

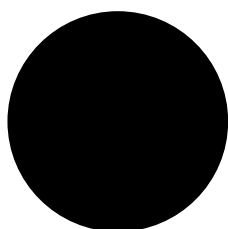
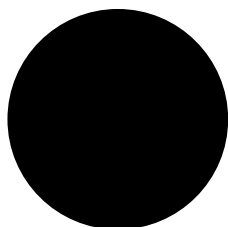
The Ratio

Common Sense Controls For Executive
Pay And Revitalising UK Business

nef is an independent think-and-do tank that inspires and demonstrates real economic well-being.


We aim to improve quality of life by promoting innovative solutions that challenge mainstream thinking on economic, environmental and social issues. We work in partnership and put people and the planet first.

nef (the new economics foundation) is a registered charity founded in 1986 by the leaders of The Other Economic Summit (TOES), which forced issues such as international debt onto the agenda of the G8 summit meetings. It has taken a lead in helping establish new coalitions and organisations such as the Jubilee 2000 debt campaign; the Ethical Trading Initiative; the UK Social Investment Forum; and new ways to measure social and economic well-being.



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'Such essays cannot await the permanence of the book. They do not belong in the learned journal. They resist packaging in periodicals.'

Ivan Illich

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Foreword

Business does not have to be business as usual. I work in a co-operative, which is an enterprise that is owned by and run for its members, rather than external shareholders. We are businesses based on the idea of sharing and we are growing in number – there are over five thousand independent co-operatives in the UK, with over twelve million members.

The idea of sharing has always been implicit in economic action, from the early guilds, to the very term 'company' whose origin is in the sharing of bread – 'con panis' – at table between master and apprentice. It is only in more recent times that business and the markets they operate in are understood as activities where the winner takes all. As night follows day, the result is that, across the UK, inequality is now at its highest since records began. One half of the UK population now owns just one per cent of the wealth. A generation ago, they had 12 per cent.

The co-operative movement has been exploring how we can rebuild an economic agenda based on fairness. Equality is one of the values that links co-ops around the world, from every one of the communities that produce your fairtrade chocolate through to every one of the co-operative banks across Europe (who, post credit crunch, now hold 20 per cent market share of EU banking). We have launched a mass campaign and public petition, backed by **nef** (the new economics foundation), calling on government to support action to share ownership and wealth in a co-operative way by: encouraging business to share profits with staff, customers and communities more widely; promoting community ownership as one way to save lifeline services, such as village shops and pubs, and enable people to take action on housing, arts, sport, land, finance and green energy; and cutting red tape

so that it is as easy to start a co-operative as any other form of business.

Co-operatives UK has supported this enquiry by Andrew Simms and David Boyle at **nef** as we wanted to explore how businesses could give all involved a wider share of ownership and wealth. Their proposal – the Ratio – goes to the heart of fairness, by arguing for measures that make it far more transparent for everyone to see who gets what slice of the cake. After all, if you think that fairness is just motherhood and apple pie, as any mum knows, just try dividing up the pie unequally between children and watch what happens.

The theme of our second Co-operatives Fortnight, in 2011, is on sharing and in 2012, the United Nations will launch an International Year of Co-operatives. These all contribute, along with the themes of this persuasive and elegantly argued report, to the growing recognition that there are now better ways to do business.

Ed Mayo
Co-operatives UK

Introduction

This report was written for Co-operatives Fortnight 2011 to explore pay inequality in the workplace, and look at the social and economic damage it causes. It also makes recommendations for how we can begin to change the counterproductive culture of high differentials in pay.

It covers the issue of the widening gap between pay at the top and bottom of corporations, the effect that has on society and the economy, and the effect it has on the companies concerned. In particular it covers how the ratio between the bottom and the top might be used in order to bring more pressure to bear, both moral and practical, on the problem.

One of the central concerns of the co-operative movement is to distribute more evenly the benefits of economic activity. Their relative success during the recent banking crisis and ensuing economic recession is testimony to the greater resilience of more fair and equal models of corporate governance. But, whilst the co-operative sector is enjoying a renaissance, a greater creeping inequality continues to spread more widely in the corporate sector, bringing with it a range of economic and social costs, and dysfunction. This report suggests how we might begin to reverse that tide.

Andrew Simms & David Boyle
July 2011

1. The divided workplace

“More unequal societies have worse health and lower life expectancy, more people suffering from drug problems and mental illness, rates of teenage births, obesity and violence are higher, and more people are in prison... It is hard to escape the conclusion that the high levels of inequality in our societies reflect the concentrations of power in our economic institutions. The institutions in which we are employed are, after all, the main source of income inequality.”

Kate Pickett & Richard Wilkinson,
social epidemiologists and authors of *The Spirit Level*.



The divided workplace

Our places of work provide us with many things: income, a social life and an environment in which we pass much of our lives. On a day to day level, however, it is less usual to think of the workplace as the dominant driver of inequality, and one which generates huge costs for society more broadly. Yet, especially in countries like the United Kingdom and the United States, this has become a prime feature of corporate organisation.

