Hutton Review of

Fair Pay

Hutton Review of Fair Pay in the public sector:

interim report

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Foreword

We live in a period of tough and profound choices. When the economy grew there were few concerns about fairness in general and fair pay in particular; a rising tide lifted all boats. Now the economy is under pressure how fairly society distributes its benefits and burdens has suddenly become more salient. The need for fairness is now on everyone's lips, especially over the divisive issue of pay. Are the highly paid deserving of their pay in an era of austerity – or being unfairly spared privations visited on the rest of society?

Citizens want to be assured that their scarce and hard earned tax pounds are being spent wisely; that public spending intended for public benefit is not being squandered on excessive senior executive pay. There is a parallel concern whether high private sector executive pay is really deserved and producing the performance that is said to justify it. Indeed, it might be part of the reason for the crisis through which we are living. The financial collapse and subsequent recession had multiple causes, but one was undoubtedly bankers taking ever higher risks in the quest for ever higher bonuses: behaviour that seems to continue despite the bail out. Private sector pay and practice necessarily impacts on public sector pay: through competition for particular professions and individuals, through a greater role for private providers in delivering public services, and through the adoption of private sector pay practices. Some may argue that what private firms pay their executives is a matter for shareholders alone. This may be true, but only up to the point when the wider economic and social ramifications require the Government to be concerned.

Principles of fair pay are urgently needed, both to guide those who determine pay and to reassure the wider public that such principles exist and are being followed, certainly in the public sector over which the government has direct control. But such principles are impossible without a more robust definition of fairness than just a disposition towards reasonableness. In the report I define fairness in pay as the due desert for discretionary effort which delivers desired results; reward should match the employee's actions and contribution. Embedded in this notion is proportionality: due desert should rise proportionally as individuals make more of a contribution. It should not rise limitlessly; there are boundaries not least because no one individual in any organisation can argue that every improvement is due to his or her actions alone – thus the case for some multiple of top to bottom pay. But fair pay also involves an attitude towards luck and process. Individuals should be paid for their effort and contribution, not for the luck of being in the right place at the right time. And pay should be determined by an impartially fair process.

I have been asked by the Prime Minister and Chancellor to analyse whether a 20 to 1 pay multiple might be justified as promoting fairness in public sector pay over: and to what extent it might contribute to changed social norms about pay in the private sector. Public sector pay has been the object of intense and growing scrutiny, not least because of some well advertised incidents of salary packages that are very much higher than those in the immediate past. High executive pay in the public sector is paid for by tax and licence fee payers. They have a right to know if such pay is justified, whether it accords with their priorities and above all whether it is fair. At present the arrangements that might provide such assurances are scant.

There are widespread myths. In general pay at the top of the public sector, even allowing for the value of defined benefit pension schemes (which in any case are under review by Lord John Hutton's Independent Public Services Pensions Commission), is lower than in comparably sized listed companies and further reduces as comparator organisations grow in size. Yet many public organisations pose no less managerial challenge, even if they are different in character, than their similarly sized private sector counterparts. Nor has the growth in top pay been anything like as fast.

By contrast over the last twenty years senior executives of listed private companies have witnessed something close to a revolution in compensation, especially in the top 100 companies. British PLCs have enthusiastically followed the American example of offering senior directors compensation packages in which ever higher cash bonuses, stock options and generous grants of shares have played an increasing part. Shares now constitute more than half of CEO compensation; a generation ago equity based compensation was very small. A number of 'rational' explanations have been offered for what has happened, notably better to align directors' and shareholders' interests, while some countervailing forces, notably trade unions, have declined. Either way, the result has been the biggest rise in senior executive pay in modern British economic history.

Good historical data that goes beyond the last ten years is hard to find, but on the basis of one reasonably indicative sample of twenty top firms that the Review publishes it seems that chief executive pay for Britain's leading listed companies rose by around eight times between 1986 and 2010, suggesting an even faster rate of increase than in the US over a comparable period, even if the ratio of top to bottom pay is still lower in the UK. It is increasingly doubtful whether this has been proportional to increases in performance, or even reflects the real demand and supply for executive services. 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 – with equity-based incentives appearing to ofer a relatively costless way of pushing executive pay ever higher, without necessarily guaranteeing the accompanying performance increases. Any one company that tries to stand out against the trend risks losing its top people and inviting markets and investors to view it as second rate. Little, not even greatly improved corporate governance, seems capable of creating more rationality or slowing the pace of increase. As Director General of the CBI, Richard Lambert said earlier this year, chief executives' compensation has become so extravagant that they risk becoming aliens in their own land. There is widespread scepticism whether this degree of increase in executive pay is fair.

However, as this report details, that does not mean there are no concerns in the public sector, which is itself increasingly heterogeneous in its compostion. There are signs that in parts of the public sector that have more autonomy – universities, foundation trusts and arms length bodies in general - there are significant upward pressures on senior pay and, before the pay freeze, some increasingly eye-catching settlements. Some of the arms race character of top private sector pay determination is also showing signs of reproducing itself in the public sector, recruiting for top posts where there is growing concern that the talent pool is insufficiently large. On the occasions when the public sector does recruit from the private sector it has to pay significantly more for staff, creating knock-on inflationary pressures. Moreover the range of top pay deals across the public sector has little coherence or relationship to the public's priorities in generating genuine public value. Without clear principles there is every prospect of the rise and potentially irrational range in senior pay settlements continuing – which will clearly accentuate already growing concerns about pay fairness.

This Interim Report articulates clear principles of fairness. It then develops some options for how those fairness principles could be operationalised in the public sector in a way that its clear and transparent to all. The Senior Salaries Review Body has called for a process in public sector pay determination that matches best private sector practice, ensures that no executive is paid more than necessary and is transparent. It is right to do so. But transparency and high quality corporate governance need some reference principles otherwise they have too little on which to bite. There is thus at the very least a case for publishing and monitoring consistently calculated multiples between top and bottom pay, explaining changes from year to year and within the public sector having to explain those cases where the ratio exceeds the chosen upper benchmark. There is more work to be done to understand the options and trade-offs from varying approaches and measures, including whether a 20:1 multiple for the public sector would be an appropriate benchmark. But the basic concept of tracking pay dispersion within certain boundaries is surely where concern with fair pay must lead. And what is true for the public sector is also true, with necessary adjustments, for the private sector.

Fairness is the necessary if insufficient condition for organisational performance. There is abundant evidence that fair organisations are high performing organisations. Organisations are above all social affairs that depend on everyone pulling together to achieve common ends; front line workers and those in the middle of the organisation need to be motivated and engaged if the organisation is to perform. They will do so much more if they feel they work for a fair employer, and that their managers belong to the same committed ethos. The benefits of fairness extend to the wider economy and society. Britain, like every other advanced modern economy, needs a high performing public sector not just to ensure value for money for taxpayers but because there is a co-dependence between private and public. The public sector is the co-creator of wealth, from public investment in science, education and skills through to sustaining the 'soft' infrastructure that underpins private innovation and investment. It is the custodian of the country's social settlement and preserves law and order. A second or third class public sector can only damage the wider economy and society.

But the public sector walks a fine line. It must create value for citizens by attracting and retaining the most talented who need to receive due desert for their efforts, not all of which can be the non-monetary reward of a sense of public service and duty – otherwise it will become a second class sector of the economy. But equally it has to be vigilant about ensuring value for money. I believe that the fair pay principles articulated in this Review offer a way of walking that fine line – and assuring the public that their public servants are fairly paid, and that if there are examples of high pay they are within clearly understood boundaries. There will also have to be better incentives to encourage performance which needs to be much better measured. Britain deserves a high performing, best value for money public sector that can demonstrate to any citizen that its employees are paid proportionally and fairly for their very necessary efforts. This interim report, I hope, is a step on that journey – and my thanks to the team that have supported me in this Review, and the experts and many others who have contributed.

Executive summary

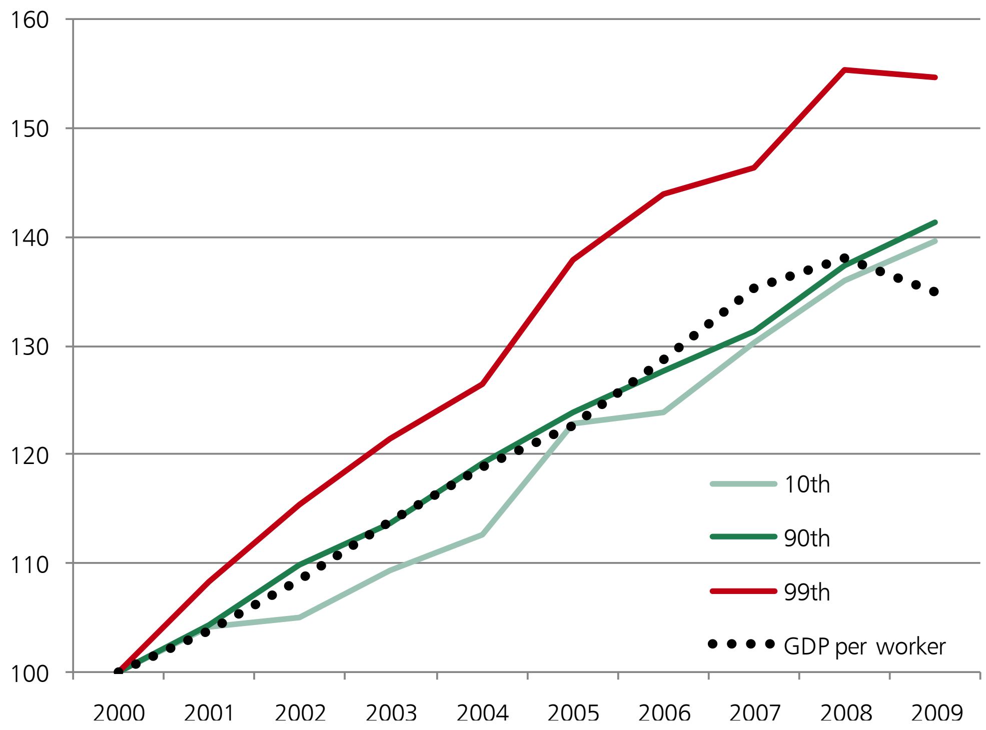
Pay Dispersion in the UK

Pay in the UK is unevenly distributed, and the gap between the top one per cent and the rest of the population has been widening steadily over the last decade.

The Top Pulling Away:

Gross annual earnings of 99th, 90th and 10th percentiles against GDP (indexed, 2000=100)

The top one per cent of earners have seen their incomes grow much faster than other earners, even relatively high earners



Source: Fair Pay Review analysis

Substantial and growing pay inequality poses a serious challenge to society and Government. Do high earners deserve such large rewards? And is it fair that a wide and growing gap should exist between the pay of those at the very top of the income scale and the rest of the population? In the current economic environment, the issue of fairness becomes all the more salient, particularly with regard to high earning public officials.

This Interim Report contributes to this debate, by:

- Defining a clear and principled approach to fairness;
- Setting out the current position on executive pay and pay dispersion;
- Analysing recent trends and drivers of executive pay in the private and public sector;
- Exploring the role of a maximum pay ratio in containing pay dispersion; and

- Establishing the case for a fairness framework for public sector pay.

Defining Fairness and Fair Pay

Fairness should not be understood as simply about equality of outcomes. Individuals' due desert will vary according to their differing contributions and choices, though the influence of chance and external circumstances should be minimised. Fairness also requires that processes as well as outcomes must be fair.

