate providers of capital – the owners of company shares – would prefer to see more modest levels of executive pay.

But they are separated from the operation of corporations by a web of financial advisors, asset managers and pension funds. These intermediaries are themselves highly paid and see no problem in paying company executives generously.

It is often asserted that CEO pay bears little relationship to company performance – the "rewards for failure" argument. As Professor Alex Edmans of the London Business School reasons, this claim requires rather more sophisticated econometric analysis than is usually employed by activists and the media.

Using such analysis, it seems that in reality pay does react to changes in performance. CEOs who perform badly do suffer financially – though Edmans points out that it is their wealth rather than their income which is affected, as much of their pay takes the form of company shares and share options (the right to buy shares on favourable terms) which lose value with poor performance.

While he believes strongly in the reform of company pay, Professor Edmans argues that compulsory disclosure of CEO/average pay ratios (imposed by Theresa May, who felt strongly on this issue) can lead to the wrong conclusions and have unintended consequences which may harm workers. For example, firms may outsource low-paid work to improve their showing on these indicators.

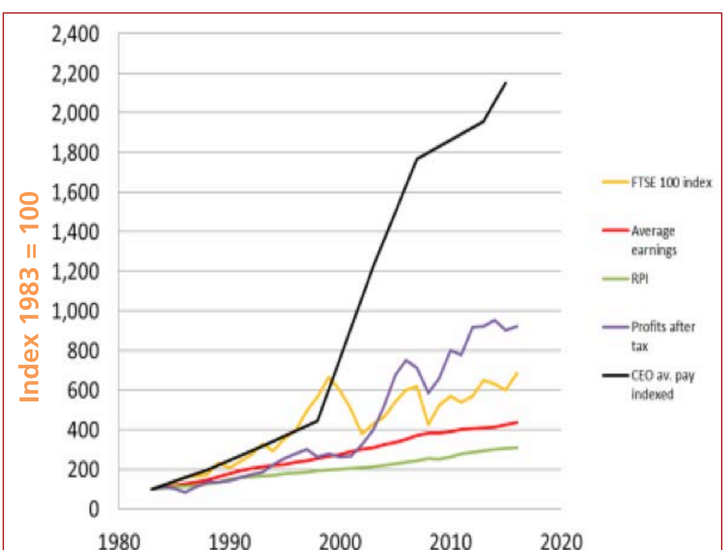
Edmans argues that reform efforts should focus on simplifying the often complicated structure of remuneration schemes, rather than the absolute level of chief executive pay.

He wants pay to simply be in cash and shares with a long holding period. And if shares can at the same time be awarded to employees, they will gain in line with CEOs, which will help address concerns about fairness.

Some defenders of high pay point to the big gains in the value of company shares associated with the reputation of top executives. When Tidjane Thiam left his job as CEO at Prudential in 2015 to join Credit Suisse, the Prudential share price fell by 3.1%, knocking £1.3 billion off the firm's value. At the same time, the Credit Suisse share price rose by 7.8%, adding £2 billion to the company's value.

Others dismiss the idea that the search for rare talent justifies high CEO pay, pointing out that most companies promote their CEOs from within the company.

Luke Hildyard argues that long-established successful businesses (as opposed to entrepreneurial start-ups) are built on effective organisational systems rather than the abilities of the current incumbent CEO, who therefore has in many cases rather little influence over a company's success.



FOR FURTHER DISCUSSION

- Discuss possible reasons why pay for CEOs of big companies has outstripped average pay in recent decades.
- What skills are required to head a major international company? Why do you think 40% of FTSE-100 companies were headed by a non-UK national in 2017?
- What do you think would be the consequences of imposing a "pay cap" on UK-based companies?
- Why do you think the public seems less bothered by high pay for entrepreneurs and top footballers than for CEOs of top businesses?

In the last few years we have moved from cross-party neutrality about the acceptability of high pay – most famously summed up by former Labour minister Peter Mandelson being "intensely relaxed about people getting filthy rich" – to Conservative minister Caroline Nokes recently asserting that no one should get a salary of more than £1 million a year.

Opposition leader Jeremy Corbyn and Shadow Chancellor John McDonnell have at various times proposed giving workers a direct say in executive pay in large companies through requiring worker representation on boards, and to impose pay caps (maximum ratios of top pay to that of the lowest paid) on the public sector, on utilities such as energy and water which they hope to renationalise, and on firms working on government contracts. Survey research suggests that Mr Corbyn's proposed pay caps are supported by a considerable majority of the public.

But governments need to be careful in how they react to populist calls for action. The public are often concerned about 'fairness' rather than anything else – why should bosses be paid so much more than others?

Even amongst those opposed to high pay, concern is oddly selective. While executives of FTSE-100 companies are targeted by critics, private equity businesses and entrepreneurs seem to get a free pass – as of course do other high earners such as footballers, musicians and movie stars.

If "fairness" is the criterion, perhaps the tax system is a better way of dealing with it than giving the state power permanently to fix pay ratios or even pay caps.

Government interventions always bring with them the risk of "government failure", where policies exacerbate rather than resolve concerns, or generate new problems.

The publication of pay ratios may encourage FTSE companies to delist and new businesses to register outside the UK. Companies may try to "game" pay ratios by outsourcing particularly low-paid jobs, or by reducing the use of performance-related pay for executives.

More radical measures such as imposing worker representation on boards may increase trade union influence over company strategy and thus inhibit rapid change and restructuring, with consequent negative effects on productivity in the long run.

Imposing pay caps or maximum pay ratios will squeeze pay distributions within organisations, with negative effects on the pay of middle management and functional experts such as accountants and engineers.

In the case of international businesses, it could make it difficult to retain top foreign executives, who currently make up a high proportion of FTSE-100 leadership.

So the issues are not clear-cut and deserve more careful consideration than they are often given•

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FOR MORE

TOP DOGS & FAT CATS, a collection of essays exploring the debate on high pay, is available for **FREE DOWNLOAD** at **www.iea.org.uk/publications/top-dogs-and-fat-cats**