The pay gap in Fortune 500 companies grew by a factor of ten between 1980 and 2007, as the recession driven by the banking collapse was beginning.¹ Before the financial crisis, boardroom pay among the FTSE 100 index companies rose each year consistently far ahead of average wage rises, and way above inflation at 16 per cent, 13 per cent, 28 per cent and 37 per cent in the year before the consequences of multiple economic misjudgements were felt. This

happened in spite of the fact that there was little if any evidence to support the existence of a meaningful relationship between executive high pay and company performance. High pay was, if anything, more a reflection of the 'dominant bargaining position' that executives found themselves in.²

In spite of political focus on public sector executive pay, it is vastly outstripped by private sector remuneration. In the USA, the 20 top paid executives from listed companies were paid 40 times more than their non-profit counterparts and 200 times more than the highest paid government employees.³

In the UK, the rising gap in workplace pay coincided with the privatisation of many industries and public utilities, and the demutualisation of many financial service providers which had been run for the benefit of member-owners. Significantly, the 'disproportionate influence' of the financial sector is thought, over many years, to have driven the huge increases in executive pay.⁴ The 'demonstration effect' of high pay in banking appears not only to have exerted a magnetic stretching of pay in other areas, but contributed significantly to unsustainable house price inflation by pulling prices at the top of the market much higher.



The divided world

These impacts from the rise of finance in relation to the economy have had global impacts. The deregulation of finance since the late 1970s has accompanied a negative redistribution of the benefits of economic activity. For example, in the 1980s, the share received by those living in absolute poverty from a notional \$100 worth of global economic growth was already an unimpressive \$2.20, but a decade later that share had shrunk to just \$0.60c.⁵ The world has experienced not the promised wealth 'convergence' of economic theory, or even the famous trickle down. Instead there was a 'flood up' of wealth, from poor to rich.

Free of the shackles of office at the International Monetary Fund, its former president, Michel Camdessus, who both presided over

and aggressively promoted financial deregulation, commented in his retirement speech in 2000 that:

"The widening gaps between rich and poor within nations, and the gulf between the most affluent and most impoverished nations, are morally outrageous, economically wasteful and potentially socially explosive? Poverty will undermine the fabric of societies through confrontation, violence and civil disorder."

Better late than never, some might say, but a shame that the economic model in which he placed so much faith had pushed those "morally outrageous, economically wasteful and potentially socially explosive" gaps ever wider. Between the top and bottom fifth of all countries, the gap has grown from 3:1 in the early nineteenth century, to 30:1 in 1960, to nearly 80:1 now. This, though, is separate to the growing inequalities also within countries.



The costs of inequality⁶

Inequality damages people and imposes significant costs on society. It also makes it harder to tackle some of our most pressing challenges. In unequal societies people die sooner, are more prone to obesity and a higher proportion of children die in infancy. Conversely, mental illness is less likely where society is more equal. More equal societies suffer less abuse of illegal drugs, their children do better at school and have higher levels of well-being according to measures used by Unicef. Levels of trust, vital for well performing firms, are higher where equality is greater, and society less harsh and punitive, with lower homicide rates, less experience of violence among children and a smaller proportion of people being imprisoned. Positive self-reinforcing feedbacks seem to correlate with greater equality and the opposite appears true for higher inequality.

So much for the social and economic benefits of equality, but another range of issues comes into view as well. Economic growth fuels climate change. But, where rich countries are concerned more growth *per se* does not raise our levels of health or well-being. Yet we cannot continue to increase our levels of consumption,

driven again partly by inequality, which fuels status competition and consumerism. Where these behaviour patterns are strong it becomes harder to gain public support for action on tackling climate change, again reinforcing a destructive spiral. In **nef's** report *The Great Transition*⁷ calculations were done on the likely impact on economic growth for the UK of committing the country to necessary reductions of carbon emissions in the run up to 2050. Growth was reduced presenting the challenge of how to pay for key public services. But by also introducing measures that moved the UK to levels of equality found in Denmark, and in the process reducing the cost of social ills dramatically, we were able to compensate for the loss of GDP. Consequently, redistribution proves a far more effective tool at tackling both social and environmental problems.



The great mistake: how money fails to motivate

Many things created the circumstances in which executive pay rose to previously unimaginable levels: the rising power of finance, the loosening and loss of corporate governance models more prone to the equitable distribution of benefits, the closed self re-inforcing world of the globe-trotting CEO. Perhaps greatest of all, though, is the seemingly unchallengeable notion, etched into 'common sense' economics, that you get what you pay for. And, if you pay more, you will get more from top bosses. The only problem with this untouchable article of faith in business management, is that it is doubtful.

