NEVER AGAIN!

Why Britain Needs a High Pay Commission

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- There is now a clear public interest in exploring the link between high pay, excessive risk taking and financial stability.

- It is in the nation's interest that near meltdown and recession, caused in part by high pay, is never experienced again.

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  - how high pay and remuneration have affected economic stability
  - the link between high pay and long-term performance within companies and financial institutions
  - the effects of high pay on wider society.

- It would suggest a number of remedies such as:
  - suggested wage ratios
  - wage caps
  - bonus and pay clawbacks
  - increased taxes on pay and bonuses
  - taxes on speculations – the Tobin tax
  - caps on bonuses
  - the end of guaranteed bonuses
  - earnings and tax transparency
  - how to reduce moral hazard so poor performing institutions can fail without repercussions for wider economic stability
  - fines for excessive risk taking
  - coordinated action through international bodies and the European Union
  - set multiple limits on leveraging
  - the establishment of a bonus and high pay watchdog.

- The power of such a commission is that it creates the public pressure and space for political action.

- A Compass/YouGov poll in September 2009 shows that there is huge public support for action[1]:
  - 78% agree that the growing gap between rich and poor is bad for our society.
  - 73% would support the government in imposing a new tax on all bonuses above £10,000 a year.
  - 68% support the government in imposing a new tax on major transactions by banks and other financial companies, to curb the bonus/risk culture, with the proceeds used for social causes.
  - 52% would be more likely to vote for a political party that promised at the next election to tax bonuses and major financial transactions, and to set up a High Pay Commission.

1 See Compass/YouGov survey of 1,943 GB adults between 4 and 7 September 2009; see www.compassonline.org.uk/news/item.asp?n=5449

Introduction

On 15 September 2008 Lehman Brothers filed for bankruptcy and the world economic system teetered on the edge of meltdown. The actions of a handful of traders and their bosses combined with a system of light touch regulation almost destroyed the global economy. The FSA has now admitted that in the week of 12 October 2008 it was only hours from closing down the British banking system.[2]

The lure of the absurd level of bonuses led to risk taking and the creation of such complex financial deals that no one fully understood them. The world suddenly became aware that Western economies were built on sand. Luckily meltdown was averted but the pain and economic suffering for millions wasn't. The worst of it may not yet be over. Britain faces a long period of mass unemployment and public service cuts – in large part because those who earn the most were out of control.

There is now a clear public interest in exploring the link between high pay, excessive risk taking and the stability of the national economy. That is why Compass is calling for the establishment of a High Pay Commission so that the threat of meltdown and the reality of recession are never repeated because of excessive rewards.

Look at what the effect has been: $2 trillion were written off from banks' balance sheets and it required $12 trillion of global bailouts (£1.2 trillion in the UK with state-owned banks continuing to make losses) to stabilise the system.[3] The UK economy has lost around 5.5% of GDP.[4] The human pain is worsening by the day. The state bailout will contribute to a generation of public spending cuts. Unemployment is at a 15-year high, 1 in 6 young people are neither in work nor education.

What is truly terrifying is that it can all happen again. The bonus culture is back. Evidence is emerging that FTSE CEOs are still taking home 90% of their basic pay in bonuses despite plummeting profits and dividends.[5] Undeterred by the £1.2 trillion government bailout of the banking sector, bonus payments could rise to a forecasted £4 billion this year.[6]

> 'The system of compensation that helped cause the crisis has not gone away and rescuing the financial system without real reform has not protected us from a future crisis'

Nothing it seems has been learned. The system of compensation that helped cause the crisis has not gone away and rescuing the financial system without real reform has not protected us from a future crisis. Public interest demands that the government takes action, at least so we understand the link between high pay, high risk taking and economic stability.

On 18 August 2009 Compass launched its campaign for a High Pay Commission with a letter in the *Guardian*. It was signed by politicians from across political parties, academics, writers, journalists, economists, bloggers, campaigners and trade unionists. What united the signatories was one simple aim: to tackle excessive pay and to rein in the so-called 'masters of the universe', in order to deliver a fairer, stable and sustainable economy for the future.

Inaction is no longer an option – it is in the public interest to urgently establish a High Pay Commission to instigate a public investigation into the effects of excessive pay on our economy and society.

