EUROPEAN HRD CIRCLE
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Steve Jefferys: Growing pay differentials and inequality: a societal and human resource challenge

The fall and rise of inequality

Having initially had access to French taxation data covering declared wages and incomes from dividends for nearly the whole 20th century,[1] Thomas Piketty worked with other income experts to produce an accessible database concerning 20th and 21st century income concentrations across a wide range of countries.[2] The results are incontrovertible: inequality declined up to the late 1970s, and has increased significantly since the mid-1980s. The nadir for the 0.1% of income earners in the UK, France and Germany was reached in the eight-year period 1976-1983. Since then, their fortunes have changed. Following the 1984 privatisation of the state monopoly British Telecom and then the 1986 UK Big Bang financial deregulation and finally the 1989 opening up of Central and Eastern Europe, the highest earners made a come-back. Figure 1 shows the average share of the national income taken by the top 0.1% of the income distribution in France, the UK and Germany over the 100 years between 1913 and 2012. Today in all three countries the richest earners have not had a greater share of all income since the second half of the 1930s and the first years of the Second World War.

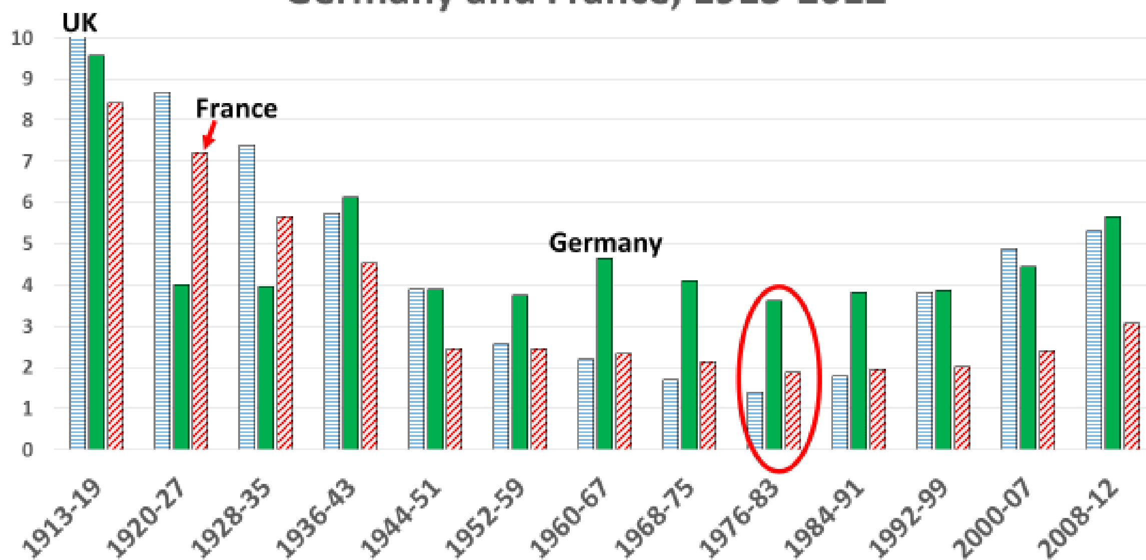


Figure 1. Income Shares of top 0.1% in UK, Germany and France, 1913-2012

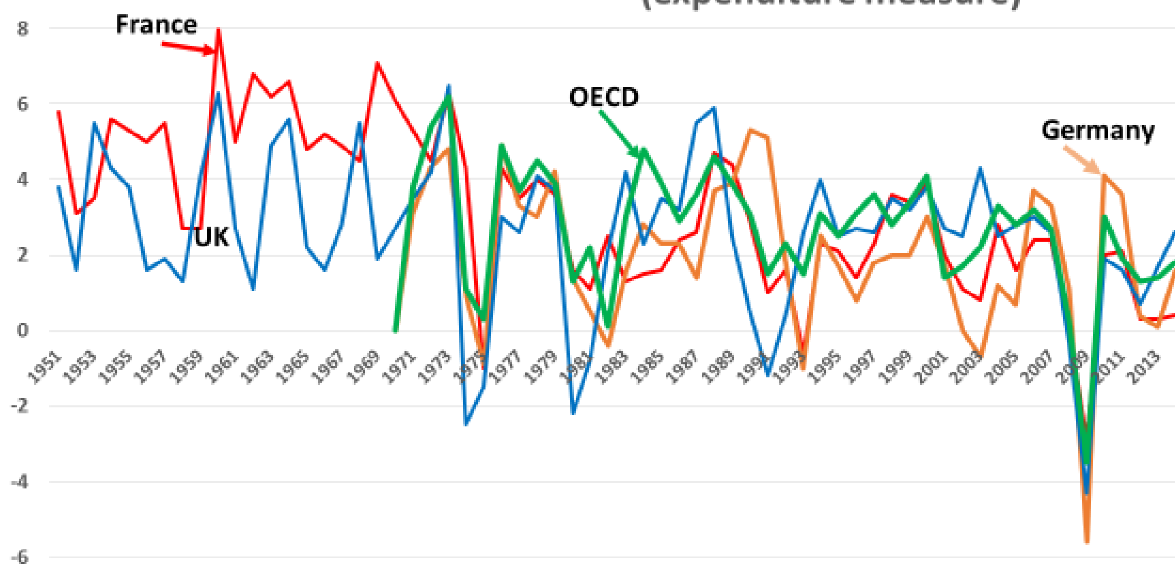
[1] Thomas Piketty (2001), *Les hauts revenus en France au XXe siècle,* Grasset.
[2] http://topincomes.parisschoolofeconomics.eu/#Database:

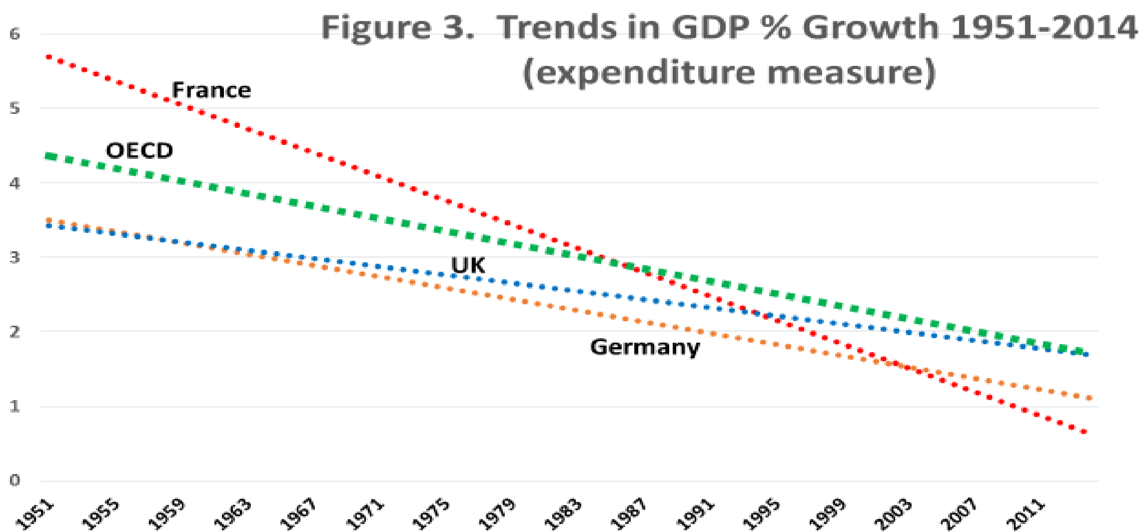
Across Europe as a whole, according to European Foundation's 2015 report on '*Recent developments in the distribution of wages in Europe*', 'overall income inequality is at a similar level to that in the US, if income is measured in purchasing power parity'(p 61). It finds (p5):

> 'Inequality increases first began in Anglo-Saxon countries at the end of the 1970s and beginning of the early 1980s, generalised by the end of the 1980s and even reached traditionally low-inequality countries during the 2000s (OECD, 2011). The most generalised widening in the distribution took place from the mid-1980s to the mid-1990s, while the patterns seem to be more diverse from the mid-1990s to the mid-2000s (OECD, 2008).'