Fair pay must therefore be proportional to individuals' contributions and set by fair pay determination processes. The value of individuals' contributions will reflect both the weight of their particular posts and their actions and efforts within them.

Proportionality in pay implies limits on pay dispersion: a maximum pay multiple would be one mechanism for maintaining those limits.

As well as being morally desirable, fair pay brings instrumental benefits to organisations, by supporting greater employee engagement and morale, and to society as a whole by helping to avoid inequality traps and assisting social mobility and incentives to productive work.

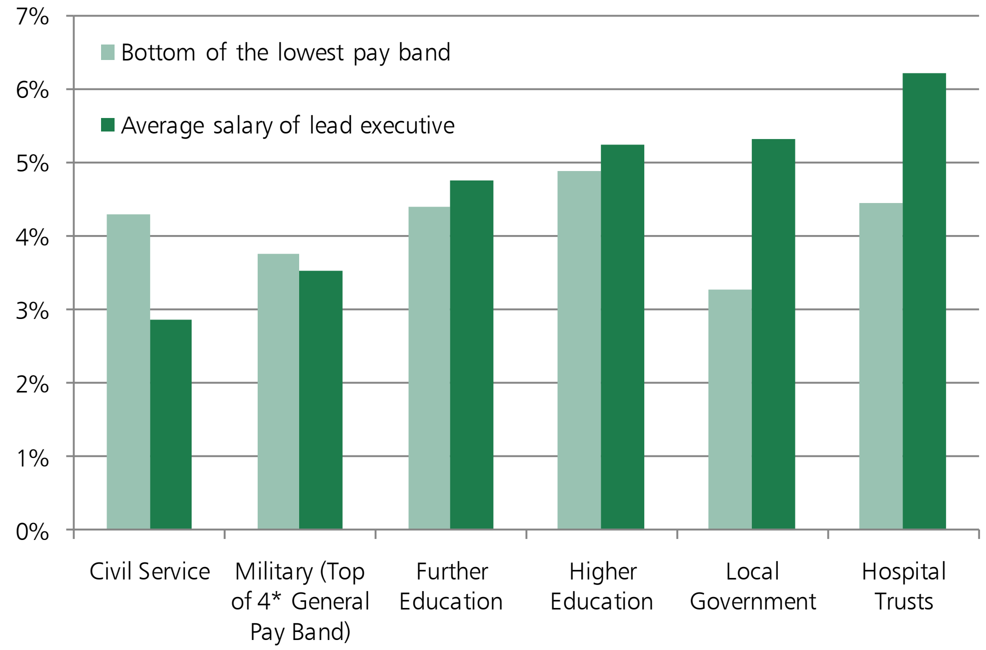
Pay Dispersion and Executive Pay in the UK

Pay in the UK is diverse, and discussions based solely on averages and aggregates are not illuminating. In particular comparisons of average pay figures in the public and private sectors are misleading because they ignore the differences in skill levels and composition of the two workforces. The myth of the overpaid public servant is just that.

Some high level trends can, however, be observed. 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. Pay ratios in the public sector have also increased over the last decade, with pay for top earners in most public sector workforces increasing faster than for bottom earners since 2001.

Average annual salary growth for top management positions and bottom of pay spine for selected workforces between 2001 and 2008

In the NHS, local government and further and higher education, median top salaries have been growing at faster rates than entry level salaries



Source: Fair Pay Review analysis

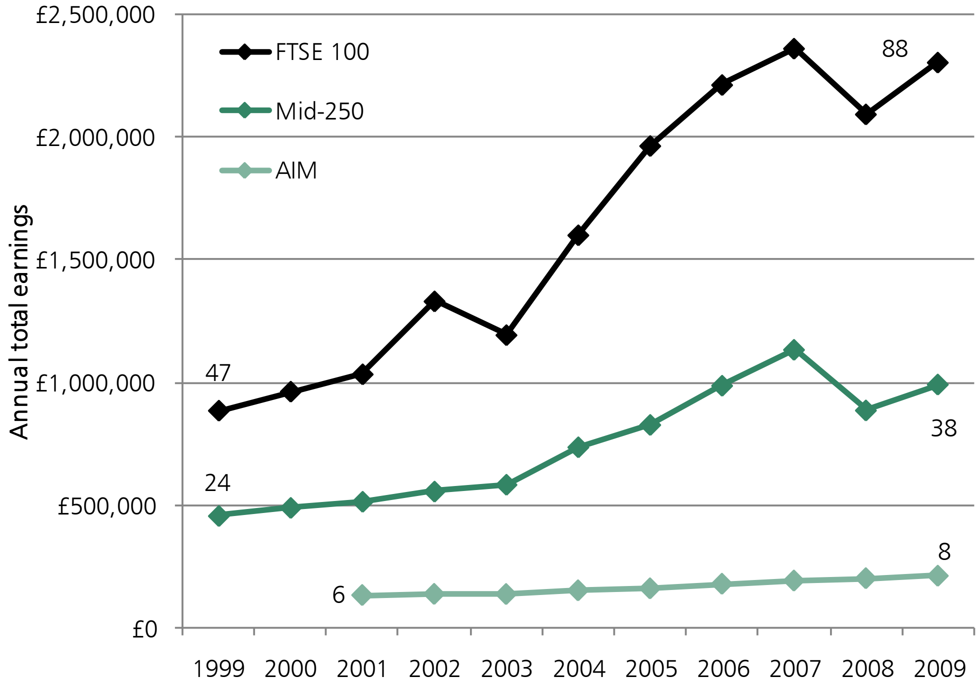
Remuneration of top private sector executives far exceeds pay for senior public servants. Even so, out of a total public sector workforce of around 6 million, estimates suggest that there are at least 20,000 individuals on the public payroll in the top 1 per cent of all earners (earning over £117,523 per annum), of whom over 4,000 are in managerial roles. The majority of these are in the NHS, local government and arms-length bodies.

The Private Sector Context

Since the 1980s, there has been a revolution in executive pay in large public corporations. Median chief executive remuneration in FTSE 100 firms has more than doubled since 1999.

Median total earnings for chief executives of FTSE 100, Mid-250 and Alternative Investment Market firms, 1999 – 2009, with ratios to UK median full time earnings overlaid

The period 2004-2008 saw a huge increase in FTSE 100 and 250 chief executive pay



Source: Fair Pay Review analysis

Much of this increase has been fuelled by the growth in equity-based incentives that have exposed executives to greater personal risk, which in theory justifies higher remuneration to compensate. Growth in firm size could also justify higher pay, as the weight and complexity of executive roles increases. However, executive pay has continued to grow even as firm size has levelled off and there is evidence that the link between compensation and performance is weak. Equity incentives are vulnerable to short termism in stock markets, share price movements (whether rational or irrational) and to manipulation. It is increasingly questionable whether current equity-based incentives represent fair pay.

In recent decades, managerial skills have become more transferable between firms and sectors, widening executives' outside options and allowing them to demand higher pay to stay. Yet more general skills should have also increased supply of potential executives. This does not appear to have occurred and there are justified concerns that firms restrict the pool of candidates for top roles by an excessive focus on 'big name' executives.

The revolution in executive pay has been accompanied by major improvements in corporate governance and transparency over pay in UK firms, intended to increase shareholder scrutiny and management accountability. But even greatly improved corporate governance has only limited executive pay at the margin. In particular, with firms benchmarking against each other, something akin to an arms race over executive pay has emerged. There is a collective action problem, with every firm feeling obliged to pay the going, and rising, rate for executives for fear of destroying shareholder value by signalling to the market that it has hired a below-average leadership team by paying below the market rate. When all firms pay above the average, pay can only spiral upwards.

Executive Markets in the Public Sector

It is important to recognise the breadth and diversity of the public sector: executive pay is being set in an increasingly complex environment of public, private and voluntary sector provision of services. The public sector has a distinctive ethos, however, which is part of the reward of working in public services. But this does not render concerns over pay irrelevant or illegitimate, and public servants' sense of public duty should not be exploited in an effort to avoid paying fair reward.

The public sector has not been strong enough on managing and rewarding performance: more imaginative variable pay options, including team-based pay, should be explored to assure the public that pay reflects performance. Greater complexity and risk in senior roles have exerted upward pressure on pay: in particular, where failure is not dealt with fairly, risks increase and the risk premium is exacerbated.

Markets for public sector executives are relatively closed, with most executives being recruited from within their own sector. An excessive focus on experienced candidates from within sectors has led to pay inflation; narrowing the candidate pool also limits organisations' openness to new ideas and experience. The public sector has not succeeded in nurturing sufficient talent internally, which would reduce the need for costly external recruitment. Recruitment from the private sector is currently limited, but where it does occur it has contributed to senior pay inflation. Recruiting from the private sector brings benefits, but public bodies must be more hard-headed and ensure higher pay is justified by performance.

Autonomy from central Government control is associated with higher executive pay: further autonomy risks fuelling greater senior pay inflation. This may be justified if roles become more complex, but governance arrangements alone are unlikely to be enough to reassure the public that senior pay is fair across the board.

The Role of a Maximum Pay Multiple

The basic concept of tracking pay dispersion within boundaries is where concern with fair pay must lead. There is a strong case for a maximum pay multiple, such as 20:1, which would demonstrate fairness by reassuring public opinion, addressing the collective action problem and benefiting productivity. It would need careful design to avoid harming recruitment and retention, creating perverse incentives and failing to respond to differences between organisations. Key issues of definition would, however, need to be resolved including the elements of reward included within the multiple, the level and base of the multiple, and what flexibility if any should be allowed to exceed the multiple. It may not be desirable to apply a single multiple to all organisations: different multiple norms for different types of organisation may be more appropriate.

Some extreme options can be ruled out at this stage: basing a ratio on the national minimum wage would be too unresponsive to organisational and regional differences in pay, while using mean pay would be too far divorced from the lowest paid and not independent of top pay levels.

Any organisation, public or private, could easily disclose its pay ratio. Disclosure would move the debate on from a populist focus on 'fat cats' to a more sophisticated conversation about desert and the relationship between pay and genuine value creation.

Conclusions

With the economy under pressure, how society distributes its benefits and burdens has become more salient. It is all the more important to ensure fairness. Pay must be proportional to each individual's contribution, and set according to fair processes.

The gap between the top earners and the rest has widened dramatically over the last decade. Public corporations have led this trend, but its across the board performance has not improved enough to justify the pay increases that have occurred. In the public sector pay inequality has also increased. The public needs assurance that higher pay is deserved, especially as public service reform could increase risks of greater senior pay inflation in the future.

A mechanism is required to contain widening pay dispersion, and to reassure the public that pay is fair and so help defend senior public servants from unjustified attacks. Negative public perceptions of senior public sector pay risk undermining the attractiveness of public sector executive jobs and the ethos of public service leadership, which in turn would impair the public sector's capacity to discharge its vital role in the economy and society as a whole.

The public sector should, however, be cautious about simply adopting 'best practice' from the private sector, as private sector pay practices and corporate governance have not delivered proportionality in pay. Improved governance in the public sector, as recently recommended by the Senior Salaries Review Body, can only be one element of a solution: a comprehensive fairness framework for senior remuneration is required that covers better governance and transparency; disclosure requirements based on a pay multiple; better use of performance pay; and a renewed emphasis on the competitiveness of executive labour markets.

There is also a broader case for private sector organisations to follow the public sector example and at the very least track and report on pay dispersion from year to year in a fully transparent manner. This would allow shareholders and wider stakeholders to monitor pay dispersion, and when it increases to hold management to account for achieving the promised performance.