In his book *Drive: The Surprising Truth About What Motivates Us* Daniel Pink cites research summarising the findings from 128 experiments.⁸ The consistent outcome observed was that, "tangible rewards tend to have a substantially negative effect on intrinsic motivation". Writing earlier, the psychologist Alfie Kohn comments that: "Not a single controlled study has ever found that the use of rewards produces a long-term improvement in the quality of work. Rewards usually improve performance only at extremely simple – indeed, mindless – tasks, and even then they improve only quantitative performance."⁹

In a now famous experiment, quoted by Pink, a group of economists from the Massachusetts Institute of Technology, the University of Chicago and Carnegie Mellon were funded by the Federal Reserve Bank of Boston to observe the influence of financial incentives. What they found astonished many. Rewards worked well in only very limited circumstances when the tasks in question were simple, ‘mindless’ and mechanical. The moment that any other cognitive skills were demanded, even rudimentary ones, the influence of a financial reward not only failed to incentivise better performance, it made things worse.

“In eight of the nine tasks we examined across the three experiments,” observed the researchers, “higher incentives led to worse performance.” Their findings were corroborated by separate research at the London School of Economics which found that, “financial incentives can result in a negative impact on overall performance.”¹⁰

From MIT, to the Federal Reserve system and the LSE, here was ‘the establishment of the establishment’, as Pink put it, coming up with findings to contradict their core philosophy. Using pay to reward and motivate senior executives, and often disproportionately compared to the contributions of other staff, was found not only to be divisive, and socially damaging with real costs attached for the wider community, it was also economically useless and actively damaging for the individual on the receiving end of the remuneration committee’s largesse.

Experimental results on high pay as a disincentive for performance have been in the literature for decades. But it is yet to cross over into mainstream business practice, which has huge disadvantages for investors which need, as a result, to know which companies have genuinely effective pay policies.



Runaway high pay

The recent report of the *High Pay Commission* puts this into perspective.¹¹ Trends towards ever widening pay gaps are continuing.

Over the decade that Labour was in government, income at the top grew by 64.2 per cent, while an average earner saw a 7.2 per cent rise. Most recently, the chief executives of the top FTSE 100 companies, who set a pattern that is broadly emulated elsewhere, earned an average of £4.2 million in 2009–2010, or 145 times the average wage. The financial sector account for one third of the 0.1 per cent at the very top of the pay scale. Unless remuneration habits change, by 2020 their pay will have reached a level 214 times greater than the average. Should this trend continue unabated, by 2030 the UK will have returned to Victorian levels of inequality.

While take home pay fell during 2010 in the UK for the first time in 30 years, boardroom pay rose by an estimated 55 per cent in the FTSE 100 and 45 per cent in the larger FTSE 350. Average wages rose just 2 per cent, below the rate of inflation.

Research by Income Data Services (IDS) revealed the degree to which financial incentives to top executives fail to relate even to the most basic measures of corporate success. In 2010, while the FTSE 100 rose by 14.5 per cent, executive bonuses rose by over a third, their share option gains by over 90 per cent and long term investment plans (LTIPs) by over 70 percent. “It seems the days of earnings restraint by FTSE-350 directors were short-lived. It is as though the recession never happened,” said Steve Tatton, editor of the *IDS Directors Pay Report*, “It stands in stark contrast to the coalition Government’s concerns about pay fairness and calls for senior executives in the public sector to accept pay cuts.”¹²

This leaves us with a picture of the UK scarred by high and rising inequality. Large scale unemployment and low pay sit uneasily beside high and rising executive remuneration. The most recent (2010) summary of the Annual Survey of Hours and Earnings (ASHE), from the Office for National Statistics revealed 271,000 jobs with pay less than the national minimum wage, a rise of 33,000 on the previous year.¹³ Alongside that several chief executives are enjoying pay levels at several hundred times the median national wage:¹⁴ **Bart Becht**, CEO of Reckitt Benckiser: **702 times** the median national wage; **Frank Chapman**, CEO of British Gas: **1,081 times** the median national wage; **Mick Davies**, CEO of mining company Xstrata: **1,042 times** the median national wage;

Martin Halusa, CEO of Apax Partners: **502 times** the median UK wage; **Bob Diamond**, CEO of Barclays: **1,042 times** the median national wage.

Something has gone wrong, both economically and socially. The idea that any individual's intrinsic worth or economic contribution could be subject to such widely diverging financial rewards appears insupportable. Economist Ha Joon Chang uses the example of comparing two bus drivers, one based on the safe streets of Stockholm, one navigating the more chaotic traffic of New Delhi, or Mumbai. The former will be paid hundreds of times more, for an easier job requiring fewer driving skills. Why?



The challenge: how to reward real contribution

But, going further still, when different metrics are applied that attempt to capture the social benefits of the contributions made to society by different professions, some startling inversions of current practice can be revealed.

Using a tool called Social Return on Investment, **nef** found that pay and the actual social and environmental value of work can be inversely related. The study *A Bit Rich* concluded that:

- Leading City bankers on salaries of between £500,000 and £10 million destroy £7 of social value for every pound in value they generate, whereas...
- For every £1 they are paid, childcare workers generate between £7 and £9.50 worth of benefits to society.
- On a salary of between £50,000 and £12 million, top advertising executives destroy £11 of value for every pound in value they generate, but...
- For every £1 hospital cleaners are paid, over £10 in social value is generated.
- For a salary of between £75,000 and £200,000 tax accountants destroy £47 of value for every pound in value they generate, yet...