Economic Context

The improvement in the trend direction for the highest earners since the 1980s did not reflect improving economic growth. Indeed, the opposite was taking place. During the fourth quarter of the 20th century economic growth slowed by comparison with the third quarter. Figure 2 displays changes in % GDP annual growth, while Figure 3 shows the trend.

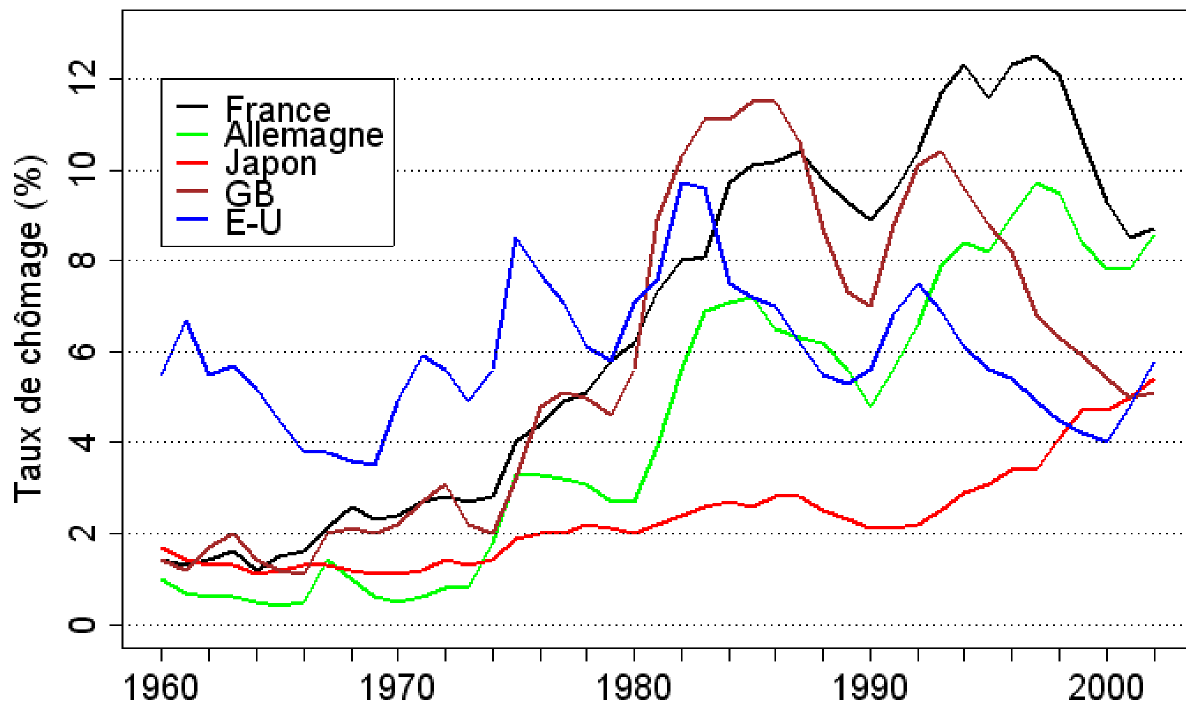




After the 1970s unemployment once again came to cast its significant shadow over labour markets. Over the period 1951 to 1973, for example, French unemployment had averaged 1.2% and was just 1.6% in the UK. The 1971 collapse of monetary stability sustained by the Bretton Woods system,[3] and the 1973 oil crisis,[4] marked the end of the global boom. Unemployment in the UK leapt to average 7.4% between 1980 and 2009, while in France it rose to average 9.5% over the same three decades.[5] Figure 4 captures the change in dynamic from the 1980s onwards:

[3] The Bretton Woods international monetary system was established by the soon-to-be victorious wartime Allies in 1944. It established fixed-exchange rates based on the US dollar and gold. In 1971 the US stopped guaranteeing a fixed-exchange rate between the dollar and gold, and by 1973 the system had effectively been replaced by the current free-floating exchange rate system.
[4] The 1971 end of Bretton Woods system led to the depreciation of the dollar. Oil was priced in dollars, and as a result the twelve principal oil-exporting countries decided collectively to demand a higher price by lowering output. Their resolve to act was finally triggered by the 1973 Yom Kippur war, after the US started to send arms to Israel. The price of oil quadrupled, the West's stock markets crashed and an economic recession set in.
[5] R. Skidelsky, *Keynes: the Return of the Master* (Allen Lane: 2009).

