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The murky politics of boardroom pay

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During her leadership campaign for prime minister, Theresa May described the gap between boardroom and worker pay as "irrational, unhealthy and growing". Her call for listed companies to publish the ratio between CEO and average worker pay reflected concerns across the political spectrum that the pay gap between rich and poor has become unsustainably wide.

Between 1949 and 1979, the share of income going to the top 0.1% of earners actually fell from 3.5% to 1.3%. But since then the trend has reversed. Pay differentials between CEOs and their employees provide a vivid illustration of this. According to the High Pay Centre, the average FTSE 100 CEO was paid 47 times more than the average employee in 1998 – by 2015 this had risen to 129 times.

The growing pay gap in UK companies takes effect against an unprecedented decline in average workers' real wages, which have fallen by around 8-10% since 2008. It is

Documents made publicly available as a result of litigation in the US, however, suggest that both models ignore the extraordinary collusion among major UK company chairs in bringing about widening pay differentials.

The Chairmen's Club

In 1982, senior officers from major UK-based companies, including Boots, the Beecham Group (now part of GlaxoSmithKline), Rio Tinto and Unilever, came together at Imperial Chemicals House to discuss boardroom pay. The Chairman's Club, as it was described in one document, had convened at the request of Sir John Harvey-Jones, then chair of Imperial Chemicals Industries. The minutes of its first meeting indicate that those present unanimously agreed that the remuneration of executive directors and senior management in the UK was "too low on any international comparison" and that most felt that this "was not rational nor acceptable".

The consensus was that there was "a need for a cohesive drive on [the] issue", despite the obvious political difficulties involved in driving up the pay of top management while "trying to persuade employees at large to accept moderate pay settlements". This difficulty was reported to be "well understood around the room" and led to "a strong emphasis on some kind of bonus or payment by results system which would be far less controversial". To counteract public disquiet, Sir Graham Wilkins, chair and chief executive of the Beecham Group, suggested that they approach the Institute of Economic Affairs to produce a written rationale supporting a trend towards higher remuneration.

It is unclear from the limited documents available how the club evolved or what actions it subsequently took. The minutes of the first meeting indicate that the chairs planned to meet regularly in the first instance and then annually "once procedures had been established."

There is no contemporary evidence of the club meeting and collectively discussing pay. Nonetheless, the documents highlight the intensely political nature of top pay and even report that the chairmen had previously been "too fearful about union and political reaction to high remuneration". More to the point, the initiative also seems to have had a profound effect in resetting the market for corporate pay.

the stagnant wages of ordinary workers in the UK that has led to high rates of pay in the corporate sector assuming greater political significance.

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CEO vs average pay (£'s, millions)

