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Dear Mr Gray

Response to "A Long-Term Focus for Corporate Britain, A Call for Evidence"

About One Society

One Society Works in partnership with the Equality Trust, to secure policy and practice that reduce inequality. One Society draws inspiration from *The Spirit Level* and other evidence of the adverse social and economic impacts that excessive income inequality has on all levels of society. Our previous work includes the Equality Pledge, signed by 75 MPs in the current parliament across party lines (including the Secretary of State for Business, Innovation and Skills).

One Society is a non governmental organisation (NGO)

Introductory remarks

One Society is pleased to have the opportunity to respond to this consultation. Due to One Society's focus on income inequality, we have responded only to questions in section 5 ("Director's Remuneration").

We welcome this review, and in particular are pleased to see a recognition of the relevance of directors' remuneration to long-term performance of companies and the economy. We are also pleased to see reference to the need to put "responsible shareholders back in the driving seat by giving them the information they need to understand the companies that they own and the power to act on it"[1].

We would be pleased to discuss our responses with you.

Responses to Questions:

11) What are the main reasons for the increase in directors' remuneration? Are these appropriate?

1 BIS: "A Long-Term Focus for Corporate Britain, A Call for Evidence", page 5

There is strong evidence that director's remuneration is *not* significantly correlated to performance. For example:

- A report published in July 2010 by pay consultants MM&K and corporate governance group Manifest showed that FTSE 100 CEO pay remuneration rose by 5% to an average of £3.1m since 2008, while earnings per share fell by 1% over the same period.[2]
- A more stark picture was provided in a survey by Incomes Data Services, published October 2010, which showed FTSE 100 directors pay rise by an average of 55 per cent in a year, compared to stagnating company values.
- The lack of correlation between performance and pay is widely recognised. For example, Cliff Weight, a director at pay consultants MM&K, said: "*Many performance related pay schemes appear designed to satisfy the chief executive and in fact offer little incentive for anything above just adequate performance*"3.

There is an increasing recognition that executive pay *is* driven by an "arms race":

- This problem is recognised in the recently published interim report of the Hutton Review of Fair Pay, comissioned by HM Treasury: "*Chief executives have become treated as business super-stars drawn from an ever narrower potential pool of potential talent for which companies have to pay the going rate. And even if these defects were eliminated, benchmarking between firms locks them into a kind of arms race, offering increasing remuneration to their chief executives in order to keep up with competitors*"4.
- The following quotation sums up the situation: "*Mark Burgess, Legal & General's head of equities, accuses consultancies of stirring up "a compensation arms race". Certainly the pressure they put on all companies to be in the top-quartile of pay rates has been hugely damaging, not to mention mathematically impossible.*"5

We note that executive pay levels do not appear to be set with reference to the earnings of the company's employees (either lowest pay or a media level). Indeed, the ratios between directors' and employees' pay have increased: "*Pay dispersion has widened over the last decade. This trend has been most pronounced among public listed companies: in 2009 median pay for FTSE 100 chief executives has risen to 88 times UK median earning and 202 times the national minimum wage, up from 47 times and 124 times respectively in 2000*"[6].

This increase in inequality is a problem for company performance : high pay is often excused by claiming that it is necessary for performance (an argument that is not supported by evidence, see above and below); however, those who seek to excuse high pay ratios rarely refer to the demotivating effects of low pay and perceptions that pay ratios are unfair. There is compelling evidence that the demotivating and stressing effects of inequality affect employee mental and physical health. These health problems and associated sickleave impact on company performance. As the DoH-commissioned Marmot Review of health inequalities pointed out: *"It is estimated that inequality in illness accounts for productivity losses of £31-33 billion per year, lost taxes and higher welfare payments in the range of £20-32 billion per year, and additional NHS healthcare costs associated with inequality are well in excess of £5.5 billion per year."*[7]. In other words, businesses that seek to improve director's performance by participating in the top pay arms race (despite the paucity of evidence for the efficacy of this approach) risk

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2 Manifest/MM&K: *Executive Director Total Remuneration Survey* 2010: http://www.mm-k.com/survey1.html. For summary see http://www.guardian.co.uk/business/2010/jul/05/executive-pay-rises-shares-fall

3 "Executive pay rises while shareholder earnings fall, says MM&K survey"; *The Guardian*, 5 July 2010 (http://www.guardian.co.uk/business/2010/jul/05/executive-pay-rises-shares-fall)

4 *Hutton Review of Fair Pay in the Public Sector: interim report*, 2010 page 4. (http://www.hm-treasury.gov.uk/d/hutton_interim_report.pdf)

5 "Put paid to pay consultants"; *The Times,* 9 January 2010 (http://www.timesonline.co.uk/tol/comment/columnists/article6981589.ece)

6 *Hutton Review of Fair Pay in the Public Sector: interim report*, 2010 page 8. (http://www.hm-treasury.gov.uk/d/hutton_interim_report.pdf)

7 Marmot et al, *Fair Society, Healthy Lives*, 2010, The Marmot Review, page 18

reducing *whole company* performance.