Figure 4. Unemployment Rates (% of labour force), 1960-2002



Incomes and wages

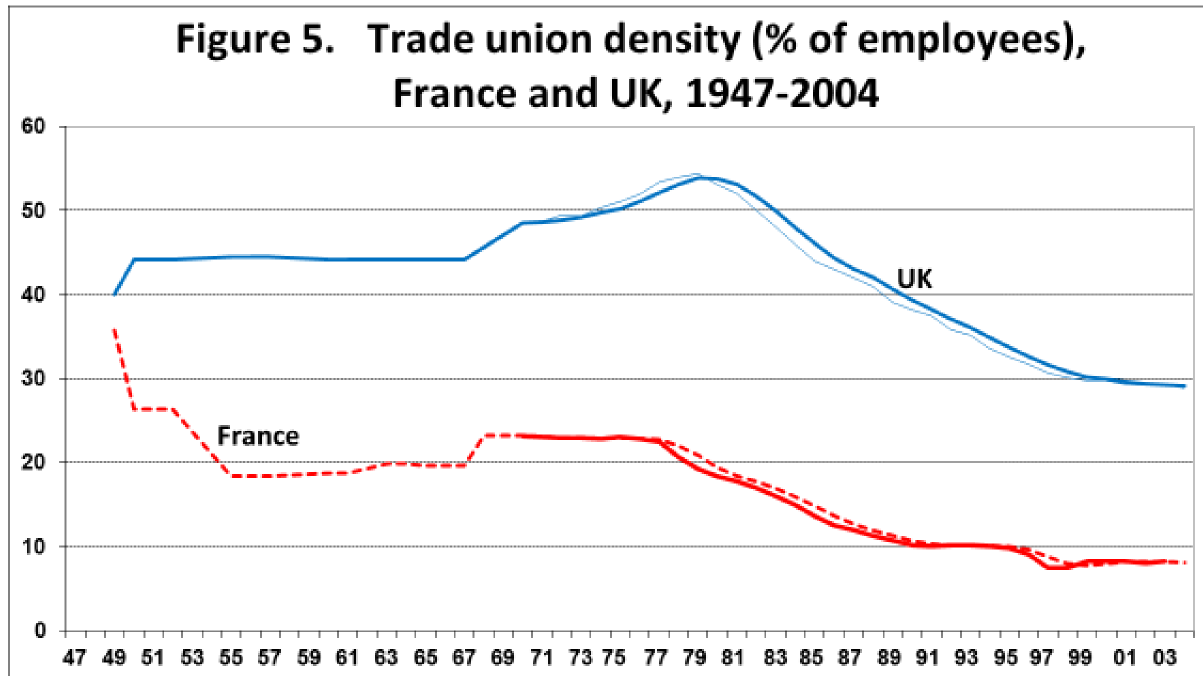
The income inequality traced above reflects both wages and incomes from dividends and rents. The pattern for wages alone is somewhat different to that of all earnings, showing both lower levels of wages inequality than for income inequality, but also much greater income extremes in many EU countries.

Very little research has so far been done on wage distribution, making the European Foundation's recent report a key point of reference. It concludes that (2015: 61)

> the level of wage inequality in the EU as a whole is below that of the US or the three most unequal countries in the EU, when wages are measured in terms of purchasing power parity. The Gini index for wages in the EU as a whole is 0.346 (for full-time equivalent wages measured in PPS), while the comparable measure for the US is around 0.4, and in the UK, the most unequal EU country, it is 0.404. The majority of EU countries have values of Gini for full-time equivalent wages well below the overall EU figure.[6]

Explanations for the growth in wage inequality since the 1970s involve the effects of rising unemployment as well as industrial restructuring towards service industries, both of which are also associated with declining trade union membership. Trade union density as a proportion of employees entered a long term decline in the 1980s in both the UK and France, as shown in Figure 5.