A maximum pay multiple has much to recommend it as part of a fairness framework, but would need to be carefully designed. In its Final Report, the Fair Pay Review will make detailed recommendations on the definition and implementation of a pay multiple, and will develop other elements of a wider fairness framework.

1 Fairness, fair pay and their benefits

Chapter summary

Fairness is not equality of outcome – rather everyone should receive their **due desert** which necessarily will vary. Due desert means individuals facing the consequences of their choices and efforts, but not being rewarded or punished for brute luck or circumstances beyond their control. This definition of fairness is supported by behavioural studies which illustrate that individuals have a strong propensity to cooperate and share with others, but at the same time want individuals to receive due reward. **Fairness requires fair processes as well as fair outcomes** – to be fair processes must ensure *Dignity*, *Equality*, *Accuracy* and *Legitimacy.*

To be fair, pay must be **proportional to each individuals' contribution**, reflecting both the weight of the post and the performance of the post holder. The processes by which pay determination processes be fair. Proportionality implies **limits on pay dispersion**, which a maximum pay ratio could help to maintain.

Greater pay compression and pay processes that are seen to be fair **improve organisational performance**, by supporting employee engagement, commitment and morale. A range of studies have found quantified improvements in productivity associated with lower pay dispersion.

Beyond the confines of an individual organisation or firm, greater fairness in pay could bring a range of benefits to society as a whole through limiting income inequality, supporting social mobility and social cohesion. Its greatest contribution, though, is to offer incentives for genuinely productive work that creates real economic and social value.

Fairness is crucial in hard economic times – essential to ensure that pain and gain are fairly shared. Government has an opportunity to use the public sector to set an example on fair pay to economy as whole.

What is fairness?

1.1 Everyone is well disposed towards fairness. But equally fairness can be interpreted through peoples' very particular prisms and preoccupations. This elastic notion if not closely defined is capable of being stretched into a range of different definitions and understandings, and then used to justify many different social and political choices. For example, at the last general election the three main political parties all managed to profess a commitment to fairness in good faith despite very different philosophies and programmes.

1.2 This malleability of fairness is something that a review of fair pay must confront. There needs to be a clearly articulated understanding of fairness that can command wide public support, yet which remains robust enough to construct similarly tough guiding principles on pay. In particular, this consensus understanding of fairness needs to reconcile the impulse for goods to be shared equally, while recognising that individuals should bear the consequences, good or bad, of their actions and choices.

Due desert: a middle way between egalitarian and libertarian fairness

1.3 **Fairness cannot simply be reduced to equality of outcome.** In his hugely influential *A Theory of Justice*, American philosopher John Rawls observed that a just society would be indifferent to the circumstances into which individuals were born. Invoking the potent image of a lottery, he argued that every individual's starting position in society was the outcome of a social lottery (their economic, social and political circumstances) and a natural lottery (their genetic and cognitive endowments). Insofar as individuals cannot plausibly deserve these outcomes, making appeals to merit alone is unfair. From this negative premise, Rawls developed his preferred system of justice in which the distribution of economic and social benefits would be guided by the 'difference principle', the notion that inequality is permissible only to the extent that those at the bottom can be said to benefit from arrangements which allow others to be very much richer.

1.4 The assumption that individuals are completely powerless over their own outcomes is open to question. Modern philosophers including Ronald Dworkin, David Miller and Gerald Cohen retain a place for personal agency in their conceptions of fairness, arguing that individual choices do matter and that as a matter of justice they should influence the distribution of 'goods' and 'bads', including pay.[1] This current of philosophy, described as 'luck egalitarianism' holds that policy should therefore be directed at correcting those inequalities of outcome that stem from circumstances over which people have no control – what Dworkin calls 'brute luck' – while requiring that individuals still bear the consequences of choices for which they can be held responsible.

1.5 **This is the idea of fairness as due desert**. Moral philosophers argue that this accords with a deeply ingrained human instinct: we understand that there should be a relationship between intentions and their consequent outcomes, and that outcomes are thus more or less deserving of penalty or praise. We therefore insist that fair rewards (and punishments) are those that are proportionate to people's actions: hence in so many cultures justice is represented by a pair of scales.[2] So just as there is a tariff of proportional punishment to match the offence of the crime, so those who make an effort to exploit their talents and do a good job deserve their proportional reward. Thus the parents of children attending Tidewell School were not prepared to join synthetic media outrage earlier this year when it was reported that Tidewell's headteacher Mike Elms had earned over £200,000 in a year. Ascribing the recent turnaround of a previously failing school to the talents and efforts of the new head, parents took the view that he was worth his hire – that his pay was no more than his due desert.

1.6 These arguments of moral philosophy receive support from a growing mass of behavioural research into our sharing preferences, which show how experimental subjects value intentions and distinguish between earned and unearned rewards. For example, in tests conducted by Matthew Spitzer and Elizabeth Hoffman, people showed a strong preference for equally sharing rewards generated purely by brute luck. If they tossed a coin, they shared whatever spoils equally. But when the experiment was altered so that some people could 'earn' the right to adjudicate how the rewards of the coin toss should be divided up, for example by doing well in a prior test, people then thought it fair if the spoils from the coin toss were distributed more unequally.[3] Other experiments reinforce the message that we human beings differentiate

[1] 'On the Currency of Egalitarian Justice', Gerald Cohen (1989) *Ethics* 99(4): 906-944;'What is Equality? Part 2: Equality of Resources', Ronald Dworkin (1981) *Philosophy and Public Affairs* 10: 283-345; *Principles of Social Justice*, David Miller (2001) Harvard University Press, *Equality of Opportunity*, John Roemer (2000) Harvard University Press and *Luck Egalitarianism: Equality, Responsibility and Justice*, Carl Knight (2009) Edinburgh University Press. For a criticism of luck egalitarianism, see 'What is the Point of Equality' Elizabeth Anderson, *Ethics* 109(2):287-337; 'Fairness, Respect, and the Egalitarian Ethos,' Jonathan Wolff (1998) *Philosophy and Public Affairs* 27: 97-122 and *Justice, Luck, and Knowledge*, Susan Hurley (2003) Harvard University Press.

[2] 'Desert: Individualistic and Holistic' Thomas Hurka in *Desert and Justice*, Serena Olsaretti ed. (2003), Oxford University Press.

[3] 'Entitlements, Rights, and Fairness: An Experimental Examination of Subjects' Concepts of Distributive Justice' Elizabeth Hoffman and Matthew Spitzer (1985) *Journal of Legal Studies* 14(2):259-297.

between deserved and undeserved gains; people choose to punish others for making undeserved gains, even at a cost to themselves.[4]

1.7 These behavioural studies illustrate that individuals have a strong propensity to cooperate and share with others, but at the same time want individuals to receive due reward (or punishment) for their efforts and choices. In the jargon we are 'conditional altruists'. Similar responses can also be seen in people's attitudes towards welfare, where an individual's beliefs about the causes of poverty are a more powerful predictor of their attitudes than whether they themselves are advantaged or disadvantaged. If the disadvantaged are perceived to be disadvantaged through no fault of their own, then support for redistribution increases; if , on the other hand, poverty is attributed to a deficient work ethic or some other factor within peoples' control, then support for redistribution falls among rich and poor alike. These attitudes are surprisingly stable across countries, showing that popular differences in support for welfare systems, for example between Anglo-American and continental European countries, depend less on fundamental differences in attitudes towards fairness, and more on different beliefs about the roots of poverty: Americans believe much more that talent and effort determine success, whereas Europeans see luck, birth and connections as more influential in shaping outcomes.[5]

Fairness and luck

1.8 Yet **the role of luck in determining outcomes cannot be denied**, for luck is pervasive in human affairs. This is the lottery of life, even of being born in the right place at the right time. For example, a sportsman or woman born in the autumn, the beginning of the school year, is more likely to be physically stronger than their younger peers at school and so attract early coaching, getting on a virtuous cycle of early good performance justifying yet more coaching and support.[6] According to an intriguing study by a group of IMF economists, cricketers who had the luck to make their debut on their home ground also did better not only in that initial debut match, but generated a virtuous circle of good performance that lasted throughout their career.[7] Local knowledge mattered, and a good debut makes selectors more forgiving of later poor performance. This is brute good or brute bad luck.

1.9 The contrast to such brute luck is what philosophers have termed 'option luck', the luck that we help make ourselves, and for which we should be held responsible. This can be understood as the knowable risk attached to possible courses of action that we might choose, for example, making career choices fully knowing that the chances of success greatly vary: we may have thrown the dice, but we knew the risks. Where people might reasonably be expected to have taken account of the relative risks of different choices and options, then we recognise that the situations in which they later find themselves are the consequences of their choices: hence these 'option luck' outcomes represent people's due deserts.

1.10 Different views of fairness can thus be shown on a spectrum, as shown in Chart 1.A:. At one extreme there is a libertarian view of fairness – all outcomes can and should be seen as the fair consequence of individuals' actions. All luck is option luck that we make ourselves; there is no disadvantage that cannot be overturned by individual effort and diligence. Nobody should be reproached from taking the full reward of any advantage, nor be expected to share it. The job of government is not to get in the way of this natural struggle. At the other extreme is an egalitarian view of fairness. This holds that all consequences are the result of economic and

[4] 'Are People Willing to Pay to Reduce Others' Incomes' Daniel John Zizzo and Andrew Oswald (2001) *Annales d'Economie and de Statistique* No.63-63. This study, however, found that 'richer' participants who were arbitrarily rewarded cared less about how gains had been made.

[5] 'Equalizing Income versus Equalizing Opportunity: A Comparison of the United States and Germany' Ingvild Almås (2008) *Research on Economic Inequality* 16: 129-156; *Fighting Poverty in the US and Europe: A World of Difference*, Alberto Alesina and Edward Glaeser (2004) Oxford University Press.

[6] *Outliers: The Story of Success*, Malcolm Gladwell (2009) Penguin Books.

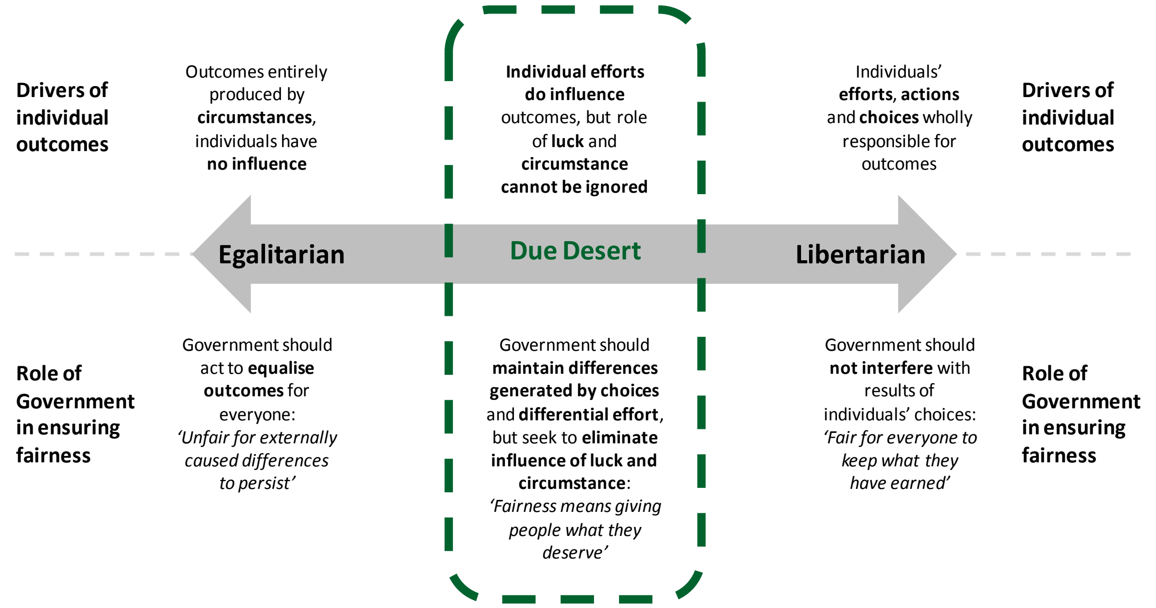
[7] 'What Can International Cricket Teach Us About the Role of Luck in Labor Markets?' Shekhar Aiyar and Rodney Ramcharan (2010) IMF Working Paper 10/22.

social structures beyond any single individual's control so there is no role for personal responsibility or agency. All gains from option luck should be denied; all disadvantage is from brute bad luck. Since human beings are of equal worth, the task of government is to equalise both opportunity and outcomes.