2 See www.guardian.co.uk/business/2009/sep/06/banks-fsa-rbs-financial-crisis

3 See Paul Mason, *Newsnight*, BBC, http://paulmason.typepad.com/MASON%20CRUNCH%20KPMG%20PREZ.ppt

4 See Office for National Statistics, Q2 2009, www.statistics.gov.uk/cci/nugget.asp?id=192

5 See www.independent.co.uk/news/business/news/top-executives-pocket-huge-bonuses-despite-recession-1773549.html

6 See http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article6736832.ece

Why we need a High Pay Commission

1 Excessive pay and the financial crisis

The link between excessive pay and the economic crisis is now widely acknowledged. According to the House of Commons Treasury Committee's report *Banking Crisis: reforming corporate governance and pay in the City*, "the 'bonus culture' in the City of London, particularly amongst those involved in trading activities in investment banks, contributed to excessive risk-taking and short-termism and thereby played a contributory role in the banking crisis".[7]

After the government bailout of the banking system there has been no major reforms to rein in or even scrutinise excessive pay. This has led to a situation of moral hazard where the system's financial liabilities are backed up by the government.

Nobel Prize winning economist Joseph Stiglitz echoed this by saying,

> The system of compensation… was designed to encourage risk-taking – but it encouraged excessive risk-taking. In effect, it paid them to gamble. When things turned out well, they walked away with huge bonuses. When things turned out badly – as now – they do not share in the losses. Even if they lose their jobs, they walk away with large sums.[8]

According to economist Paul Krugman, it is a case of "heads they win, tails other people lose",[9] the most obvious example being Fred Goodwin, former Chief Executive of RBS, who oversaw the collapse of the Royal Bank of Scotland only to keep his £703,000 per year pension. Andy Hornby, formerly of failed bank HBOS, is now CEO of Alliance Boots. Richard Burrows, governor of the disastrous Bank of Ireland, has now taken up the chairman's seat at British American Tobacco.[10]

To guarantee the financial system without scrutiny of excessive pay is to store up major economic problems for the future. After the great crash of 1929, the American government bailed out its financial system, it responded with much tighter regulation to ensure that the situation would not be repeated. To create informed legislation we need a transparent and evidence-based investigation into high pay and its effect on financial stability.

Andrew Haldane, executive director of the Bank of England, has said that banking profits have largely been based on increased leverage: "Since 2000, rising leverage fully accounts for movements in UK banks' ROE [return on equity] – both the rise to around 24% in 2007 and the subsequent fall into negative territory in 2008."[11]

The industries profits have been based on a gamble; when you play with higher stakes you can win big, but as the crash of 2008 has shown, sooner or later you inevitably lose big.

2 High pay – high performance

A major justification for high pay is that it is the result of high performance. Jeroen van der Veer, the retiring chief executive of Royal Dutch Shell, recently said, "You have to realise: 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."[12] There is a growing body of evidence that suggests that the link between pay and performance at the top is unproven.

Over the last ten years the ratio of CEO to employee pay has risen from 47 times to 128.[13] On 31 December 1998 the FTSE 100 index stood at 5,896; ten years later it had fallen to 4,562. On this analysis, the typical FTSE 100 leader has been awesomely rewarded for failure.

For the average FTSE 100 CEO this equates to a total salary hike of 295%. Over the same period, average UK earnings went up by only 50%, retail prices by 32%. The myth that the performance of those on high pay is linked to the performance of the economy as a whole has been shattered.

A report by the Work Foundation entitled *The Risk Myth* found that there is huge market failure among the highly paid; CEOs are no more likely to be competing for their jobs, nor experiencing more labour market risk.[14] There was also little evidence that long-term performance is really reflected in the way remuneration is rewarded. This concurs with a study of UK firms between 1994 and 2002 that "suggests that overall there is little relationship between pay and performance"

7 House of Commons Treasury Committee, Ninth Report of Session 2008–09, *Banking Crisis: reforming corporate governance and pay in the City*, HC 519, www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/51905.htm#a1

8 Ibid.

9 See www.nytimes.com/2009/07/17/opinion/17krugman.html

10 www.guardian.co.uk/commentisfree/2009/aug/24/mega-earners-pay-commission

11 See Robert Peston, BBC, www.bbc.co.uk/blogs/thereporters/robertpeston/2009/07/why_bankers_arent_worth_it.html

12 See http://news.bbc.co.uk/1/hi/business/8090948.stm

13 Robert Peston, BBC, www.bbc.co.uk/blogs/thereporters/robertpeston/2009/06/bosses_pay_and_wpp.html

14 See Nick Isles, *The Risk Myth:CEOs and labour market risk* www.theworkfoundation.com/research/publications/publicationdetail.aspx?oItemId=146

of UK executives.[15] One study has even showed that there is an *inverse* relationship between pay and performance.[16]

Pay statistics tell a similar story. In 2008 FTSE 100 chief executives saw their basic salaries increase by a massive 10% despite plummeting profits and dividends.[17] London paid out £7.6 billion of bonuses in total in 2008, only 40% down from the previous year at a time when the entire financial system was on the verge of meltdown.[18] Bonuses in the banking and finance sector are predicted to reach £4 billion this year.[19] We have witnessed the biggest economic downturn in our lifetime but the structure that keeps the well-paid insulated from economic failure remains.