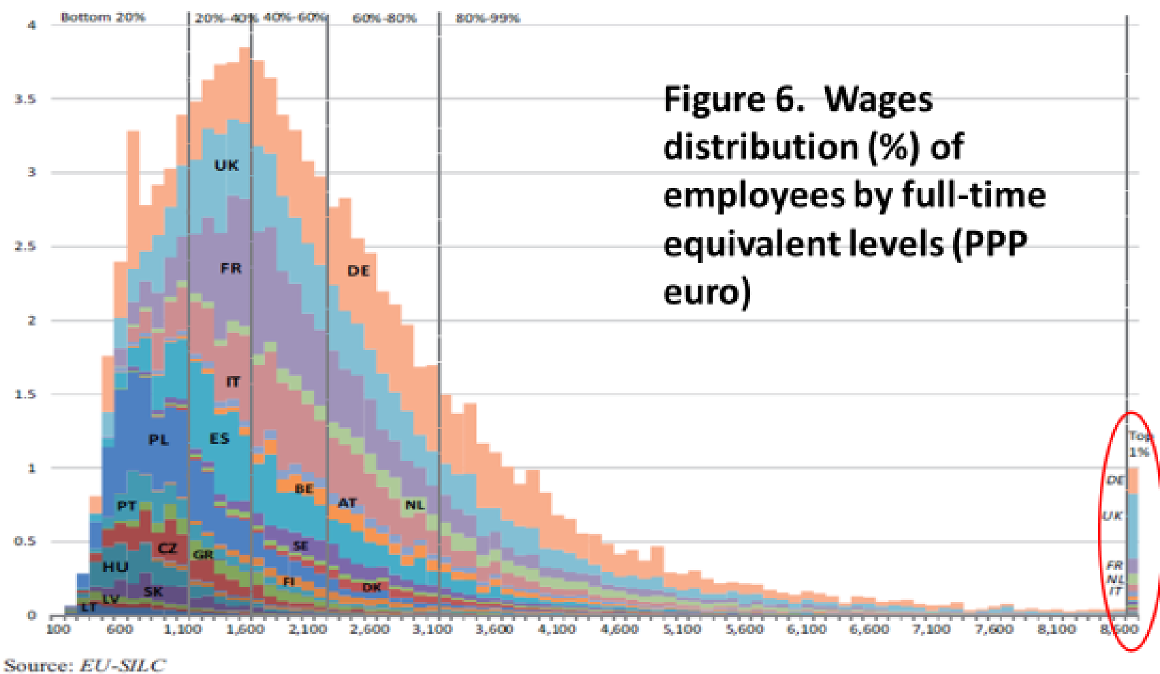
[6] If the Gini coefficient were 0 it would mean complete equality.



Declining membership weakened the capacity of trade unions to maintain collective bargaining coverage and to influence wage distributions. The European Foundation (2015: 57) demonstrates that 'wage inequality decreases as the extent of collective agreements rises: sectors are more equal in countries that have more collective bargaining on pay.' Its conclusion (p.62) is that 'Collective bargaining has a compressing effect on wages, so that the sectors with a higher bargaining coverage have had noticeably lower levels of wage inequality.'

The distribution of wages for full-time equivalent employees across the EU in 2011/12 is illustrated by the European Foundation report (2015: 16) in Figure 6.[7]

[7] The horizontal axis is in euros adjusted for purchasing power parities (PPPs); the vertical axis represents the % of all EU wage earners that corresponds to the level of wages.



Source: *EU-SILC*

Its key feature, for our discussion here, is the presence of a very significant peak on the extreme right of the graph in Figure 6. This corresponds to the very top 1% of the wage distribution, with all earnings *above* a PPP of €8,700 per month.[8]

The graph confirms what HR directors of Europe's major companies are fully aware of: senior executives are now commonly receiving salaries that are no longer linked to average salaries.

The issue that I do not have time to consider further here, is how far this extreme wages distribution is actually driving overall societal income equality. It has been argued that rising inequality is itself a significant source of slower growth and the resurgence of nationalisms. If true, then reversing the trend towards inequality would be a clear public good. These are clear challenges in implementing corporate social responsibility, but would need a full Circle meeting alone to start to do justice to.

What I will turn to is the available evidence that is used to justify the decisions on remuneration that lead to this skewed distribution.

[8]The result of an income survey, the European Foundation (2015: 15) warns 'that the figures of top wage levels presented here should be interpreted with caution; they should be seen more as the lower bound of an estimate than as an estimate as such.'