1.11 **The definition of fairness of outcomes adopted by this Review sits between these two extremes.** A range of rewards is fair as the due desert for peoples' diligence, effort and application. Moreover people should get rewarded for the luck they make themselves. However circumstance and brute luck matter. Organisations, like economies and societies, do make a collective and social contribution to success, so reward for any one individual within an organisation should be proportional. Nor should people be rewarded for brute good luck or penalised for brute bad luck. Being in the right place at the right time should not be a determinant of outcomes, but everyone should receive their due desert.

Chart 1.A: The spectrum of definitions of fairness

Due desert sits between egalitarian and libertarian concepts



Fair process

1.12 Fairness is not just about proportional outcomes reflecting individual actions and reconciling individuals to the role of luck. **People also care passionately about the fair or due process by which decisions are reached**, often showing considerable willingness to make sacrifices on outcomes in return for satisfying themselves that processes were fair. For example in a seminal study of responses to arbitration processes, Lind et al (1993) found that individuals rated the fairness of the dispute resolution process so highly that they were willing to forgo as much as $800,000 in return for the chance to participate in an arbitration process that they trusted to be impartial, that treated them respectfully and offered them an opportunity to make their case.[8]

1.13 Current theories of procedural justice set out a range of criteria that a process must meet to qualify as fair. The key qualities of a fair process are:

[8] 'In the eye of the beholder: Tort litigants' evaluations of their experiences in the civil justice system', Allan Lind, Robert MacCoun, Patricia Ebener, William Fesltiner, Deborah Hensler, Judith Resnik and Tom Tyler (1990) *Law and Society Review* 24(4): 953-996. See also 'Procedural Justice and Compliance with the Law' Tom Tyler (1997) *Swiss Journal of Economics and Statistics*, 133(2): 219-20.

- **Dignity** – A fair process must treat all parties involved with respect, including giving all concerned a voice, and the opportunity to make their case;
- **Equality** – A fair process must treat (and be seen to treat) all individuals the same, applying consistent, transparent rules in all cases with no scope for favouritism;
- **Accuracy** – A fair process must take full account of all available information, exhaustively establishing the facts of each particular case;
- **Legitimacy** – Flowing from the above criteria, a fair process must be trusted by all parties to be seeking a fair outcome for all.

1.14 Procedural fairness matters, for if the processes by which outcomes are produced are seen as unfair, then it is highly unlikely that even a distribution based on strenuous efforts by decision-makers to balance competing interests will be accepted as a fair one. There can also be situations in which uncertainties, for example about how much different individuals contributed to a particular result, are such that an outcomes-based judgement on fairness is simply not possible. In these circumstances, procedural fairness, providing a minimum guarantee that morally arbitrary factors will be ignored, is the only form of fairness that is available.

1.15 **A complete understanding of fairness cannot restrict itself simply to a consideration of distributional outcomes. The processes that produce those outcomes are also an indispensible component of determining fairness**.

What is fair pay?

1.16 From these principles of fairness as due desert realised by due process it follows that fair pay must be both:

- **proportional** to each individual's contribution, and
- set according to a **fair process.**

Proportionality

1.17 **Proportionality means that each individual's pay must be** proportional to their value of their contribution. Some would argue that linking individuals' pay only to *caused* outcomes in this way is redundant, and that an organisation should be grateful for success (and willing to pay for it) regardless of how (or by whom) that success was produced. But a pay system that rewarded success however caused would violate the principles of fairness described above; it would allow some individuals to profit from brute good luck – favourable circumstances that they did little or nothing to create.

1.18 Similarly, detaching rewards from the value of individuals' contributions allows some to profit from the efforts and diligence of others. In the great majority of cases, the success of organisations, and the value they create, are the product of a collective effort by a large number of individuals, and fair rewards for that successful value-creation must reflect this collective contribution. Part of the role of a leader is to encourage and enhance the performance of all employees in their organisation, so a good leader should receive credit for the proportion of that collective contribution that his or her efforts and leadership have unleashed. However, there is a limit to how much of wider staff performance can fairly be ascribed to an organisation's leadership (productive work does not all cease the instant a leader leaves); so there should be a limit on how far rewards for collective success can accrue to a single individual or small group. It cannot be fair for a small elite to 'scoop the pool' entirely.

1.19 Pay that is proportional to the value of an individual's contribution should reflect both:

- The nature of the **post** – senior executives managing large organisations will manage greater complexity, have greater influence, and greater responsibility for their organisations' outcomes than a new graduate entrant or junior employee; and

- The performance of the **post holder** – some individuals will make greater efforts than others to put their talents and abilities to productive use.

1.20 Proportional pay is thus likely to consist of two key elements: a fixed salary reflecting the size, complexity and responsibility of the post; and a separate component that varies to reflect fairly how post holders use their position and abilities to contribute to the success of their organisation.

Fair process in pay

1.21 Proportionality alone, however, is not enough. Fair pay must also be pay that is set by a fair process, which satisfies the criteria for procedural fairness discussed above. These require that:

- Pay is set according to a process that allows scope for employees to participate and make their case *(Dignity)*;

- Decisions on pay are based on consistent principles that apply equally to all employees *(Equality)*;

- Pay must be based on a full and accurate assessment of employees' true performance in all aspects of their work *(Accuracy)*; and

- Pay determination is transparent, so that all employees can understand the processes and criteria used, and assure themselves of the independence of pay decisions *(Legitimacy)*.

1.22 It is not human nature for all employees to be fully satisfied with the level of their own pay. However, a pay determination process that meets these criteria for procedural fairness can at least help workers to understand the basis on which their pay is set, and reassure them that their pay is not subject to arbitrary decisions or susceptible to bias or prejudice. Fair process can thus help to address some of the emotional tensions that are inevitably attached to the issue.

Fair pay and the role of the market

1.23 Placing a price on the weight of a role or the performance of an individual is not easy. The best mechanism available for doing so is a free, competitive labour market in which prices respond to scarcity, abundance and consumer (or employer) preferences. A properly organised, competitive market can also meet the requirements of procedural fairness discussed above. Open markets are fora in which individuals are free to participate, with no discrimination except on the basis of the ability to pay. Similarly, in a competitive market prices apply equally to all and are the product of an exhaustive process of price discovery. The legitimacy of free markets is also widely accepted in the absence of an alternative process for determining value.

1.24 Competitive markets can thus be consistent with fairness. Yet the verdict of markets cannot be blindly accepted, for three key reasons:

- Firstly, markets are indifferent to the initial distribution of wealth and resources: the genius of a perfect market is only that it will produce the socially optimal allocation of goods for any given starting distribution. Markets are thus distributionally blind to individuals' initial endowments and to the fairness of any initial distribution. So if the starting distribution is unfair, we cannot expect markets to correct this. Further, given that markets do discriminate on the basis of individuals' ability to pay, an unfair starting distribution will block some individuals' opportunities to participate, undermining the procedural fairness of the market.

- Secondly, markets in practice are often far from perfect, and exhibit a wide range of market failures. This includes labour markets, which are frequently distorted by asymmetries of information and the excessive market power of some actors. Employees, especially managerial employees, are often in possession of much better information about their own work and performance than their employers (an aspect of the 'principal-agent' problem). This can make it harder for employers accurately to judge the price they should be willing to pay for the employees' labour, allowing employees to distort wages upwards. Executive employees can also restrict competition by blurring the distinction between post and post holder and in effect redefining their own roles such that only they are able to fulfil them. This allows them to act as monopolists, pushing their pay up above market-efficient levels, aided by the difficulties that outsiders face in signalling their willingness to fill a given post for a lower wage. Pushing up their own pay may result in executives in effect being paid for the contributions of others, which can also be seen as imposing an external cost on other employees and conferring an external benefit on the executives scooping the pool.

- Finally, there are many goods whose value is not captured in market prices. These include goods such as social networks or pleasant surroundings. Governments in the UK and elsewhere have recently begun attempting to compile indices of 'General Well-Being' alongside traditional economic measures such as GDP. The French Government recently established a commission led by Nobel laureates Amartya Sen and Joseph Stiglitz, with Jean-Paul Fitoussi, to construct such an index, while the UK Government has announced a similar intention. Human Resources experts have long recognised that the intangible benefits of work, such as interesting tasks, pleasant colleagues or a friendly workplace environment, are crucial elements of an employee's 'total reward'. Yet these factors are not captured in market prices, suggesting that the 'market rate' cannot be the final word on the value of employees' labour.

1.25 **Fair pay should correct some of the limitations of labour markets through a renewed focus on pay that is proportional to contribution, and fairness of process.** It should support greater efficiency and a more socially optimal allocation of resources, by ensuring that employers get what they pay for, and pay for what they get.

Fair pay, pay dispersion and pay multiples

1.26 It is clear that fair pay does not simply demand equal rewards for all. Those who through their discretionary efforts produce value for society – innovatorsor entrepreneurs who develop new products, technologies or ways of working – should plainly benefit from that value-creation. However, often the most successful value creation is a collective endeavour. Even the most talented of individuals depends on the support of a network of others and on the presence of the appropriate structures, ranging from the investment in skills and research base to the intellectual property rights framework and public procurement for them to work successfully.

1.27 Innovative new companies benefitting from such structures will owe some of their success to the business ecosystem created by Government and society as a whole. At a deeper level, the architecture of skills and activities that are enabled and valued in the wider economy will also have a profound influence on the ability of individuals to create wealth. For example, billionaire investor Warren Buffet has recognised that his great wealth derives to a great extent from having the brute good luck to live in a country at a time when his particular talents for allocating capital are valued – talents that in other contexts could be worthless. Thus almost all valuecreators owe at least some of their success to the wider environment created by society as a whole. The fruits of that success should therefore be shared in society, rather than accruing disproportionately to particular individuals. Proportionality thus implies some limit on pay dispersion between high and low earners.

1.28 **This points to a role for a maximum multiple between top and bottom pay, as one means of preventing top executives' pay from becoming too far detached from the value of their actual work efforts**. This Review is not aware of any such maximum pay multiple being deployed by the public sector before. But the use of such multiples to limit pay dispersion have had their proponents, notably the management theorist Peter Drucker, and they have been used with success in some organisations.

Box 1.A: Maximum pay multiples: a history

The principle of a maximum bound on inequality or pay dispersion is not new. Writing in classical Greece, Plato famously argued that no citizen should be worth more than four times another, for fear that excessive inequality would undermine the harmony of his ideal polity.

In more recent times, arguments in favour of a maximum pay ratio have been made both on the basis of specific benefits for organisations, and of the wider social benefits of greater income equality. In the 1920s, banker John Pierpoint Morgan capped executive pay at twenty times the pay of junior bank employees, arguing that any greater degree of pay dispersion would be harmful to company morale and hence productivity. Morgan's cap, however, applied only to base salary, not to stock or stock options or other bonus payments.

