The Telegraph

Workers won't benefit if politicians give in to crude populism on executive pay

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July 22, 2017

It is that time of year again, when column inches are filled with politicians and commentators telling us their summer reading material. If previous years are anything to go by, we can expect a mix of historical biographies, anti-capitalist tracts, punk economics texts and political diaries to dominate the suggestions. Inspired by their reads, our MPs will no doubt return from their holidays refreshed and ready to ban, regulate, tax or control more of our activities.

So let me make one alternative reading recommendation for the long break. All those politicians concerned or interested in the subject of executive pay should junk the suggestions of their peers and spend quite some time digesting a comprehensive new academic paper by Alex Edmans, Xavier Gabaix and Dirk Jenter entitled "Executive Compensation: A Survey of Theory and Evidence". The economics is tough going at times, but it contains a raft of interesting data and insight, which should give our legislators pause for thought.

Reports from pressure groups regularly make the case that "something must be done" about the rising pay of executives in the UK. The High Pay Centre highlights how the ratio of FTSE 100 CEO pay and average total pay of their employees has risen from 48:1 in 1995 to 129:1 in 2015. The Equality Trust puts it another way: the average FTSE chief executive earns 386 times more than a worker on the National Living Wage. This is not just a UK phenomenon. In the US, examining the S&P 500, the average ratio of CEO pay to average worker pay was 335:1 in 2015, compared with just 40:1 in 1980.

To some, such an explosion in top-end pay is evidence enough of rent-extraction by executives. That some firms go to great length to hide or disguise pay from shareholders, appear to reward executives for poor performance, and lower pay levels when corporate governance is stronger, appears to support this thesis. But there is a key trend that it cannot explain: why executive pay has jumped so much since the Seventies, over a period where corporate governance has strengthened and transparency improved.

In fact, there are good economic reasons why it may have risen so substantially over these years, even if we believe contracts are designed with the larger aim of maximising shareholder value. Firms have grown larger, changes in product markets appear to have increased the demand for CEO talent, and CEO skills appear more closely monitored and important. This is seen in market judgments on CEO changes. When Tidjane Thiam, the chief executive of Prudential,announced in March 2015 that he was moving to Credit Suisse, Prudential's shares fell by 3.1pc (a fall in value of £1.3bn) while Credit Suisse's shares rose by 7.8pc (£2bn). Evidence suggests the impact of CEOs on share prices has been growing.

Despite claims to the contrary, FTSE 100 performance usually is reflected, to some extent, in chief executive pay too. The economists Brian Bell and John Van Reenen have found that a 10pc increase in firm value is associated with an increase of 3pc in CEO pay. Perhaps more importantly, they found declining firm performance led to CEO pay cuts and more CEO sackings.

It might not be the simple answer that politicians want then, but any account of executive pay must consider board and shareholder attempts to maximise firm value, executives' attempts to maximise their own rents, and institutional forces such as legislation, taxation, accounting policies and social pressures.

All these affect contract design and the incentives embedded within them, as can be seen by remuneration packages changing dramatically in composition in the past few decades. Using all of these insights, the academics produce a raft of ideas that companies and politicians could think about to better align incentives, and to report pay levels to show that pay is determined fairly. But they warn strongly against the crude Government attempt to control pay directly through pay ratios.

The Conservative manifesto wanted all listed companies to publish the ratio of executive pay to the broader UK workforce. Labour promisedmaximum pay ratios of 20:1 for companies undertaking public contracts. Britain is currently sleepwalking towards a statutory cap between executive and average worker pay within each firm.

Such disclosures and regulations would direct public anger at the wrong firms and bring unintended consequences. It implicitly assumes away that a particular CEO might just be more talented or have better options elsewhere, and thus a higher market value. It also ignores the industry context. One might expect, for example, that a supermarket chain would have a larger ratio than an investment bank, given the lower median earnings of the broader staff. But is this problematic? Different business models, such as franchising, might also affect the figure.

But the main damage of a cap or heavy public pressure would come from perverse incentives in reducing the ratio. CEO pay tends to be more sensitive to performance than that of average workers, so avoiding spikes in the ratio will lead to less performance-linked pay packages, undermining shareholder value. Raising average worker pay might likewise be "gamed" by replacing workers with machines, outsourcing or shifting non-pecuniary benefits into salary.

With a populist mood in the air, it would be tempting for politicians to ignore the evidence and simply go with their moralising instincts on high pay and such a crude measure. But if they really want to help workers and the economy more broadly, they need to escape this zero-sum mindset and do the hard thinking and preparation necessary for evidence-based reform.

Let us hope they spend their summer productively.

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