Top pay and performance

CEOs and directors of many large companies in Europe are now receiving levels of remuneration of more than a million euros a year. Some are receiving reward packages many times greater than that. An analysis of the top FTSE 100 CEO pay declared by companies in their annual reports for 2014 suggest the UK-based lead executives have benefited on average from a five-fold increase since the late 1990s, and that the median amount they were being paid was £5m a year (more than €6.5m).[9]

A common argument used to justify the most excessive pay levels does not pretend to be about objective performance. Instead it is claimed that the high pay levels reflect the global market must pay for the best executives. This argument is weakened considerably by an analysis of the evidence. An examination of the Fortune Global 500 list of the world's biggest companies revealed that 'Fewer than 1% of the CEOs of these companies were recruited from an international rival. 80% of the CEOs had in fact been promoted from
within the ranks of the company.' US researchers also found 'that companies with CEOs who had been promoted from within tended to out-perform those that had recruited externally'.[10]

A second argument is that 'they earn it' through exceptional performance. Top executive remuneration packages in the UK thus typically include an annual bonus and 'long-term incentive plan' (LTIP) on top of base salary. This formula offers the appearance of a rationale based on 'performance measures', yet it is not only deeply flawed and is not justified by objective criteria.

The evolution of the FTSE 350 directors' median remuneration between 2000 and 2013 was graphed in Figure 7 alongside selected corporate indicators in an IDS Thomson Reuters report.[11] Here I have flagged up median annual bonuses, which rose by 314%, and LTIP income, which rose by 268%.

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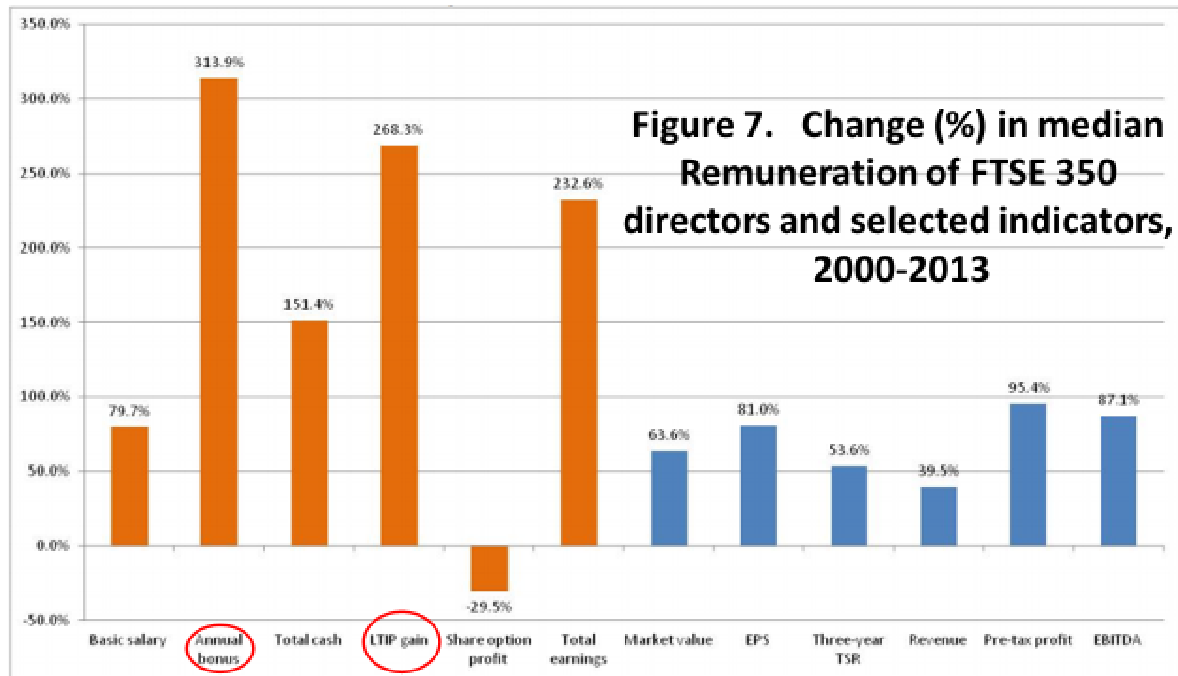
[9] High Pay Centre, *No Routine Riches: reforms to performance related pay*, London 2015.
[10] High Pay Centre, *Global CEO Appointments: A very domestic issue*, 2013
[11] http://highpaycentre.org/files/IDS_report_for_HPC_2014_final_211014.pdf



