Harvard Business Review

HBR Blog Network

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The Political Case Against Out-Sized Executive Pay

December 2, 2011

The exponential growth in executive compensation over the last thirty years, as compared to slow growth in average worker pay, has been at the center of debates about the financial crisis and its aftermath. But these debates have, so far, had little political impact.

A recent UK report from The High Pay Commission sets out a multi-faceted political case — on business, economic, and social grounds — against such extreme compensation growth. Coming at a time of renewed populism during continued economic hardship, the broad arguments articulated in the report may affect upcoming elections or legislative and regulatory policy on both sides of the Atlantic. At a minimum, the report should be carefully scrutinized by U.S. and UK shareholders, boards of directors, and business leaders as they try to find right-sized pay for performance in these turbulent and politically risky times. As in 2008-2009 when excessive pay was seen as linked to excess risk-taking, the issue — and the broader role of business in society — is under heightened scrutiny and needs to be addressed by the business community.

The Commission's Report — "Cheques with Balances" — sets forth important facts on pay in the UK that are similar to those found in U.S. studies:

- UK executive salaries have risen by up to 5,000 per cent since 1980, compared with 300 per cent increase for the average worker.
- The pay for CEOs is many multiples of the companies' average pay today — e.g. 63 times at BP and 74 times at Barclays (four or five times greater than 30 years ago). The multiple for U.S. CEOs may be as much as 300 times the average pay today. Moreover, increases in pay for the FTSE 350 occurred at a much faster rate than increases in company profits or share price.
- Income inequality is increasing. In 2007, the top one percent of the UK population took home 14.5 percent of the national income compared to 5.93

per cent in 1979. (In the U.S., the top 1 per cent received a remarkable 23.4 per cent of national income in 2007.)

The report cites pre-"Occupy" polls showing public distaste for huge pay differentials, which then became a centerpiece of the widespread OWS movement. In arguing the "business, economic and social case for fair pay," the Commission makes points which, while not conclusive, are worthy of serious consideration by business leaders across the political spectrum. In sum:

- The Commission argues that the *business case* for "companies to tackle the growing pay gap" is to enhance employee engagement and productivity; to reduce reputational harm to particular firms; and to arrest plummeting general trust in business. For example, only 20 per cent in the UK believe the CEO is "a credible spokesperson," according to an Edelman study cited by the Commission.
- The *economic case* for slowing the dramatic escalation in executive pay is that it adversely impacts: entrepreneurship (high rewards from executive pay discourage risking own capital); economic growth (society cannot grow when the rich receive a disproportionate amount of income and when the middle class stagnates); economic instability (in pursuit of personal wealth business executives take excessive risk); sectoral imbalances (due to high pay financial sector is drawing talent disproportionately and is not financing the real economy); and social mobility (a middle class with lack of real income growth cannot provide opportunities for children).
- Finally, the Commission argues that the *social case* for addressing skyrocketing executive pay is to reduce societal instability (to the extent wealth disparities reflect lack of opportunity, this can lead to social unrest) and the undue political influence of the wealthy (who have out-sized access and voice in shaping public policy).

Each point in Commission's case is supported with research, but the argument remains more of an outline than an extended analysis or proof. It says pay is "too high" but doesn't explain what is "high enough" or "what is fair." It makes a series of "process" recommendations for changes in legal requirements or corporate practice, some of which are familiar (disclosure of highly compensated employees, clearer comp reports, advisory shareholder say on pay votes), some new (employee on comp committee, a report on percent of profits distributed to executive team over time, a quasi-governmental body to monitor and report periodically on exec comp).

But the Commission avoids the fundamental substantive questions: What are the purposes of the corporation? What are the operational objectives which express those purposes? How should executives be compensated based on success or failure in attaining the operational goals? As I have argued elsewhere, total shareholder return or return on equity are inadequate measures of corporate purpose and performance. I believe that the purposes of the corporation today are threefold: creation of durable value for shareholders and stakeholders through sustained economic performance;

sound risk management; and high integrity. (See *Restoring Trust in Corporate Governance: Six Essential Tasks of Boards of Directors and Business Leaders*) Each of these purposes should be reflected in annual substantive operational goals publicly stated (e.g., customer satisfaction, risk audits, adherence to company ethics). And, it is against these measurements that overall performance should be measured, pay constrained and corporate accountability established.

In light of the continuing lack of trust in business, and the increasing controversy surrounding issues of inequality, the High Pay Commission's report serves a valuable purpose by outlining in one place a broad political case for restraining the rate of increase of executive pay. Shareholders, directors, and business leaders should review the arguments carefully and assess the risk that they pose to their corporation and to the role of business in society. Many have not done the needed task of then addressing more comprehensively and substantively the issue of right-sizing pay.

But this is not just about better process. It also must mean *establishing and publicizing substantive measurements of economic performance (beyond stock price), sound risk management and promotion of high integrity* to guide, justify, and constrain future executive compensation.

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