JP Morgan's approach to pay dispersion has had recent followers. In the United States, Ben and Jerry's ice-cream company initially maintained a 7:1 maximum ratio between the highest and lowest paid employees. This still allowed the company to pay its chief executive up to $150,000 per annum. In 1995 the ratio was abandoned when the company chose an external recruit as CEO, appointing Robert Holland Jr, formerly of McKinsey & Co, on a base salary of $250,000 with a potential bonus of $125,000 plus $180,000 of stock options. The Whole Foods company similarly employed a maximum pay ratio of 8:1 until the 1990s, when it was increased to 14:1. More recently still, the current CEO of retailer Costco has voluntarily capped his pay at $350,000, arguing that wide pay dispersion harms productivity and profitability by alienating lower paid staff.

In the UK, the founder of the John Lewis Partnership, John Spedan Lewis, famously included a maximum pay ratio of 25:1 in the Partnership's original constitution, but with a very particular definition of low pay that was artificially high. This ratio was increased to 75:1 when the constitution was revised in 2000, with the denominator set at 'the average basic pay of non-management Partners', which John Lewis say was lower than the previous definition. However, the salary of the current chair, Charlie Mayfield, was in 2010 significantly below the cap that this ratio would produce. John Lewis also seek to maintain a 'partnership ethos' both through electing five directors and a partnership council and through a profit-sharing scheme, in which all staff receive an equal percentage of their salary as a dividend each year. The John Lewis Partnership argue that this partnership model fosters a high level of engagement and commitment among their staff, contributing to the organisation's overall performance.

Leading engineering and design consultancy Arup follow an analogous model, the group having no shareholders, and being structured as a trust whose beneficiaries are its employees past and present. Arup set great store on fostering a sense of fellowship among their staff, both through employee profit-sharing and by seeking to maintain a maximum pay ratio of 10:1 between the highest and lowest earners (defined as a graduate entrant).

The argument in favour of maximum pay ratios was also forcefully made in the 1970s and 1980s by management theorist Peter Drucker, who 'often advised managers that a 20-1 salary ratio is the limit beyond which they cannot go if they don't want resentment and falling morale to hit their companies'. Drucker took the argument further, arguing that very wide pay dispersion was socially corrosive, even if the number of individuals earning very large multiples of bottom pay were very small. This sentiment has been echoed by investor Warren Buffett, who described pay fairness as 'a statement of our values as a society, of our views of equality and prosperity'.

1.29 There are, of course, other fairness concerns that a maximum pay multiple would not directly address. These include the problems of pay discrimination on grounds of race, gender or disability, issues of regional variation in pay and the question of the minimum level of pay required for a decent and fulfilling life: the 'Living Wage' debate. These wider fairness concerns lie outside the Terms of Reference of this Review, yet the principles of fairness articulated above clearly apply. It is unfair that anyone should be rewarded or punished for the brute luck of having been born male or female, or into any given ethnic or socio-economic background. Fair pay means rewarding equal contributions equally, with clear and accountable processes for ensuring that this is so. And it is fair that all workers should receive some minimum level of reward for their contribution, especially if that minimum is the precondition for dignified participation in a market economy. **The principle of fairness as due desert applies more widely than the issue of pay dispersion and executive pay – though these are the issues upon which this Review has been asked to focus.**

The benefits of fair pay to individuals and organisations

1.30 There is evidence that pay that is both proportional to the value of individuals' contributions and set according to fair processes can improve organisational performance and employee engagement.

Proportional reward and pay compression

1.31 A wide range of academic studies, covering large and small businesses across different sectors, and even sports teams, in North America and Europe, suggest **there is a strong correlation between narrower pay dispersion within an organisation and improved organisation performance.**[9]

1.32 According to this research, not only do wide gaps between top and bottom pay harm performance overall, but wide pay dispersion can have particularly strong negative effects in certain circumstances, many of which apply particularly to the public sector. For example, one study has shown that the more interdependent work tasks are, and the greater the degree of interaction between employees jobs require, the stronger the correlation between pay compression and improved performance. This suggests that large pay disparities are undeserved because outcomes are jointly produced. Another study demonstrates that the negative effect of pay dispersion on productivity is greater in R&D-intensive firms. These firms are both more likely to be collaborative and have employees with sector-specific skills: this limits their outside options and so their ability to leave a firm where pay dispersion is high. As a great proportion of public sector workers have specialist skills and as public sector jobs are often collaborative and interdependent, it is highly significant that these are the circumstances in which pay dispersion is most harmful.

1.33 It can be argued that restricting pay dispersion could harm an organisation by weakening incentives for individuals to seek promotion to the top jobs through good performance. The argument that greater pay dispersion acts as a strong incentive is known as 'Tournament Theory', but the argument has a number of limitations (Box 1.B:). Overall, the evidence on pay compression within organisations leans towards it having more benefits than costs.

[9] 'Product Quality and Pay Equity Between Lower-Level Employees and Top Management: An Investigation of Distributive Justice Theory', Douglas Cowherd and David Levine (1992), *Administrative Science Quarterly* 37(2):302-320; 'The Performance Effects of Pay Dispersion on Individuals and Organizations', Matt Bloom (1999), *Academy of Management Journal*, 42(1): 25-40; 'Pay Dispersion and Workforce Performance: Moderating Effects of Incentives and Interdependence', Jason Shaw, Nina Gupta and John Delery (2002) *Strategic Management Journal*, 23(2): 491-512; 'Dispersion in wage premiums and firm performance', Pedro Martins (2008) *Economics Letters* 101:63-65; 'The Effect of Executive-Employee Pay Disparity on Labor Productivity', Olubunmi Faleye, Ebru Reis and Anand Venkateswaran (2010) Unpublished.

Box 1.B: Justifying pay dispersion: tournament theory

Some economists have argued that high pay dispersion in an organisation can improve performance. 'Tournament theory' describes the benefits that can be produced by an executive pay structure where the pay gaps between different levels of a firm's hierarchy increase exponentially with movement up the hierarchy; the largest pay gap being between the chief executive and his or her immediate subordinates. Pay bands are thus structured like prizes in a sports tournament. The efficiency of the tournament is established on the grounds that it is self-financing: lower-level executives and employees accept lower pay because of the prospects of much greater rewards upon promotion. The high performance of all of the individuals striving for the next 'prize' boosts the overall performance of the firm.[10]

However, this justification for excessive top pay and wide pay dispersion is subject to challenge on a number of different grounds.

- Firstly, it is not clear whether such large pay jumps, alongside dwindling promotion opportunities, are a necessary or desirable way of creating incentives. Tournament theory does not account for the fact that other reward structures may be as or more successful.[11]
- Secondly, tournament theory assumes that firm success can be ascribed entirely to the performance and talent of individuals, ignoring the harmful effects of wide pay dispersion upon teamworking.[12] In fact, large pay gaps between chief executives and their immediate subordinates are frequently associated with poor decision-making and dysfunctional firm leadership.[13]
- Thirdly, tournament theory assumes that competition for promotion among staff at one grade is an efficient way to identify who will be successful at the next, when this is not necessarily the case. More senior posts may require one set of skills whereas competition among subordinates may reward a different skill-set – including more destructive skills in sabotaging peers' efforts as a route to relative success.[14] This backward focus also means that tournament theory has little to say on the behaviour of those who 'win' the top spot of chief executive, and have no further 'prizes' before them. Studies that have analysed the records of such 'superstar' chief executives, find that they subsequently underperform significantly, as well as devoting increased time and energy to private interests outside the firm.[15]

Employee comparisons and judgements of what is fair

1.34 **The key channel through which pay dispersion affects organisations' performance is its impact on staff engagement, motivation and morale.** In the 1960s behavioural psychologist

[10] 'Testing the Theory of Tournament: An Empirical Analysis of Broiler Production', Charles Knoeber and Walter Thurman (1994) *Journal of Labour Economics*, 12(2):155– 79.Most empirical evidence for tournament theory comes from the sports field: 'The Incentive Effects of Tournaments Revisited: Evidence from the European PGA Tour', Ronald Ehrenberg and Michael Bognanno (1990), *Industrial and Labor Relations Review* 43(3):74-88.

[11] 'The Provison of Incentives in Firms', Canice Prendergast (1999), *Journal of Economic Literature* 37(1):7–63.

[12] 'Top Management Team Coordination Needs and the CEO Pay Gap: A Competitive Test of Economic and Behavioral Views', Andrew Henderson and James Fredrickson (2001), *Academy of Management Journal* 44: 96-117. The unwillingness to cooperate when large rewards from promotion are present have also been observed at lower rungs of the firms: 'Incentives for Helping on the Job: Theory and Evidence' Robert Drago and Gerald Garvey (1994) *Journal o fLabor Economics* 16(1): 1-25.

[13] 'Pay Distribution in the Top Executive Team', Lucian Bebchuk, Martijn Cremers and Urs Peyer (2006) Harvard Law and Economics Discussion Paper No. 574

[14] 'The Trouble with Tournaments', Ronald Dye (1984) *Economic Inquiry*, 12:147–149 and 'Compensation and Incentives: Practice vs Theory', George Baker, Michael Jensen and Kevin Murphy (1988) *Journal of Finance*, 43:593–616.

[15] 'Superstar CEOs', Ulrike Malmendier and Geoffrey Tate (2008), NBER Working Paper No. 14140.

John Stacey Adams noted that employees who do not receive their due desert, which Adams defined as comparable pay to colleagues performing similar work, experienced emotional distress which manifested itself as disengagement.

1.35 Exchange theory also posits an implicit trade between employers and employees in which labour is exchanged for remuneration. According to this theory, employees who feel that they do not receive their due desert for their labour will attempt to restore the balance in the 'trade' between themselves and their employers by withdrawing effort and in some cases sabotaging or stealing from their employers.[16] They may also simply end the 'trade' by leaving their jobs, but research by Towers Perrin has shown that public sector employees are far less likely than average to react this way, even when reporting dissatisfaction. According to their surveys, in 2010 as many as 21 per cent of disengaged public sector workers had no plans to leave their current jobs, twice the equivalent level in the private sector. Public sector workers are more likely, therefore, to stay discontented within their organisations, with harmful effects on overall performance.

1.36 Employers should therefore want to maintain the perceived fairness of this exchange, in order to retain the loyalty of their staff and their continued willingness to exchange labour for pay – this is, after all, a trade employers want to repeat many times, not a one-off deal.

1.37 Perceptions of fairness are relative, not absolute, so the comparisons that employees make when deciding whether their own pay is fair will be of great importance. Behavioural studies have repeatedly confirmed that individuals compare their situations on three axes: horizontal (with similar people), vertical (with those better or worse off) and temporal (with their own experiences of the past), and respond noticeably to these comparisons.[17] Individuals' tendencies to look back to their own experience implies that a sense of their condition improving can be highly influential. The evidence suggests that to maintain this sense, improvements must be continuous as individuals quickly become accustomed to their situations: even winning the lottery does not appear to bring long-lasting pleasure.[18] This has important implications for organisations' reward strategies, emphasising the importance of progression and suggesting that individuals may be willing to accept low pay levels in the short term as long as they see a reasonable chance to progress in the future.

1.38 As for horizontal comparisons, some studies have suggested that most employees do not look beyond the boundaries of their own organisation, and instead compare themselves to similar colleagues. In more highly unionised workplaces, however, such as public sector organisations, employees do tend to be much better informed of comparators further afield, while research on social networks has suggested that comparisons can be influential even at three degrees of separation.[19] Horizontal comparisons can be highly emotive and controversial, prompting disputes over whether different roles are comparable (for example, are nurses comparable to teachers, or firefighters to police officers?).