- For every £1 of value spent on the wages of waste recycling workers, £12 of value will be generated.¹⁵

Not only does there appear to be an urgent need to reverse the widening pay gap, but also to produce a more rational basis upon which to decide remuneration. Public attitudes are shifting decisively in favour of action. In evidence to the High Pay Commission, Liane Hoogland from the University of Sheffield cites a ComREs survey for the BBC showing strong support for lower incomes to be higher, and higher incomes to be lower. A more recent survey commissioned by the Institute for Public Policy Research found 82 per cent in favour of government intervention to close the pay gap.¹⁶

Yet resistance to change is deeply entrenched. In the aftermath of the bank crisis, John Varley, then Barclays' chief executive, reacted in horror to the suggestion by a BBC Radio 4 interviewer that some parameters should be put around pay and bonuses awarded to bank staff. It would "interfere with the market," he said, despite the fact that the banking market had at that stage been interfered with in the form of a public bail-out, or it could not have survived.

Audience eyebrows raised when Digby Jones told an audience at the Hay Festival in 2011 that his move from the private sector to become head of the Confederation of British Industry led to a move from a comfortable salary to one which was "appallingly" lower. What constituted an appalling level of pay, asked a member of the audience? With unemployment high and thousands of public sector jobs being cut, Jones apologised profusely. It turned out that hard times, for him, had meant going from £600,000 per year, to just £250,000 per year. Perhaps it was a joke, but revealing nevertheless about levels of expectation and senses of entitlement in the higher echelons of business. What can be done to return common sense to executive pay and reduce inequality?

This report is not concerned with the level of executive pay in itself, but with the widening gap between pay at the top and bottom of companies, and between the top and bottom of society. This gap is usually expressed as a ratio, and the next sections look at the history and practice of the ratio between bottom level and top level pay,

and how it might be used in future to draw more attention to the problem – and to exert some pressure on the level of CEO pay.

The co-operative spirit

One way forward is to promote mutualism in the workplace. The evidence is that, when employees are also owners of the business, then more of the rewards will come in their direction rather than being reserved for directors and the most senior managers. A 2011 survey by Co-operatives UK found that only six per cent of those co-operatives that replied operated with a maximum pay ratio, but half start all staff members on the same pay and 35 per cent distributed profits to members in the form of a bonus or dividend.

Most of the larger co-operatives, according to the survey, organise their staff on a team basis, which is the same way that a range of innovative businesses like Semco or WL Gore organise. There is impressive evidence from General Electric's Durham aero engines plant in the USA of how successful an egalitarian team-based organisation can be.¹⁷

Clearly it is not practical, at least as things stand, to expect all businesses to envisage an entirely mutual future. But if they are all not going to become co-operatives, then we need – for the reasons set out above – to find ways in which the corporate world can provide some of the benefits of mutualism, by sharing the rewards of their business more generously and equally with employees.

2. Practice so far

We have seen how the issue of the pay gap, between the highest and lowest paid, can have a significant and destructive effect on both corporate and national life. We have also lived through a period when that all important ratio – between the lowest and highest paid inside so many organisations, and within society as a whole – has increased steadily in size. There is a parallel debate about the size of CEO pay packets, and about directors' pay, just as there is about what kind of performance-related pay is appropriate, if any. This report is specifically about the ratio, and how it might be used to provide a more powerful impact on our national debate.

Our argument is that, no matter what the complications of CEO pay are in any given company, the ratio has a power to reveal important information about that company to potential investors, customers or employees which almost no other metric can do. If the ratio is compressed, it tends to reveal a company which is well run, and managed for the long-term. It reveals a company prepared to make efforts to work alongside stakeholders.

If, on the other hand, the ratio is extreme – and it can be as high as 1:1,000 or more in some American companies – then it tends to reveal organisations with an unhealthy fixation on combative and competitive leadership, with a blindness to the need for co-operation among its own staff, and a contempt for its lower-paid employees. It reveals a short-term outlook.

No ratio will do this unambiguously. The meaning of the figures will depend on the size of the company, on the make-up of the CEO pay package and, above all, on the kind of people they employ. But, nonetheless, it has a revelatory power which ought to be more widely available.

One of the reasons executive pay has become so uncontrolled and excessive is that the restraining power of shareholders has been so underused. Providing the ratio as a revelatory tool for shareholder activists, as well as for the day-to-day information for institutional investors, may be a means by which shareholders might be emboldened to act more effectively.

There have certainly been signs of shareholder interest in CEO pay as an issue, as a result of which a whole range of major European companies have put a 'say on pay' resolution down for future annual general meetings.¹⁸

But that requires some kind of consensus about precisely what the ratio should cover, and how in practice it might be made more transparent. The ratio is not a new idea. It comes with a history and some recent developments:

1. Traditional business ethics

The banker John Pierpoint Morgan, founder of JP Morgan, used to say that nobody at the top of a company should earn more than 20 times those at the bottom (a bottom-to-top ratio of 1:20). That was widely understood by many companies for most of the twentieth century. These are not new ideas.