3 Excessive pay, economic stability and growth

The gains from higher productivity have been increasingly siphoned off by the super rich since the 1980s.[20] The share of GDP going to profits has continued to rise while at the same time there has been a decline in the share allocated to wages. The reduction of the relative share of labour in national income has led to a reduction in aggregate demand. In short, if profits and output rise faster than wages, who will buy the output?[21]

Demand was kept up in the short term by increasing the supply of credit and keeping interest rates low, but this is not a sustainable economic model. A low wage, high debt economy needs to be reformed into a more sustainable model of greater equality and higher median wages for all.

Jean-Paul Fitoussi and Joseph Stiglitz in a document entitled 'The shadow GN: the ways out of the crisis and the building of a more cohesive world' stated unequivocally that

> the crisis has structural roots. The aggregate demand deficiency preceded the financial crisis and was due to structural changes in income distribution. Since 1980, in most advanced countries the median wage has stagnated and inequalities have surged in favour of high incomes.[22]

The super rich, far from being the wealth creators in our economy, have had a hugely destabilising effect. Excessive remuneration and bumper pay packages have pulled Britain's best minds into finance, a sector of the economy that arguably generates little real value and skews investment into short-term, high-risk, low-growth activities.[23]

> "The values of excessive pay and short-term profits from the financial sector have permeated into the real economy – boardrooms are increasingly cut off from their employees and less focused on long-term strategy"

The values of excessive pay and short-term profits from the financial sector have permeated into the real economy – boardrooms are increasingly cut off from their employees and less focused on long-term strategy. This is why a High Pay Commission will have to focus on the issue of high pay in its entirety.

4 High pay, transparency and the good society

Due to the huge collapse of the financial system, large swathes of the banking system are now in public ownership. Despite this, the culture of high pay has been reinforced in the publicly owned banks. Stephen Hester, CEO at the Royal Bank of Scotland, has a potential salary package of £9.6 million[24] and these £1 million plus remuneration packages are not confined to the chief executive.[25] This raises very real questions about taxpayer value and democracy. When such huge pay packages are awarded should there not be transparency?

Those banks and financial institutions that remained in private ownership have been saved indirectly by £1.2 trillion of taxpayers' money and a huge number of citizens have an interest in FTSE 100 companies through their pension funds. It may well be the case that the public are best served financially by providing the executives of the state-owned banks with huge incentives, but either way, this issue is in the public interest and should be examined in an open and transparent manner.

15 Paul Gregg, *Executive Pay and Performance in the UK 1994–2002*, http://ideas.repec.org/p/bri/cmpowp/05-122.html

16 See www.guardian.co.uk/politics/2003/aug/06/executivesalaries.economy

17 See http://www.guardian.co.uk/business/2009/sep/14/executive-pay-keeps-rising

18 See www.guardian.co.uk/commentisfree/2009/sep/06/g20-financial-crisis-banking-bonuses/print

19 See http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article6736832.ece

20 George Irvin, 'From profit squeeze to wage squeeze', *Renewal*, Vol 17 No 3, autumn 2009

21 Gerald Hotham, 'Workers of the world compete', *Prospect*, December 2008

22 See Jean-Paul Fitoussi and Joseph Stiglitz *The shadow GN: the ways out of the crisis and the building of a more cohesive world* www.feps-europe.eu/fileadmin/downloads/political_economy/090528_StiglitzFitoussi_Gn.pdf

23 See www.guardian.co.uk/commentisfree/2009/aug/27/city-banks-turner-attack

24 See http://news.bbc.co.uk/1/hi/business/8112199.stm

The debate around high pay and the super rich is hampered by misinformation and hyperbole. Research conducted by the Fabian Society and the Joseph Rowntree Foundation showed that most people (even the top 10% of earners) place themselves in the middle income bracket of society.[26] We cannot hope to have a serious debate unless we shine some light onto the subject.