1.39 Horizontal comparisons appear to play out even in the very high compensation of executives; the restless itch to keep up with the Joneses can put upward pressure on executive pay. One study has found that as the number of company chief executives in a given geographical area or membership group (e.g. golf or country club) increases, social comparisons

[16] 'Employee Theft as a Reaction to Underpayment Inequity: The Hidden Cost of Pay Cuts', Jerald Greenberg (1990), *Journal of Applied Psychology* 75(5):561-568.

[17] 'A Theory of Social Comparison Processes', Leon Festinger (1954) *Human Relations* 7(2):117-140; 'Social Comparison Affects Reward-Related Brain Activity in the Human Ventral Striatum', K. Fliessbach, B. Weber, P. Trautner, T. Dohmen, U. Sunde, C. Elger and A. Falk (2007) *Science* 318(5854):1305 – 1308.

[18] 'Lottery winners and accident victims: is happiness relative?', Philip Brickman, Dan Coates and Ronnie Janoff-Bulman (1978) *Journal of Personality and Social Psychology*, 36(8): 917-927; 'Does Happiness Adapt? A Longitudinal Study of Disability with Implications for Economists and Judges', Jonathan Gardner and Nattavudh Powdthavee (2006) IZA Discussion Paper No. 2208.

[19] *Why Wages Don't Fall During a Recession*, Truman Bewley (1999) Harvard University Press; *Connected: The Amazing Power of Social Networks and How they Shape our Lives*, Nicholas Christiakis and James Fowler (2010), Harper Press.

become more intense. Average pay for chief executives of S&P 1500 companies with a social circle of 82 other chief executives (the 75th percentile) was $560,000 higher than for those with a social circle of just 15 chief executives (the 25th percentile).[20] Research on chief executive social networks by has also shown that size of chief executives' social networks was associated with poorer performance – suggesting that chief executives use their networks to further their own interests, to the detriment of firms and shareholders.[21]

1.40 The evidence on the extent to which employees make vertical comparisons, for example to the pay of the chief executive of their firm, is mixed. One study has shown that the chief executive's salary is an important comparator for organisation managers, but that its influence declines the further down the firm hierarchy individuals were.[22] Other evidence suggests that although individuals with high self-esteem are more prone to make upward comparisons, in general employees are likely to be indifferent to those vastly more senior or skilled than themselves, making median pay a more relevant benchmark for junior staff.[23]

1.41 Vertical comparisons do, however, retain enormous emotional power, especially in the messages they send to employees about the nature of the workforce and the relationship between senior executives and other staff. During the recent recession, one reason firms succeeded in avoiding industrial unrest even while cutting wages, hours and jobs was that they were able to convince their employees that senior executives were 'sharing the pain', by accepting wage cuts or bonus freezes. **As long as the economic outlook remains uncertain and austerity is the order of the day, organisations will need to convince their staff that sacrifices are being fairly shared to avoid the damaging perception that senior executives have become 'aliens', totally divorced from their junior employees.**

Fair pay process and employee engagement

1.42 As well as responding to the perceived fairness of the level of their pay, employees are also highly sensitive to the fairness of pay determination processes, as surveys conducted by human resources specialists, employers and trade unions bear out. Key procedural factors identified as influencing employees' perceptions of fair reward include clarity over criteria for determining pay and employers' expectations of their workers, objective pay setting processes, transparency over pay decisions, and channels for the representation of employees' views.

1.43 In turn, there is strong evidence linking employees' perceptions of procedural fairness and levels of employee engagement (Chart 1.B:). Academic and human resources literature emphasises the role of pay processes as part of a 'bundle' of management practices that contribute to fostering employee motivation and engagement: pay is not the only factor, but is a key channel for communication between management and staff.

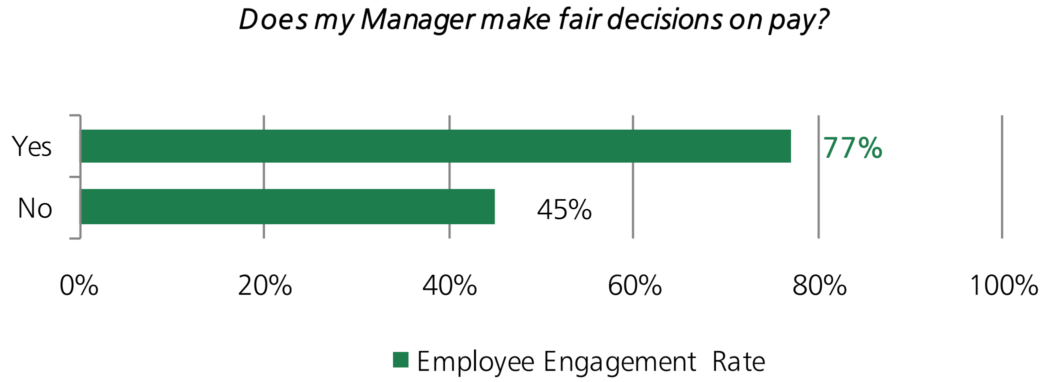
[20] 'The Effect of Social Pressures on CEO Compensation', James Ang, Gregory Nagel, and Jun Yang (2009) SSRN Paper, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1107280

[21] 'From Fiction to Fact: the Impact of CEO Social Networks', Thomas Kirchmaier and Konstantinos Stathopoulos (2008), LSE Financial Markets Group Discussion paper 608.

[22] 'Overpaid CEOs and Underpaid Managers: Fairness and Executive Compensation', James Wade, Charles O'Reilly III and Timothy Pollock (2206) *Organization Science* 17(5):527-544.

[23] 'Inequality at Work: The Effect of Peer Salaries on Job Satisfaction', David Card, Alexandre Mas, Enrico Moretti, Emmanuel Saez (2009) NBER Working Paper 16396. *Handbook of Social Comparison: Theory and Research*, Jerry Suls and Ladd Wheeler (2000), Springer.

Chart 1.B: Employee engagement and perceptions of fair decisions on pay
Engagement is higher amongst employees who say managers makes fair decisions on pay



Source: Towers Watson Global Workforce Survey 2010 (survey of 20,000 employees)

1.44 Employee engagement brings a range of benefits to organisations, improving productivity and performance. Evidence for these benefits was set out in the 2009 MacLeod Report (Box 1.C:).

Box 1.C: The MacLeod Report: Benefits to Organisations of Greater Employee Engagement

The MacLeod Report, on behalf of the Department of Business, Innovation and Skills, gathered evidence from a wide range of firms to build a case for the benefits of employee engagement.

Financial Performance:

- Hay Group research concludes that engaged employees generate 43 per cent more revenue than unengaged employees,
- The Institute for Employment Studies found that a 1 per cent increase in employee commitment can increase monthly sales by 9 per cent.

Business Growth:

- A Gallup study showed that growth rates for units with high-engagement workforces were 2.6 times growth rates for low-engagement units.

Staff Turnover:

- The Corporate Leadership Council in 2008 reported high-engagement organisations can reduce staff turnover by up to 87 per cent.

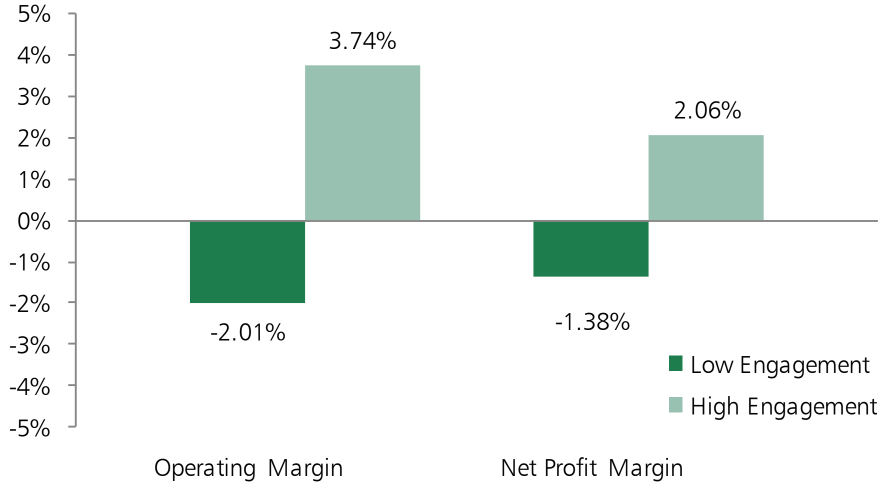
Staff Sickness Absence:

- Research by Watson Wyatt covering 115 firms in 2008-09 showed that highly engaged employees missed 43 per cent fewer workdays due to illness.

1.45 Research by Towers Watson on private sector companies shows how greater employee engagement brings clear benefits to firms' bottom line (Chart 1.C:).

Chart 1.C: Impact of employee engagement on profitability

High employee engagement is associated with improved business performance



Source: Towers Watson 3 year study across 41 global companies

The benefits of fair pay to society: inequality, social mobility, social cohesion

1.46 Beyond the confines of an individual organisation or firm, greater fairness in pay could bring a range of benefits to society as a whole through limiting income inequality, supporting social mobility and social cohesion. Its greatest contribution, though, is to offer incentives for genuinely productive work that creates real economic and social value.

1.47 **If proportionality in pay places limits on pay dispersion, then it will have an impact on restraining income inequality more generally.** This point was made in numerous submissions from members of the public to this Review's call for evidence. Many drew attention to the benefits of restraining income inequality made by Kate Pickett and Richard Wilkinson in *The Spirit Level*.[24] This Review is not charged to resolve the *Spirit Level* debate, though it notes both that Wilkinson and Pickett have responded robustly to criticism of their claims and that even their strongest critics have agreed that on one issue – the association between greater inequality and higher infant mortality – the evidence unambiguously supports the *Spirit Level* hypothesis. This is a potentially significant concession if this extends to related outcomes such as malnutrition, given the importance of early childhood to long-term learning and development.[25]

1.48 The evidence for the economic benefits of greater income equality is mixed. Some macroeconomists have argued that greater income equality can lead to improved economic growth, either by supporting consumption demand from those lower down the income scale, or reducing the likelihood of growth-harming social tensions and distributional conflicts.[26] Former IMF chief economist Raghuram G. Rajan has argued that the policy of easy credit for those in middle incomes pursued by American politicians in the 1990s and 2000s was intended to mitigate growing inequality, as middle income households' real income failed to keep up with

[24] *The Spirit Level: Why More Equal Societies Almost Always Do Better*, Richard Wilkinson and Kate Pickett (2009), Allen Lane.