The Royal Navy, which was sensitive about its own equitable culture, especially after the embarrassment of the Invergordon Mutiny against pay cuts in 1931, had for many years a ratio of lowest-to-highest of 1:8.

Successful manufacturing company Scott Bader Commonwealth was once a conventionally run, profit-maximising business. Now it has no shareholders and the maximum differential between highest and lowest paid is 1:7. A democratic members assembly made up of staff committed to the firms ethos holds the board to account, in line with their founding principles

2. The Hutton Review

The journalist and author Will Hutton was commissioned by the UK government to look at the fair pay problem in the public sector, after controversy around the six-figure pay packages and bonuses of a number of chief executives of public organisations, including

local authorities and quangos. One of the possible policies he was asked to consider was a limit in the public sector of a bottom-to-top ratio of 1:20.

He rejected this on the grounds that it was not helpful in such a diverse public sector. Sticking too closely to a 1:20 ratio would mean that the pay of the CEO would be determined according to what kind of staff were employed, rather than by the principle of 'due desert' that Hutton sets out in his report.¹⁹

His 2011 report does argue that the ratios should be published and available for scrutiny, so that – although there is no limit – unexpectedly broad ratios will then have to be explained. But he suggests that these are not the bottom-to-top ratios, but median earnings-to-top, because that would be less variable according to the kind of junior staff employed.

3. The USA

One reason why Hutton opted for a ratio of median earning-to-top was because that was the formulation adopted by the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 in the USA, which forces listed companies to disclose precisely that ratio. The Dodd-Frank ratio includes salary, performance pay, allowances, in-kind benefits and contributions to pensions, though the details remain controversial in the USA.

It does not include the kind of benefits that are available to all employees, including contributions to group insurance schemes and medical saving accounts. Medical insurance contributions would certainly make it hard to then compare with other countries. At present, the average median earnings-to-top ratio in the USA is 1:5.4 but it can be over 1:200 or more in the biggest companies.²⁰

The political significance of this is that there have already been moves in Congress to use this ratio to give preferential tax status or government contracts to companies with a ratio of less than 1:100. That was also the benchmark for government contracts under the Patriot Corporations Act 2008.

4. The European Union

The European Commission has not so far recommended revealing any kind of pay ratio. It recommends that listed companies have regulatory regimes for directors' remuneration, and that individual salaries, bonuses and stock options should be disclosed. Both the Netherlands and Sweden have gone further and now require boards to give shareholders a vote on their remuneration and policies.

The Company Act 2006 in the UK requires directors' pay packages to be revealed in a remuneration report which is open to a shareholders' vote. In practice that means that directors must liaise with shareholders in advance to make sure the report is going to pass. The German Appropriateness of Management Board Remuneration Act also gives shareholders the right for a 'say on pay', though this is not binding on the management.

The European Commission's best practice set out in March 2009 also suggests some kind of system for 'clawing back' pay in the event of failure.

5. Whole Foods

The American supermarket chain Whole Foods has always organised its executive pay according to a pay ratio of bottom-to-top, and they are now the most prominent company in the world to do so. The ratio was originally set at 1:8 but, two decades on, when the sales have increased to over \$8 billion, the ratio cap has been shifted to 1:19. That means that nobody at Whole Foods is allowed to earn more than \$650,000.²¹

"Is this cash compensation too low to retain top executives?" asks Whole Foods co-founder and CEO John Mackey. "Apparently not, because Whole Foods has never lost to a competitor a top executive that we wanted to keep since the company began more than thirty years ago."²²

6. People Express

Whole Foods is certainly not the first. One of the most prominent companies to operate a pay cap based on a ratio was the pioneering budget airline, People Express. The management and founders had a strong belief that companies with compressed ratios are more

effective than those where the pay ratios are higher, and the airline had a meteoric rise from its launch in 1981.²³ But the purchase by People Express of Frontier Airlines and others during 1985 put an intolerable strain on the finances of the company and they sold out to Texas Air Corporation in 1986.

Other US companies operating a ratio cap at that time included the ethical ice cream manufacturer Ben & Jerry's, which began with a cap of a bottom-to-top ratio of 1:5.

7. Church Investors Group

The powerful Church Investors Group in the USA have their own distinctive approach which they believe is more important than the size of individual pay packages. Their ratio is between the chief executive and the average pay of the lowest ten per cent of employees, which they argue should never be higher than 1:75.²⁴

Faith investors are among the most important forces who might be involved in policing any pay ratio. The Interfaith Center of Corporate Responsibility, also in the USA, was among those activists that began a recent series of shareholder resolutions on executive pay, including the famous vote at the telecoms giant Verizon, which went to a recount in 2007.

8. Ethical investors

Few ethical investors ask about pay ratios because, at present, these do not have to be published, at least in the UK. But the ethical investor research service EIRIS does register whether companies have large gaps between directors' and employees' pay. They also ask whether the highest paid in the company are paid more than 25 times UK average earnings.