The growing gap between high earners and the rest of society is politically, socially and economically damaging. It erodes the bonds of common citizenship, and undermines the principles of equal opportunity and the recognition of equal worth. It has never been clearer that gross inequality damages not just those at the very bottom but all within society.[27] Inequality creates shorter, unhappier and unhealthier lives, and it increases the rate of obesity, teenage pregnancy, violence and addiction. Inequality under New Labour has decreased within the middle 90% but the richest 10% of society have increased their share of income dramatically to over 30% of total income.[28]

Wealth is created socially – not just by CEOs, everyone in a company helps create the profit – all are valuable. Companies are socially embedded; they need communities and families to exist and develop so we need a balance between social and economic priorities. For decades a kind of market fundamentalism deemed that the needs of the economy and those at the top must always come first; we now know that to be disastrous – not just for society and the environment but for the effective operation of the economy itself. Markets always tend towards crisis and need political and democratic intervention to ensure they thrive. The chair of the FSA, Adair Turner, has said that the casino elements of the City's activities are "socially useless".[29] In reality it is worse than that; they are socially damaging. It is time to return to a better balance between the demands of the economy and the needs of society.

5 Others are taking action

Other countries are taking action to prevent the return of this level of high risk taking in the pursuit of such high rewards. This British government has insisted that only international action works, but nation states can and are taking action. A High Pay Commission would allow an informed debate to take place without tying the government into any short-term, ill-informed actions. It is the duty and responsibility of government to act on institutions and markets that damage society. The government stake in a large section of the banking sector gives the government and the public huge influence – they can demand what they want.

The G20 finance ministers meeting held in London during early September fell far short of taking the necessary international action. The centre-left governments of the USA and the UK blocked stronger moves from the centre right governments of Germany, France and Sweden. France have established a 'bonus watchdog' and introduced provisions to defer traders' bonuses over three years.[30] The Netherlands have introduced a bonus cap of 100% of annual salary and a redundancy pay limit[31]. In Sweden there is full pay transparency through income tax disclosure.

Australia is a particularly interesting case study. In March 2009 Kevin Rudd, widely seen as a politician in the mould of Tony Blair, opened a public inquiry into the regulatory framework around remuneration of directors and executives of companies. The Treasury stated openly that

> unrestrained greed in the financial sector has led to the biggest global recession since World War II… There is significant community concern about excessive pay practices, particularly at a time when many Australian families are being hit by the global recession.[32]

The Australian Labour government commissioned this public inquiry because of the economic and social concerns around excessive pay. Specifically, the Commission was requested to consider:

- trends in director and executive remuneration in Australia and internationally
- the effectiveness of the existing framework for the oversight, accountability and transparency of director and executive remuneration practices
- the role of institutional and retail shareholders in the development, setting, reporting and consideration of remuneration practices
- any mechanisms that would better align the

25 See http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article6801456.ece

26 See Louise Bamfield and Tim Horton, *Understanding attitudes to tackling economic inequality* www.jrf.org.uk/publications/attitudes-economic-inequality

27 See Richard Wilkinson and Kate Pickett *The Spirit Level: Why More Equal Societies Almost Always Do Better*

28 See www.poverty.org.uk/09/index.shtml#g3

29 See www.guardian.co.uk/business/2009/aug/27/fsa-bonus-city-banks-tax

30 See http://www.ft.com/cms/s/0/912504b6-91ae-11de-879d-00144feabdc0.html?catid=75&SID=google

31 See http://news.bbc.co.uk/1/hi/business/8246651.stm

32 See www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/025.htm&pageID=003&min=wms&Year=&DocType=

interests of boards and executives with those of shareholders and the wider community
- the effectiveness of the international responses to remuneration issues arising from the global financial crisis.

The 'issue paper' published by the inquiry into executive remuneration has also explored how to align executive, shareholder and wider societal interests.[33] A British High Pay Commission would also have to examine the effects on society of high pay.