[25] 'Beware False Prophets: Equality, the Good Society and The Spirit Level', Peter Saunders and Natalie Evans, 2010, Policy Exchange. For Wilkinson and Pickett's responses to criticism, see http://www.equalitytrust.org.uk/resources/response-to-questions

[26] For perspectives that emphasise political-economy arguments see 'Distributive Politics and Economic Growth', Alberto Alesina and Dani Rodrik (1994), *Quarterly Journal of Economics*, 109(2):465-490 and 'Is Inequality Harmful for Growth' Torsten Persson and Guido Tabellini (1994) *American Economic Review*, 84(3):600-621.

those of the top ten per cent. This stemmed largely from inequalities in access to education that left more and more Americans ill-equipped to adapt to changes in technology and long-run competitiveness. Cheap credit temporarily papered over these cracks, allowing those with squeezed incomes to compensate by borrowing and so continue to increase their levels of consumption.[27] However, other economists argue that too much equality weakens incentives to work and the amount of resources available for investment, since the rich have a higher marginal propensity to save than the poor. Investments, especially those with high sunk costs, may thus be harmed if wealth is not sufficiently concentrated. Empirical studies have so far been unable conclusively to demonstrate a straightforward link in either direction, although studies focusing on micro benefits tend to show that inequality is damaging.[28]

1.49 **A more clear cut argument is that persistent inequalities of income can harden over time into inequalities of opportunity or 'inequality traps'.** This can occur through a number of channels. For example, former World Bank Chief Economist Francois Bourguignon has argued that income inequality can become entrenched across generations, if income is dependent upon levels of education, and the children of wealthier families generally receive more and better education than those from poorer families, as only those who themselves attended better and more expensive schools are later able to send their children to such schools.[29]

1.50 Income inequality can metamorphose into inequality of opportunity, damaging social mobility and allowing privileged groups to entrench themselves. This in turn can lead to elites monopolising top jobs regardless of their talent, and gaining preferential access to capital, given the imperfections in capital markets. As a result, across society as a whole, top jobs will not be held by the most talented individuals and investment will not flow to the most potentially productive new business ventures. As the World Bank argued in its 2006 World Development Report, poor social mobility will thus be harmful to long-run economic growth, leading the Bank to advise developing countries that 'in the long run, equity [of opportunity] and efficiency may be complements, not substitutes.'[30]

1.51 **By aligning reward more proportionately to individuals' efforts and the value of their contributions, fair pay should strengthen work incentives and aspiration, and ensure that hard work pays.**

1.52 Furthermore, matching pay proportionately to the value of each individual's contribution should incentivise productive work - activity that increases the total stock of wealth in society – over unproductive rent-seeking, behaviour that simply redistributes wealth from one organisation or individual to another. One example of such behaviour would be executives who abuse their managerial power to inflate their own salaries, activity that generates no extra revenue for their firms, but merely diverts resources that might otherwise be used for investment to individual executives. In a world of fair pay, there would be no rewards for such unproductive behaviour, so ambitious individuals would instead be incentivised to devote their talents and energy to genuine wealth-creation, for which they would be proportionately rewarded.

1.53 Recently, it has been argued that much activity within the financial services sector has involved mere transfers of wealth rather than genuine value creation, with Bank of England Executive Director Andy Haldane arguing that the gross value added of the financial sector in

27 *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, Raghuram Rajan (2010), Princeton University Press.

28 See 'A reassessment of the relationship between inequality and growth', Kristin Forbes (2000) *American Economic Review* 90(4):869-887and 'Inequality and growth in a panel of countries', Robert Barro (2000) *Journal of Economic Growth* 5(1):5-32. 'Inequality and Growth: What Can the Data Say?', Abhijit Banerjee and Esther Duflo (2003) *Journal of Economic Growth* 8(3):267-299 conclude that persuasive evidence for a relationship between equality and growth can be found at a micro-level.

29 'Equity, efficiency and inequality traps: A research agenda' François Bourguignon and Francisco Ferreira and Michael Walton (2007), *Journal of Economic Inequality* 5:235–256; *Poverty Traps,* Samuel Bowles, Steven Durlauf, and Karla Hoff eds. (2006) Princeton University Press.

30 *World Development Report 2006: Equity and Development*, World Bank, Oxford University Press; 'The Allocation of Talent: Implications for Growth', Kevin Murphy, Andrei Shleifer and Robert Vishny (1991) *The Quarterly Journal of Economics*, 106(2):503.

recent decades has been massively exaggerated. Outsized rewards were generated less by productivity gains on banks' underlying asset pool than by leverage and an explosion in balance-sheet risk.[31] The sector appears to have grown larger than is necessary for it to carry out the indispensible function of intermediating between investors and entrepreneurs, even though its ability to harm the wider economy has not diminished.[32] Over the period it expanded, financial sector remuneration has outpaced other sectors.[33] Between 1998 and 2007, 60 per cent of the rise in the overall income share of the top 10 per cent flowed to finance workers.[34] Not surprisingly, many of the most talented and qualified have flocked to finance, with ambiguous consequences for the allocation of talent in the economy as a whole.

1.54 By supporting greater aspiration and work incentives, pay that is proportional to effort may in turn reinforce social cohesion. If the distribution of reward is not perceived as proportionate and/or the product of fair process, this could undermine social trust more generally, encouraging people to become suspicious of one another and to contribute less to public goods.[35] Cross-national evidence suggests that low levels of trust go hand in hand with high levels of government intervention as individuals fear being exploited and demand regulation as a way of compensating for the lack of order. If greater state intervention further reduces trust, a vicious circle could be created, with the public eventually favouring state control over untrammelled activity by 'unneighbourly' or 'untrustworthy' citizens, even if they know that Government itself may be corrupt and that excessive regulation will have a chilling effect on entrepreneurship.[36] **Ensuring fairness in pay could thus support a wider agenda of fostering civil society and greater social capital among communities and reducing dependency upon state intervention and regulation.**

The Current Context and the Need for Fairness

1.55 This is a critical juncture. In hard times it is all the more essential that the burdens of adjustment are distributed proportionally and fairly otherwise their legitimacy will be called into question. Whether the sensitivity over bankers' bonuses at a time of widespread austerity beyond the financial sector or the strength of student feeling over the proposed hike in tuition fees, there is no doubt that fairness issues are rising in salience. Politicians from all strands of opinion recognise the new mood. Yet this is also a great opportunity. By making a commitment to fair pay in the public sector, the Government can signal the importance it attaches to ensuring that pain and gain are fairly shared – and set an example about what it expects from the wider economy and society beyond. Why should it be that only the public sector is committed to fair pay?

31 *The Contribution of the Financial Sector: Miracle or Mirage?* Speech by Andy Haldane at the Future of Finance Conference, London, 14 July 2010.

32 'Why has the US Financial Sector grown so much?', Thomas Philippon (2010) NBER Working Paper No.13405.

33 'Skill biased financial development: education, wages and occupations in the US financial sector', Thomas Philippon and Ariell Reshef (2007) NBER Working Paper No 13437.

34 *Bankers Pay and Extreme Wage Inequality in the UK*, Brian Bell and John Van Reenan (2010) Centre for Economic Performance.

35 'The Logic of Reciprocity: Trust, Collective Action, and Law', Dan Kahan in M*oral Sentiments and Material Interests: On the Foundations of Cooperation in Economic Life*, Herbert Gintis, Samuel Bowles, Robert Boyd and Ernst Fehr (eds.) (2005) MIT Press.

36 'Regulation and Distrust', Philippe Aghion, Yann Algan, Pierre Alhuc and Andrei Shleifer (2010*) Quarterly Journal of Economics*, 125(3):1015-1049.

2 Pay dispersion and executive pay in the UK

Chapter summary

Pay in the UK is diverse, and discussions centred on averages and aggregates are unhelpful. Direct comparisons of the public and private sectors are particularly misleading as they do not take into account differences in functions, workforce characteristics and pension variation as well as the problems of defining the 'public sector'.

Pay dispersion in the UK is characterised by an increasing disparity between the top one per cent of earners and the rest. This movement is largely a private sector story. The share of top percentile wages earned by public sector workers has been declining, and now accounts for less than one per cent of those top wages. Even so, there are likely to be at least 20,000 individuals earning over £117,523 in the public sector. This includes over 4000 managers (out of a total public sector workforce of over six million).[37]

Over the past decade, and **in a range of public sector workforces, the pay of top executives has risen at faster rates than those of the lowest earners**. The pay multiple of top to bottom earners in these public sector workforces is typically around 10:1, and has been increasing gradually.

Pay for chief executives in the top private sector has increased at faster rates than for the top executives of public sector organisations. In 2009 FTSE 100 CEOs achieved a pay ratio of 88 times the median UK wage (2000: 47 times) and 202 times minimum wage (2000: 124 times).

Public perceptions of top pay in the public sector do not match the facts. Growing media scrutiny has illuminated that there are problems but has not placed examples of 'fat cat' excess, real or perceived, in the context of both the average pay of public sector managers and the transformation in certain areas of private sector pay and the challenges it poses. The resulting confusion creates an appetite for easily understood, but flawed benchmarks such as the Prime Minister's salary.

Introduction

2.1 The UK's workforce numbers over 29 million[38]. Describing coherent trends in a workforce of this size in a diverse economy is challenging. Every sector, industry and region will have its own tale to tell. There will always be exceptions to the general trends that can be identified.

2.2 The overall workforce is diverse, as are the workforces of the public and private sectors. The 'public sector worker' could be a refuse collector or a top hospital consultant. The 'private sector worker' could be a check-out attendant or a hedge fund manager. Talking in averages, aggregates and generalisations is therefore unhelpful. Yet much of the recent debate over top pay has been couched in such terms (Box 2.B). An important focus of this Interim Report is to

[37] The precise size of the public sector workforce depends on the definition of the 'public sector'.
[38] *Labour market statistics*, October 2010, Office for National Statistics.

shed some light on the overall situation in executive pay and pay dispersion in the UK: hopefully challenging some misconceptions in the process.

Box 2.A: The overpaid public sector worker: myth and reality

A recent Economic and Labour Market Review article caused media interest with headline figures that seemed to suggest that public sector workers are paid more than private sector workers.[39] However, use of average figures to make such simple comparisons is fundamentally misleading.

- Both sectors are hugely diverse, covering a wide range of job types in a wide range of organisations, making average figures unhelpful.
- The public sector workforce has a different composition and function. The public sector includes a greater proportion of skilled workers, for example in the NHS.
- The public sector has a different age profile – with a greater proportion of over 35 year olds.[40]

Wage differentials between public and private sectors have been investigated by the Institute of Fiscal Studies. They conclude that 'Overall, pay levels in the public sector are probably not significantly out of line with those of similar workers in the private sector, once you take into account factors such as their age, education and qualifications'.[41]

There is however a marked difference in pensions. More public sector employees have them, and they are in the round more generous. But even here it is important to avoid overstatement. The average pension received by public sector workers is below £10,000 a year. The largest group of public sector pensioners, former local government employees, receive less than £5,000 a year on average. As Lord Hutton's Independent Public Service Pensions Commission has noted, 'it is mistaken to talk about "gold-plated" pensions as being the norm across the public sector'.[42]

2.3 This chapter sets out some general information on pay dispersion in the UK, an overview of executive pay in the public sector, before setting that pay in the context of the lowest pay in the public sector, pay of politicians, and trends in the private sector.

Data and definitions

2.4 Transparency requirements for senior pay vary considerably sector by sector. Since the Greenbury Report, in the private sector, remuneration committees of publicly listed corporations have been required to report each year to shareholders on the remuneration of board members. In the public sector, the situation is more complicated, with a variety of requirements operational in different areas. Details are set out in Annex B. The Senior Salaries Review Body has expressed dissatisfaction with the situation. 'For most senior staff who are paid in accordance with national pay systems or contracts, general salary scales or ranges are routinely published, but not details of individuals' salaries, bonuses, pensions, benefits or total remuneration. It is not always clear what elements of

[39] 'Total reward: pay and pension contributions in the private and public sectors', Sarah Levy, Hazel Mitchell, Guled Guled and Jessica Coleman, *Economic & Labour Market Review*, Office for National Statistics, September 2010.

[40] 74 per cent of those working within the public sector in 2006 were over 35 years of age, compared with 62 per cent of those working in the private sector. B. Millard and A Machin, Characteristics of public sector workers, Economic & Labour Market Review, Vol 1 No 5 May 2007.