They also ask companies whether bonuses are linked to ESG (environmental, social and governance) risk management systems, which they say are increasingly recognised as linked to long term financial stability.²⁵

9. Mondragon

The famous network of more than 200 linked co-operatives in the Basque region of Spain has an explicit set ratio between bottom and

top. The original ratio was no more than 1:6, as a deliberate way of forcing managers to raise pay if they needed a pay rise themselves. This lasted until 1980 since when the ratio has grown to about 1:15 as a means of tackling the problem that too many managers were being lured away out of the co-ops by higher pay elsewhere. Now pay is also set according to a range of measures including productivity and absenteeism and measures of how well staff members get on with other people (which constitutes 20 per cent of the pay decision). Salaries are called *anticipos*, because they are intended to be seen as advances on future profits. The Mondragon example is interesting now because of the collaboration that began last year between the Mondragon co-ops and the US Steel Workers Union which is intended to launch similar co-ops in the USA.

10. The UK co-operatives movement

Co-ops in the UK have a range of different ways of deciding how to pay people, but some of these are deliberately organised with the pay ratio in mind. The training co-op Zebra Collective has a flat management and pay structure, and pay is decided according to how much training and how much administration staff members do. In the wholefood wholesaler Suma, all staff are paid around £25,000. Others, like Co-opportunity, have equal basic pay but pay a large dividend based on a series of weighted factors which differ between individuals.

3. Which ratio to choose?

There are at least two major practical problems about transparent pay ratios.

The first is the problem which influenced Will Hutton in his report on public sector pay.²⁶ This is that pay ratios – and in particular the simplest pay ratio of bottom-to-top – is too sensitive to changes at the bottom of the organisation for it to say enough clearly about the top. For example, a supermarket chain that employs large numbers of people on relatively low paid customer-facing jobs is likely to have a higher ratio compared to an investment bank which has long since outsourced their cleaning contract. The danger is then that ratios say more about the employment pattern of the company than about CEO pay, limiting CEO pay to something that is determined primarily by the sector they are in.

This is true, but it did not prevent Hutton from recommending that organisations reveal their ratio – not for regulation but for explanation.

More worryingly, there is a risk that a highly public ratio might actually encourage companies to outsource more functions simply to keep the executive pay grades higher. One partial solution to this problem is that any ratio should include the pay of contract staff, which would also encourage companies to contract service companies which pay the Living Wage.

The second problem of ratios is the extreme complexity of stock options and pension rights. There is a dilemma here: excluding these is to risk shifting CEO pay even further in this direction so that it is hidden from the transparent ratio; including them risks deeply complicated rules which will not apply to every company.

Pension rights are particularly difficult to include. The employer contribution rate can simply be offset against the employees pension contributions, so it makes sense to exclude both, as the SEC does in the USA. Nor is the cash equivalent transfer value much use as a guide for the calculation either. This depends on rights that have already been accrued, terms of service, age and other details, which makes it hard to compare accurately.

This pension data is also usually owned, not by the company, but by the pensions schemes, and companies would have to buy this information from them in order to calculate their own ratios.

There are no perfect solutions to these problems, or any other single number which sums up corporate pay. But the alternative to ratios which is now widely used on both sides of the Atlantic – the principle of transparency – is equally flawed in this respect. Transparency by itself may also have another serious disadvantage. It is possible to argue that pay transparency has precisely the opposite effect in practice than was intended.²⁷

The first disclosure rules in the USA were enacted in 1992 and expanded after the Enron and Worldcom scandals in 2006, and have been in force during the most egregious increase in CEO compensation. One explanation is that transparency has allowed CEOs to leapfrog each other, by giving them the crucial information which drives pay inflation, rising in the USA from five per cent of average annual corporate earnings in 1993 immediately after the disclosure rules to an average of ten per cent of company earnings in 2003.²⁸

The ratio is a potential solution to this problem. It provides pay transparency without encouraging leap-frogging by envious CEOs.

There are at least three possible ways of calculating a common ratio:

Lowest to highest or top-to-bottom

This is the most obvious and the common sense way of calculating the ratio. It also maximises the impact on people because the ratio is between real salary figures and not averages, which are harder to read and imagine.

The disadvantage, as we have seen, is that a bottom-to-top ratio is extremely sensitive to changes in staffing at the bottom of the company. It may even encourage companies to outsource more of their lowest paid staff, although this may be unlikely and, in any case, attract opprobrium. It is not the ratio that has been enshrined in US law, which is a disadvantage because comparisons with US companies will be made more difficult.

Median earnings-to-top

This is known in the USA as the *compa-ratio*, and it provides a comparison between the CEO's pay and the midpoint of the company's pay range. The advantage of adopting this is that it is already enshrined in US law, which means that direct comparisons can be made with companies across the Atlantic. It also means that small changes in the way the staff is composed will have less of an impact on the ratio.

The disadvantage is that it takes the attention away from the lowest paid in the company. The median point may not also be a figure that will command instant recognition among the public. It requires interpretation and will therefore have less impact. It is also much harder to calculate because it means that everybody's salary must be computed in the company before the ratio can be announced, including their pension rights in a comparable way.