The Australian model is a good example of how a High Pay Commission could work in Britain. The outcome of the inquiry has yet to be decided and the Rudd government "has made it clear that it will examine all workable options with regards to executive remuneration".[34]

33 See www.pc.gov.au/__data/assets/pdf_file/0003/87375/executive-remuneration-issues.pdf

34 More information on the Australian model available at www.pc.gov.au/projects/inquiry/executive-remuneration

The concept of a High Pay Commission

The concept of a High Pay Commission is not new, but it is an idea whose time has come. A Policy Network document written by former Downing Street policy adviser Roger Liddle in 2007 suggests creating

> a Top Pay Commission to match the Low Pay Commission that would scrutinise pay awards to top executives in the private as well as public sector, with a remit to expose unnecessary excess and create a more open debate about just and proportionate rewards.[35]

A report for the Work Foundation written by Nick Isles suggested establishing a High Pay Commission similar to those that operate in the public sector, which could give objective guidance on what to pay whom.[36]

> The High Pay Commission should be the main body to research into the broader impact of high pay on the economy and society

The High Pay Commission should be the main body to research into the broader impact of high pay on the economy and society. Like the Low Pay Commission, it should provide extensive research and consultation; and take written and oral public evidence at hearings from a wide range of organisations and individuals. It should carry out fact-finding visits throughout the UK to meet employers, employees and representative organisations. It should also be open to real consultation with the wider public, using online tools to invite input.

35 See Roger Liddle, *Creating a culture of fairness: a progressive response to income inequality in Britain* www.policy-network.net/publications/publications.aspx?id=1938

36 See Nick Isles, *The Risk Myth:CEOs and labour market risk* www.theworkfoundation.com/research/publications/publicationdetail.aspx?oItemId=146

What should the commission focus on?

The High Pay Commission should focus on three main things:

- how high pay and remuneration have affected economic stability
- the link between high pay and long-term performance within companies and financial institutions
- the effects of high pay on wider society.

What would its powers be?

The High Pay Commission's main power would be to take evidence and make recommendations to ministers. With powers to investigate, it would make transparent who is earning what and why, ending secrecy. We should not underestimate the power of transparency.

The Commission's reports would help create a debate with real information rather than myths and conjecture, which have spoiled the debate so far. Its recommendations would spark debate and offer the public and politicians ideas about how to balance the needs of high pay and wider society.

Proposing remedies

It would be able to make a number of recommendations on possible remedies. These could include:

- suggested wage ratios
- wage caps
- bonus and pay clawbacks
- increased taxes on pay and bonuses
- taxes on speculations – the Tobin tax
- caps on bonuses
- the end of guaranteed bonuses
- earnings and tax transparency
- how to reduce moral hazard so poor performing institutions can fail without repercussions for wider economic stability
- fines for excessive risk taking
- coordinated action through international bodies and the European Union
- set multiple limits on leveraging
- the establishment of a bonus and high pay watchdog.

The process

1. The British government decides to initiate an inquiry.

2. The government establishes the Commission, appoints commissioners, and outlines its powers and terms of reference.
3. The Commission advertises the inquiry and calls for all parties to register their interest.
4. The Commission distributes a paper to focus attention on the issues it considers relevant and invites written submissions.
5. The Commission conducts extensive research and consultation, and takes written and oral public evidence hearings from a wide range of organisations and individuals.
6. The Commission publishes a draft report or position paper and invites comments, using online tools to gauge input and opinion from the public.
7. Hearings are held on this preliminary report.
8. The Commission makes a final report to the government.
9. Departmental consultations are held and the report is considered by relevant ministers.
10. The Treasury announces the government's decision on the report.

Who would sit on it?

Similar to the Low Pay Commission, membership of the High Pay Commission should be made up of eight commissioners and an independent chair. The commissioners could include two trade union representatives, two independent economists, two members of FTSE 100 remuneration committees and two representatives of civil society groups. The addition of two civil society representatives is key to making sure the Commission can relate its work to wider society.

Conclusion

In February 2009 Gordon Brown said, "I believe, as a society, we should support hard work, effort, enterprise and responsible risk-taking."[37] So do we.

Those who helped create the economic crisis have been rewarded for irresponsible risk taking and only with a genuine exploration into the issue of high pay can we prevent a second crisis. The rest of us have paid the price. There is a clear public interest and support in controlling excessive salaries. Indeed polling commissioned by Compass shows that 63% support establishing a High Pay Commission. 78% agree that the growing gap between rich and poor is bad for our society and 73% would support the government in imposing a new tax on all bonuses above £10,000 a year.[38]

This is an issue not just of sound economics but of democratic principle. No one can be beyond restraint if their actions harm others. A failure to act will not be forgotten by the British people.

37 See www.independent.co.uk /news/uk/politics/no-rewards-for-failure-insists-brown-1605027.html

38 For full polling results see http://www.compassonline.org.uk/news/item.asp?n=5449

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