Beyond the impact of pay and pay ratios on the individual companies that collectively make up "UK plc", national income inequality, (of which pay inequality is a major component) creates economically-costly social problems including poor physical and mental health (referred to above), low educational performance and social conflict. Comparing an Index of Health and Social Problems with national income inequality for 23 developed countries, we find an extremely strong correlation coefficient (0.87, with strong statistical significance (p value of less than 0.01))[8]. The same source also presents evidence that there is a *causal* relationship between inequality and social problems[9]. In addition, there is a wealth of other evidence showing similar relationships[10]. In contrast, some economically-useful attributes for modern economies, such as innovation (measured by patents per capita) are correlated to greater equality of income[11].

12) What would be the effect of widening the membership of the remuneration committee on directors' remuneration?

There is evidence to suggest that widening the membership of remuneration committees to include company staff (or their representatives) who are not part of the management team would be beneficial. This is partly due to the 'cooling' effect of introducing the scrutiny of people who do not see high pay as 'normal' and who are therefore likely to give thorough consideration to the case for particular pay levels. Also relevant are the performance benefits likely to be associated with a workforce perceives top pay is fairer and more accountable (see above).
A survey of the studies of employee involvement and improved performance is provided in John L. Cotton's "*Employee Involvement: Methods for Improving Performance and Work Attitudes*", (1993, Sage).

13) Are shareholders effective in holding companies to account over pay? Are there further areas of pay, e.g. golden parachutes, it would be beneficial to subject to shareholder approval

Since the duty for British Companies to produce a remuneration report (introduced in 2002) and undergo an advisory vote at AGMs, there has been increased shareholder interest in pay issues, which indicates that transparency is having some positive impact in increasing scrutiny .

However, there is less to the activism of investors than meets the eye. The shareholder advisory service PIRC objects to approximately a third of remuneration policies of UK listed companies, but even high-profile cases of investor disquiet about top pay do not see most investors vote against management. In 2010, "the largest shareholder rebellion seen in the City this year"[12] about top pay at Tesco, saw 47% vote against management or abstain.

Figures suggest that shareholder assertiveness may not actually be on the rise. In 2007 an average of 4% of votes were cast against remuneration policies, actually falling to 3% in 2008 before a surge to 17.5% in 2009, (a result heavily skewed by the opposition to bankers' pay.) The first quarter of 2010 shows a return to previous levels, and it is thought that the 2010 average will only show a slight rise on the 2007-8 figures.[13]

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8 Wilkinson & K Pickett; *The Spirit Level",* page 20 (figure 2.2), source statistics shown on p 310
9 Ibid, p182-196
10 See for example Hills et al, *An Anatomy of Economic Inequality in the UK*, 2010, Government Equalities Office;

11 Wilkinson & K Pickett; *The Spirit Level",* page 311
12 "Tesco AGM: Nearly half of shareholders fail to back boardroom pay policy"; *The Guardian*, 2 July 2010 (http://www.guardian.co.uk/business/2010/jul/02/tesco-agm-shareholders-reject-pay-policy)
13 "Shareholders' anger grows but bosses' pay deals are safe – for now"; *The Scotsman*; 15 July 2010

One Society believes that it would be beneficial if companies were required to report pay ratios to investors and others (through the annual report). The author of this submission has spoken to investors keen to engage with companies on the issue of pay ratios but frustrated by lack of information.

There is precedent for mandatory pay ratio disclosure. In the United States, Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires companies to report Chief Executive pay, the organisation's median pay and the ratio between these. There has been criticism in the US of this requirement, but the criticism mainly focuses on the alleged difficulty of calculating median pay (One Society believes that this criticism is overblown, and will recede as measurement practices are put in place; we also note that there is no such issue with calculating the ratio between top pay and *bottom* pay, and that even those who criticise the median pay element do not criticise the principle: "*"We're not debating the concept of disclosure – we think it's a good thing," said Larry Burton, executive director of the Business Roundtable, which represents chief executives of the biggest US companies*"[14]).

We also note that when the Companies' Remuneration Reports Bill (Private Members Bill) was debated in the Lords on 24 April 2009[15], all the members who spoke (Con, Lab and LD) supported the principle of the Bill. The Bill proposed that "the ratio between the total annual remuneration of the highest paid director or executive and the total annual average remuneration of the lowest paid ten per cent of the workforce".

One Society believes that votes on pay (both top pay and ratios) should be *binding*, rather than advisory, in order to promote the principle and practice of accountability.

14) What would be the impact of greater transparency of directors' pay on the:

- linkage between pay and meeting corporate objectives
- performance criteria for annual bonus schemes
- relationship between directors' pay and employees' pay?

For reasons outlined above, we suggest that greater transparency of directors' pay (and the ratio between this and employees' pay) would be beneficial to all of the above criteria.

If you have any questions about this submission, please feel free to contact me.

Yours sincerely

Duncan Exley
Campaign Director

(http://thescotsman.scotsman.com/market-reports/Terry-Murden-Shareholders39-anger-grows.6420476.jp?articlepage=1)

14 "US pay law branded "logistical nightmare"": *Financial Times*, 30 August 2010 ("http://www.ft.com/cms/s/0/977211ac-b461-11df-8208-00144feabdc0.html#axzz1ApCtylhY)

15 Lords Hansard 24 Apr 2009 : Column 1704 (http://www.publications.parliament.uk/pa/ld200809/ldhansrd/text/90424-0003.htm)