Nor does the median-to-top ratio avoid the problem that it depends on the kind of staff the company employs. The satellite communications group Inmarsat has an average salary as high as £119,000, which is why their median-to-top ratio is only 1:19.²⁹ This makes real comparisons extremely hard across the different companies involved.

Average of lowest tenth to highest

This is the compromise position advocated by some investor groups in the USA, chosen because it combines the advantages of both. The problem is that it also combines the disadvantages. Although it puts the emphasis back onto the lowest paid in comparison with the highest, it does so with a complex formulation which seems unlikely to capture the imagination of the public unless it is very widely used.

4. What next?

The publication of the crucial ratio between lowest and highest paid in every public company would encourage debate about pay and corporate responsibility. It would, we believe, kickstart a more informed debate about what kind of pay gap is acceptable and what is simply divisive and inflationary. It would also have a healthy effect on both fairness and equity in the UK, and on the companies themselves. One of the more surprising revelations, shocking even, is the absence of any evidence to support and justify high pay ratios, compared to the large body of evidence concerning the costs of inequality. We believe that the burden of proof should shift, so that companies operating a ratio above 1:20, or even 1:10 (this is the debate we need to have), would need to show how the economic and social benefits of doing so outweighed the costs.

Our recommendation is that every public company should be required to reveal this, and also companies seeking government contracts which are over a certain size. The sooner we can make this happen, the sooner it will start drawing investors' attention to what are the most important and relevant aspects of corporate pay. While disclosure of size of CEO salaries, as happens now, may simply tempt remuneration committees into greater levels of excess, disclosure of the ratio can potentially shame or guide the corporate world into more equitable arrangements – or to explain why they are genuine exceptions.

We also believe that this will be good for the companies themselves. It will allow them to row back the levels of greed and excess that have prevailed over the past decade. That alone will save them on average around five per cent of their annual revenues (if they are to return to 1993 levels of CEO pay) which they are paying so inefficiently at present.

It will also require them to take some account of a measure of equity that we have known for some time is also an indicator of corporate success. Exactly how that success might be measured requires further research, but companies that had a lower pay gap, as revealed in their ratio, are demonstrably better corporate citizens, with longer time horizons and a better understanding of the value of their own staff. We also know there is a link between high quality work and pay equity within companies.³⁰ In a **nef** report *The Good Jobs Plan*³¹ a number of conditions are outlined that might optimise both the experience and effectiveness of work. They relate to income, security, amount, satisfaction and their relationship to sufficiency, community and environmental sustainability.

Three things need to happen now in order to launch the ratio into national debate, but also to embed it in a wider understanding of the issues.



Legislate to make disclosure of their pay ratio compulsory for UK public companies

Although companies would, of course, be free to publish their median earnings-to-top pay ratio, the crucial figure is the simple bottom-to-top ratio. This is the ratio which has the simplicity and the power to capture the public imagination. Even the median-to-top ratio can produce some eye-watering ratios (Tesco's was 1:900 under Terry Leahy).³² But these are formulations the meaning of which are not immediately apparent in the way that the bottom-to-top ratio is.

We propose that the legislation does not just require disclosure, but that the ratio should be published on the front of the annual report in a common and comparable format. At a future date, we will launch a debate about whether it should be published on all products and publications of public companies.

In order to make sure this does not provide a further impetus towards outsourcing the lowest paid staff, we propose that the ratio should include the pay of all contract staff as well – which will

provide some encouragement to employ contractors which pay a Living Wage.

Political parties and policy-makers will need to be convinced that the ratio is the logical next step, and a more effective next step, than the simple disclosure of salaries that we have seen over the past decade or so. The argument is that disclosure of salaries encourages leap-frogging; disclosure of the ratio encourages equity.



Embed the ratio in a Charter of Responsible Pay

By itself, the ratio risks a kind of tokenism. Single metrics do not create change by themselves. It makes sense, therefore, to include the ratio in a Charter of Responsible Pay which can be endorsed by investors and employers organisations, and will need to be drafted partly by them – because it will be pressure from investors that will force companies to sign up to the precepts of the charter. We need to encourage a situation whereby companies that do not sign up are asked difficult questions by investors about why they have not.

The charter might include a maximum acceptable bottom-to-top pay, aware that there may be reasonable exceptions to this, but which can be explained by the companies and organisations themselves. It could also include:

- Transparent executive pay processes.
- Binding provisions for shareholders to have a ‘say on pay’ for CEOs and directors.
- Non-inflationary pay – companies need to be responsible for the social and inflationary effects of their executive pay.
- Employee representatives on the remuneration committee.
- Bonuses linked to environmental, social and other risk factors.
- The possibility of pay clawback for failure to balance bonuses for success.

- No hiring bonuses or golden parachutes. If new CEOs are not committed to the future, they should not be hired.
- Stock options must be available to all staff at the same price.



Launch a campaign for better management

For too long, campaigns against corporate greed and ever-widening pay ratios have tended to be defensive and negative. They have been campaigns *against* rather than campaigns *for* equity, or anything else. That needs to change.