The bonus schemes employed have largely been aimed at incentivising directors to achieve short-term goals. Yet the evidence of a significant statistical link between bonus payments and either pre-tax profits or earnings per share in this UK data is missing. Between 2000 and 2013 median bonuses rose by 314%, while Pre-tax profits increased by 95% and Earnings per share by 81%.[12]

Table 1 below, also from the IDS Thomson Reuters report, shows the significance of the different forms of annual performance targets both between the FTSE 100 and the next 250 firms in the FTSE 350, and how they use of different targets changed between 2003/4 and 2012/13.

[12] Average bonuses, taking into account the numbers of directors, rose 250% compared to a weighted average increase of 79% in EPS and a weighted average of pre-tax profits of 44% (IDS Thomson Reuters, p 13).

Table 1 Key annual performance targets used in the FTSE 350 2003/04 and 2012/13 (Source: ECR)						
	2003/04		**2012/13**			
Target	**FTSE 100 %**	**Mid-250 %**	**FTSE 100 %**	**Average bonus weighting* %**	**Mid-250 %**	**Average bonus weighting* %**
Profit targets	45.7	54.4	65.0	49.8	51.5	63.9
Personal objectives	50.0	41.6	57.0	26.8	49.0	23.7
EPS	41.3	25.6	25.0	45.5	16.3	64.7
ROCE	19.6	7.2	9.0	16.0	7.1	26.9
Cash flow targets	15.2	11.2	35.0	18.8	23.4	24.4
Customer satisfaction/service	6.5	1.6	11.0	15.0	5.9	15.7
TSR	2.2	1.6	4.0	25.0	1.3	29.1

* Where schemes have more than one target their contribution to the final payment are given weights. If a scheme has two targets – profit and EPS – 50% of the final bonus payout could be based on profit achievement and 50% on EPS performance. The figures in the column are an average of these weights for each target. Please note that bonus weighting not available for 2003/04

Another High Pay Centre study examined the reported executive performance systems of the Eurofirst 100 companies in August 2014.[13] It found that in the UK companies the five most frequently reported measures of financial performance used in determining targets and bonuses were in order of importance: *Relative* Total Shareholder Return (TSR), EPS, Cash Flow, Revenue and Profit Measures. In the French companies the top five were: Profit measures, followed by *Relative* TSR, Return on Capital Employed (ROCE), Share Price and Return on Equity (ROE). Among the German companies the top five measures were Share Price, Revenue, EPS, ROCE and Absolute TSR.

What is the evidence that pay rises based on 'performance measures' and 'personal objectives' for CEOs and directors had improved company performance? In its 2014 IDS Thomson Reuters conducted an examination of the link between the pay of the FTSE 350 directors and company performance the detailed findings were. Its study found (p5-6):

- the statistical correlations between changes in two key annual bonus performance metrics, pre-tax profit and earnings per share (EPS), and subsequent bonus payments were insignificant;
- 98.7 per cent of the change in annual bonuses could not be explained by changes in pre-tax profit;
- 99 per cent of the change in annual bonuses could not be explained by changes in Earnings per share (EPS);

[13] High Pay Centre, *Metrics Re-loaded: examining executive remuneration performance measures*, London 2015

- there was no noticeable correlation between the relative ranking of long-term incentive plan (LTIP) share awards and the relative ranking of changes in total shareholder return over three years;
- there was no noticeable correlation between the relative ranking of long-term incentive plan (LTIP) share awards and the relative ranking of changes in EPS over three years.