0 0.5 1 1.5 2 2.5 3 3.5 4 4.5 5

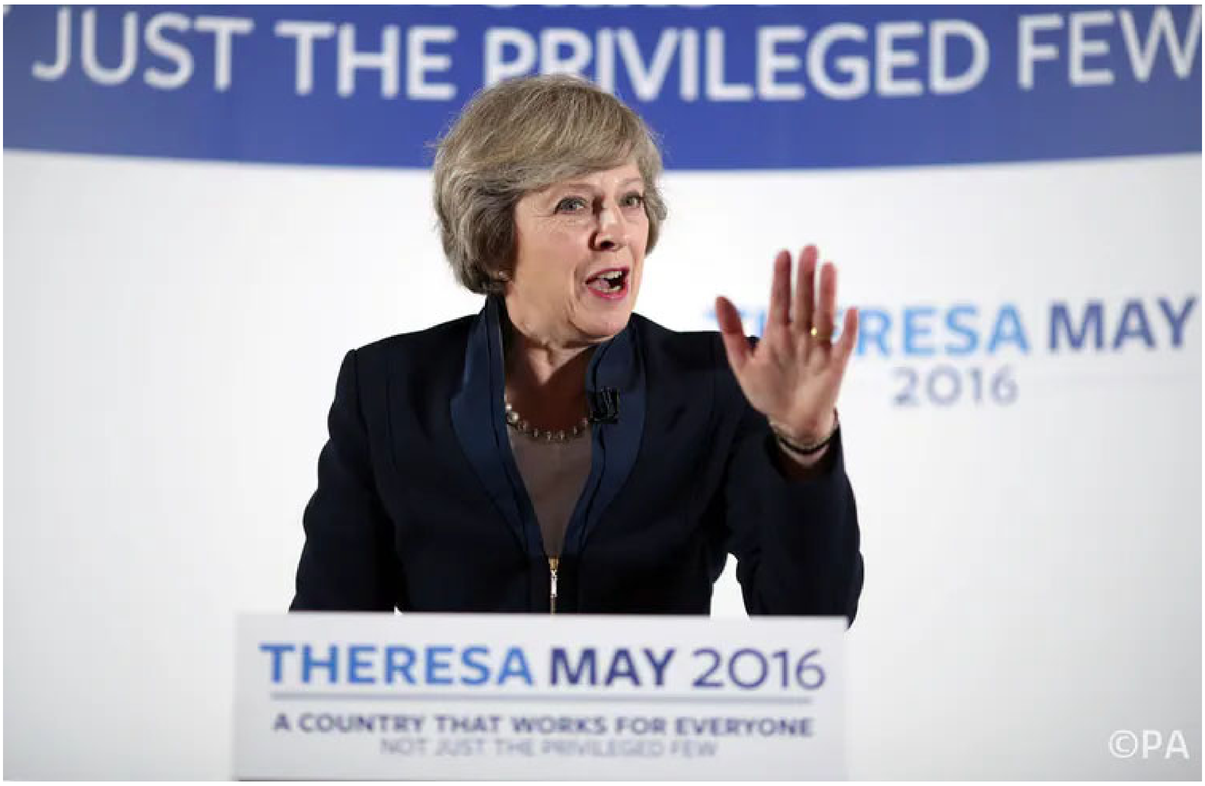
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2013
2014
2015

Source: High Pay Centre Get the data

Surveys consistently report public concerns that CEO pay in the UK is too high and that political intervention is warranted to reduce the gap between high and low earners. If wage differentials continue along their current trajectory, the UK will have returned to Victorian levels of income inequality by 2030. The key question, however, is how did we get here?

Explanations for the inequality in pay must take account of both structural issues, such as the reduced influence of collective bargaining, which explain poor wage growth for average workers, and the various drivers of inflation-busting increases for high-earning executives.

Research on the reasons for the growth in executive pay is notoriously contradictory. The standard economic approach of executive pay – known as the optimal contracting model – maintains that firms design the most efficient compensation packages possible in order to attract, retain and motivate executives. This contrasts with the managerial power model, which suggests that boards and compensation committees connive with CEOs to agree excessive compensation packages that are neither justified by market fundamentals nor CEOs' market power.



May has talked tough on tackling inequality. Chris Radburn / PA Wire

The power of collective action

Accurate data prior to the 1990s is limited. But there is a measure of consensus that both large increases in executive pay and stock-based compensation as a significant feature of executive pay first emerged in the 1980s. It is stock-based compensation that now typically accounts for much of senior executives' rewards. Executive pay in the UK is also now significantly higher than that in comparable European countries.

The justification for the initiative is also fascinating. The club noted that "competition for management talent [was] growing internationally", that senior executives in major UK companies were "insufficiently trained and professional", and that "performance [had] been inadequate by international standards".

The idea of an international market for CEOs has since been used ad nauseam to justify high CEO pay. But there is little evidence to support it.

One recent study found that 80% of CEO appointments in the Fortune Global 500 were internal promotions and only four CEOs had been poached while they were CEOs of another company in a foreign country. There is some evidence to suggest that this makes economic sense. CEOs promoted from within seem to perform better than external recruits.

Whether UK senior management has improved relative to their international counterparts since the 1980s is a moot, and untestable, point. The Chairmen's Club does, however, appear to have been successful in ensuring that the lion's share of improvements in company value and productivity have gone to those at the top. The irony is that this seems partly a consequence of elite collective action – which when practised by conventional trade unions is claimed to price their members out of work.

Wage inequality not only undermines the consumption of core goods and services, which keeps the economy on an even keel, it also de-legitimises the very system that rewards the rich. The logical conclusion is that the government should use everything at its disposal to control excessive pay: regulation, the tax system and further lobbying reform. Perhaps it might start by ignoring the pleas of various business groups currently lobbying against the planned increase to the UK's minimum wage.

Inequality UK politics Executive pay Business Theresa May CEO pay Pay gaps