It needs to change partly because having a compressed pay ratio is not just a good thing ethically. Nor is it just a better way of motivating staff and providing greater equity in society, with all the economic benefits that will bring. It is also a sign that a company is sensitively, fairly and imaginatively run, that its management and board understands the role that all their staff can play, and that collaboration inside and outside the company is as important to their success as competition. It is a sign of a company that is more flexible, faster moving, more imaginative and more successful.

It is our contention that a more effective corporate form is emerging based on these ideas. Many of these will be co-operatives, but some will simply have a more co-operative spirit that understands the need to include staff and use their resources more effectively. In time, these companies will push aside the kind of corporate dinosaurs that minimise the pay of their lowest and maximise the pay of their highest echelons, a sign of fatal inflexibility and short-term thinking. They will do so because they earn more money, waste less on leadership fantasies and are more successful.

But this is not yet widely understood, either in the corporate or policy world, and there needs to be a campaign to speed the process along. The faster this process takes place, the more successful and imaginative UK business is going to be. To get there we need to encourage shareholders to use their power to encourage more

equitable pay structures, to vote down unacceptable remuneration packages and to use their power to remove, where necessary, the chairs of remuneration committees.

The transparent ratio and the Charter of Responsible Pay are both means towards this objective. They need to take place within the context of a wider debate about corporate behaviour that emphasises the benefits and inevitability of change, rather than simply complaining about the injustice of the current situation.

Appendix

The myths the realities... (An extract from *The Independent on Sunday*, 15 May 2011³³)

'Big money is needed to get the best chief executives'

That assumes most are brought in, when 59 per cent of CEOs in the FTSE 100 were already at the company for five or more years.

'Being a CEO is risky, so they need to be compensated'

Hardly. Only six CEOs left FTSE 100 companies in 2009, a turnover rate of 6 per cent, which is less than half the national average.

'Big pay packets are linked to business success'

What about the bumper pay for bankers that caused the crisis? Over the past 10 years, CEO pay has quadrupled while share prices have fallen.

'Big bonuses mean better results'

Not necessarily. Research suggests performance-related pay works 50 per cent of the time – and bonus culture didn't stop bankers leading us all to crisis.

'Without big pay packets, executives will be lured abroad'

Only one FTSE 100 company has had its chief executive officer poached by a rival in the past five years – and that was by a rival British firm.

'Our high pay is in line with other leading countries'

It is significantly higher than the rest of Europe – it is less than in the US, but its CEO pay is 170 per cent higher than the rest of the world.

'Highly paid people at the top boost a company's success'

Having a pay gulf between staff at the top and bottom of a company can damage personal and corporate relations. Just look at how popular bankers are now.

'Top earnings have always risen faster than average wages'

Until 30 years ago, the gap had been decreasing. From 1949 to 1979, the proportion earned by the top 0.1 per cent decreased from 3.5 per cent to 1.3 per cent.

'Top earnings rise at the same percentage rate as average pay'

No. The earnings taken by the top 0.1 per cent increased by 64.2 per cent in the past decade, while average pay went up by just 7.2 per cent.

'Attempts to regulate CEO pay would be bad for the economy'

When you pay disproportionately high rewards in one sector – such as finance – it is harder to attract good graduates into other vital areas of work.

About the authors

Andrew Simms is an author, activist and Fellow of **nef** (the new economics foundation). He was **nef**'s Policy Director for over a decade and founded its programmes on climate change, energy and interdependence. Described by New Scientist magazine as “a master at joined-up progressive thinking,” he was co-author of the groundbreaking Green New Deal report and coined the term ‘Clone Towns’ to describe the impact of chain stores. He is author of *Ecological Debt: Global Warming and the Wealth of Nations* (2009); *Tescopoly: How One Shop Came Out on Top and Why it Matters* (2007); was co-editor of *Do Good Lives Have to Cost the Earth?* (2008), and author, with David Boyle, of *The New Economics: A Bigger Picture* (2009). His new book with David Boyle published in 2010 is, *Eminent Corporations: the Rise and Fall of the Great British Corporation* and includes a history of the tragic oil company, BP.

David Boyle has worked for **nef** variously since 1987, writing and editing, developing new projects, launching the timebanking movement, advising on the future of money and volunteering and most recently participating in research on localism and the future of public services.

David is the author of a range of books about money, change and the future, including *Funny Money*, *The Tyranny of Numbers*, *Authenticity* and *Money Matters*. He also writes history books.

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The Great Transition

Photo: Joel Sternfeld



The Great Transition is a growing movement finding new ways for everyone to survive and thrive through financial crises, recession, climate change and the end of the oil age.

Securing the Great Transition is at the heart of all of **nef**'s work. But meeting the challenges we have identified needs new approaches. The Great Transition is a growing movement of individuals and organisations who recognise that creating a different world is necessary, desirable and possible.

At its heart is an emerging new economy built on well-being, social justice and the inescapable need to learn to live within our available biosphere. This calls for experiment, innovation and bold action by government, business and civil society. By working together to make change happen we believe we can make the Great Transition.

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