The problem is compounded by the composition of the remuneration committees. Typically for the FTSE 100 they comprise one third executives from other FTSE 100 companies. But in addition the CEOs of fund management companies, who control shareholder votes, are themselves often recipients of the same million+ salaries. This gives them, too, a vested interest in maintaining the consensus that such salary levels are a 'fair, proportionate market value for an executive'.[14]

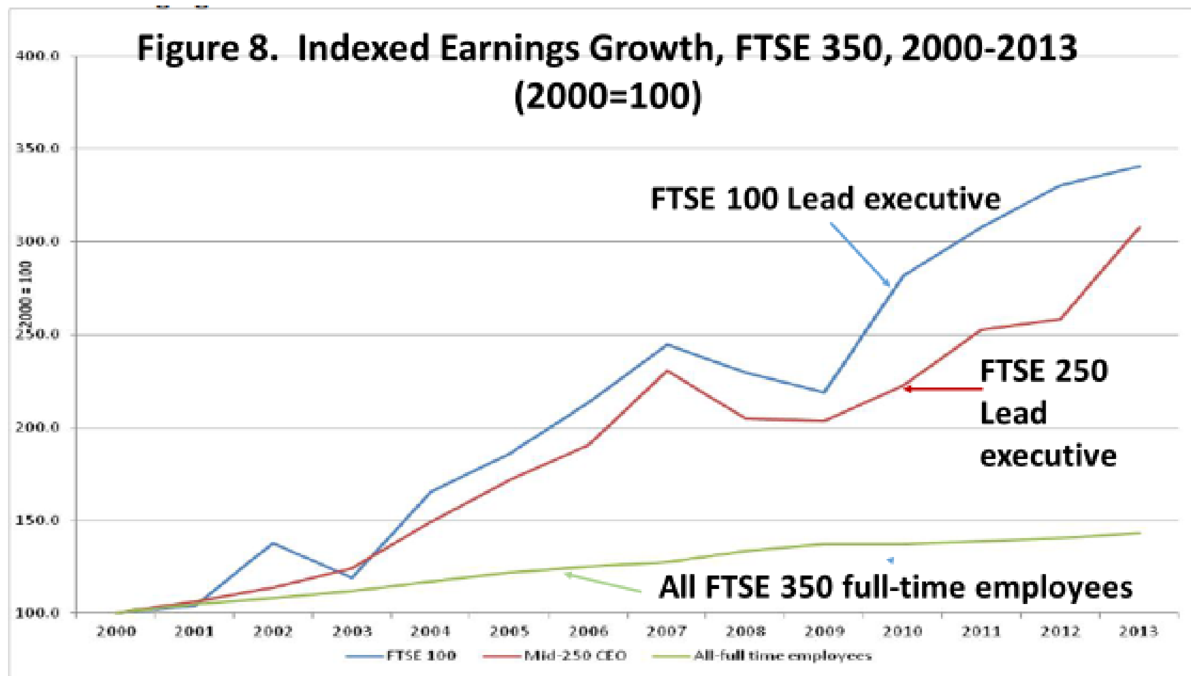
A second issue relates to the advice remuneration committees receive from 'external consultants'. Research on UK-listed firms, where the use of compensation consultants has been required since 2003, suggests it 'is associated with higher levels of total CEO pay' and that 'when firms change compensation consultants… CEO pay is both higher and less sensitive to performance in the year when the change is reported.' This is considered to be the result of 'opinion shopping' on the part of firms using consultants to 'legitimise higher CEO pay'.[15]

Issues for HR

Alongside the broader questions concerning the extent of the responsibility of large companies to implement remuneration policies that help reduce overall societal inequality rather than sustain and bolster it, there are the tensions inherent in reproducing and increasing inequalities within the organisation. Our final Graph 8 illustrates the problem.

[14] *No Routine Riches*, p. 10

[15] Alistair Bruce and Rodion Skovoroda, The Empirical Literature on Executive Pay: context, the pay-performance issue and future directions', Nottingham University Business School, May 2015: p. 15.



The growth of inequality thus offers several direct challenges to HR teams:
1) Can transparent remuneration systems be introduced that fully recognises the contribution of all employees?
2) Can maximum pay ratios be introduced so that the senior executives should not earn more than a fixed ratio above the average employee of their company?
3) Can wider employee involvement and trade union participation in remuneration committees be introduced if it does not already exist?
4) Is it possible to ensure that the remuneration of senior executives reflects longer term company interests rather than those of the investment professionals?