[41] Antoine Bozio and Paul Johnson, *Public sector pay and pensions*, The IFS Green Budget, 2010.

[42] Independent Public Service Pensions Commission: Interim Report, October 2010.

remuneration are – and are not – included in published figures.'[43] This means that data used in this report has come from a wide range of sources (Box 2.B).

Box 2.B: Data used in this Report

This Review has not sought to be a definitive pay survey, but to highlight indicative trends. There is no public sector pay data base. As the Office of Manpower Economics has noted, 'Comprehensive, consistent and high-quality data relating specifically to the remuneration of senior public sector employees are not available for all public sector bodies'.[44] The data underlying this report has been gathered from a variety of sources, which have included (but are not limited to):

- Cabinet Office
- Higher Education Funding Council
- HMRC Survey of Personal Incomes
- Incomes Data Services (provided data for public sector and private sector comparison)
- Local Government Association
- Manifest (provided data for private sector comparison)
- NHS Employers
- Office of Manpower Economics
- Panorama dataset based upon Freedom of Information Requests
- Skills Funding Agency
- University College Employers Association

Many of the datasets have limitations, which this Review has sought to address through cross-checking with other datasets and by reference to remuneration disclosures in annual reports and accounts. As the Review has been asked to make recommendations to the Prime Minister and Chancellor we have focused our data gathering on England. However, due to the nature of data available, some of our statistics will include staff employed across the UK.

For more details, see Annex C.

2.5 The first definition needed is what constitutes 'pay'. Executive remuneration packages can include: a base salary, performance-related bonus, recruitment and retention extra payments, non-monetary benefits such as company cars, long-term incentives including share options (in the private sector) and pensions. Ideally, a full comparison would be based on 'total remuneration', and include all of these elements. However, the extent to which these elements are clearly disaggregated in corporate disclosures, particularly in the public sector, varies. Though base salary is usually specified, disclosures over other elements do not make for easy comparison. In much of what follows, therefore, the Review relies on comparisons of salary, but notes for each chart describe precisely what is included. Fortunately, executive pay in the public sector is predominantly base salary (bonuses and other benefits are a relatively minor component). Pensions are difficult to include in comparisons, for reasons set out in Box 2. C. At this interim stage, pensions are mostly excluded, but the analysis will be developed further by the Review's final report.

[43] *Initial report on Public Sector Senior Remuneration 2010*, Senior Salaries Review Body.

[44] *32nd Report on Senior Salaries- 2010*, Senior Salaries Review Body.

Box 2.C: Comparing pensions

Senior executives in the public sector are subject to a range of pension schemes and arrangements. Whilst data exists to calculate median salaries for executives in various sectors, it is not possible to do the same for pensions.

Many senior executives in the public sector will be members of defined benefit, final salary, schemes. The value of such pensions depends on:

- the specific scheme and terms
- how long they have been in the scheme (and at what wages)
- how long they will remain in the scheme (and at what wages)
- when they choose to take their pension.

Though under many schemes individuals and/or employers will pay a standardised contribution to pensions each year, this does not directly relate the pension that will actually be received. Hence disclosures in annual accounts tend to include two measure which are only indicative of the pension that may be received: the standardised annual contribution and an estimate of the totalchange in year of the Cash Equivalent Transfer Value (CETV) of the pension 'pot'. In the case of defined benefits, the CETV is a value determined on actuarial assumptions about the future course of events affecting the scheme and the member's benefits.

These complexities mean that comparative data on top public sector pensions is even less readily available than for salaries.

There have been attempts to compare the value of defined benefit schemes against other types of pension, and of public sector schemes to private sector schemes. Such work has found that public sector schemes are worth more to the average worker, but has not made comparisons focusing on executive packages.[45] These findings may not apply at senior levels: employer pension contributions in the private sector increase more at higher earnings levels than in the public sector.[46] Moreover, private sector executives can enjoy much more generous pension arrangements to their workforces, whereas public sector executives are more likely to remain part of the same scheme as theirs.

As for comparisons between high and low earners within the public sector, work by the Pensions Policy Institute for the Independent Public Services Pensions Commission has identified that high flyers get a better deal from final salary schemes than others. In short, if you retire on a higher final salary, you will enjoy a larger pension per £ of career contributions.[47]

The analysis in this report mostly excludes pensions for the reasons above. In terms of comparisons between high and low salaries within the public sector, it is reasonable to assume that differences would increase were pensions included.

The Pensions Commission is planning to undertake further work in this area and this Review's final report will take account of this work. It will include more analysis of pensions within the total executive compensation package and consider any implications for executive pay of the Pensions Commission's recommendations.

[45] 'What is a public sector pension worth?', Disney, Emmerson and Tetlow, *The Economic Journal*, November 2009.

[46] 'Total reward: pay and pension contributions in the private and public sectors', Sarah Levy, Hazel Mitchell, Guled Guled and Jessica Coleman, *Economic & Labour Market Review*, Office for National Statistics, September 2010, Figures 1 and 2.

[47] Independent Public Service Pension Commission: Interim Report October 2010.

2.6 There are also a range of difficulties in defining the boundaries between public and private sectors. The sources used for this Report contain different definitions of what constitutes the public sector. Examples of institutions on the boundaries of the public sector are universities (part-publicly funded and dependent upon government-administered student loans but autonomous from government), trading organisations (such as the Met Office, which is part of the Ministry of Defence but is self financing through commercial activity) and even so-called 'parastatal' companies (businesses such as Serco and Capita which rely heavily on business with the public sector and thus taxpayer funds). Chapter 4 sets out the issue of defining the public sector in more detail. For now, we endeavour to describe trends by specific sectors such as health and local government.

Pay dispersion in the UK

2.7 According to the Office for National Statistics, the median salary for a full time employee in 2009 was £25,428 (£21,320 for all employees, including part-timers).[48] This median masks:

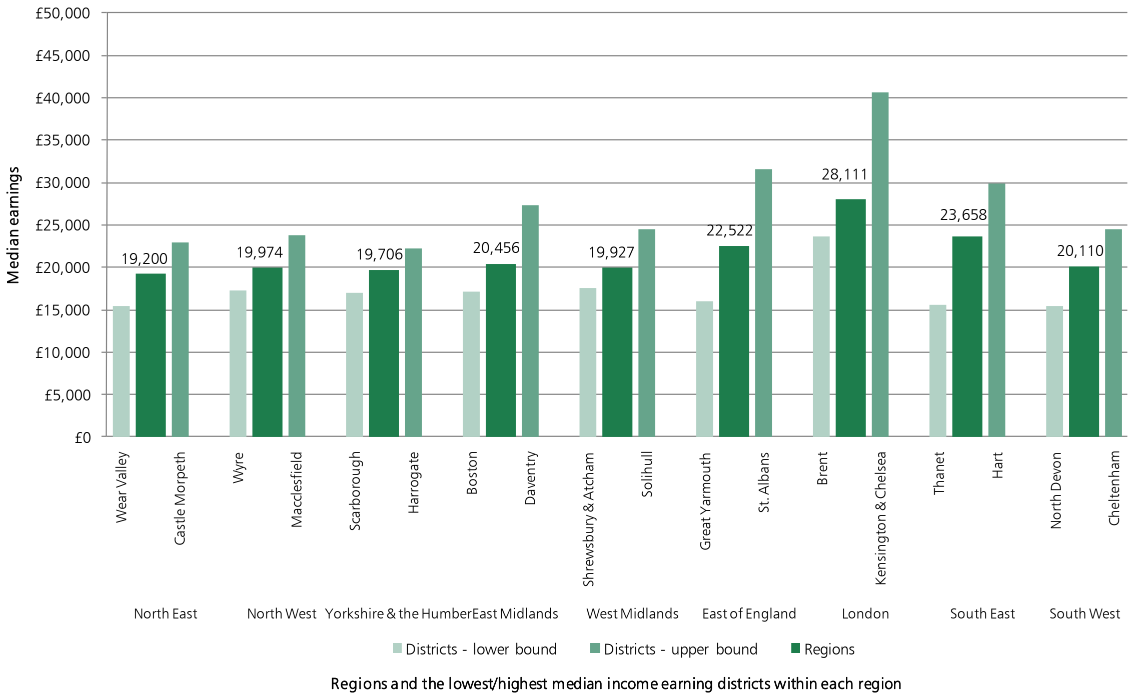
- Variation by region. Median incomes vary dramatically between local authority, ranging from £12,300 in Penwith, in the South West, to £53,100 in the City of London (Chart 2.A);
- Variation by personal characteristics. Comparing individuals by gender, ethnicity, religious belief, physical condition and many other characteristics reveals differences.[49] For example, there is a substantial disparity between the median pay of men and women (Chart 2. B);
- Variation by sector. Because of the nature of the people they employ, the median in the information and communications sector is £34,194; in the catering industry ('accommodation and food service activities') it is £15,940 (Chart 2.C).

[48] Annual Survey of Hours and Earnings 2009, Office for National Statistics.

[49] For a more detailed analysis see John Hills, 'An anatomy of economic inequality in the UK: Report of the National Equality Panel', January 2010.

Chart 2.A: Median gross annual pay by region with highest and lowest districts

Median incomes vary widely both nationally and within regions

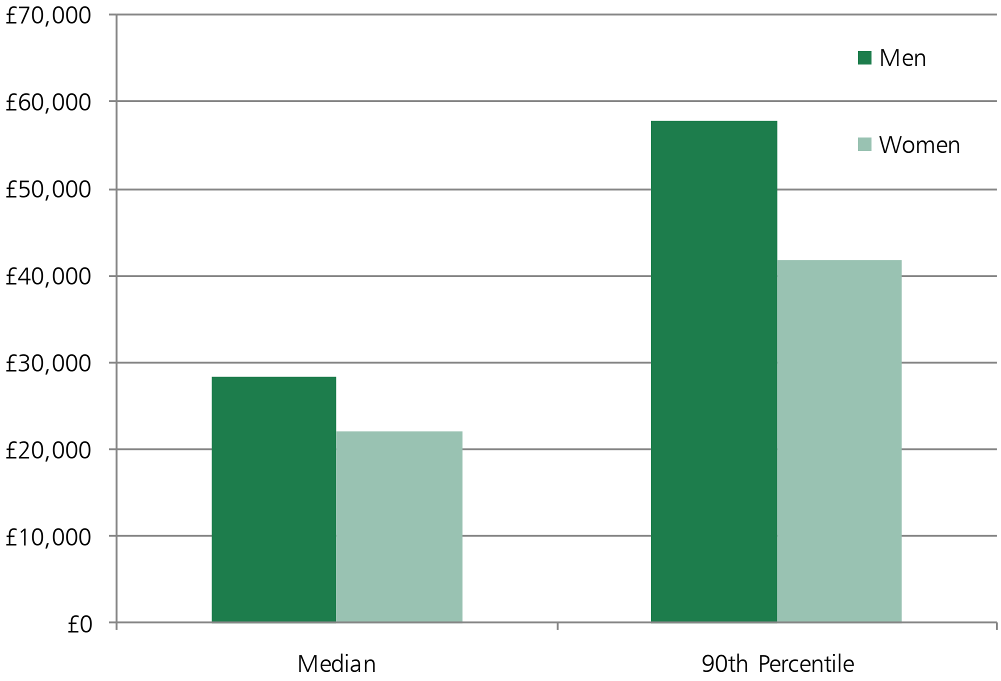


Source: Fair Pay Review analysis of Annual Survey of Hours and Earnings, Office for National Statistics, 2009 (ASHE)

Full and part-time employees

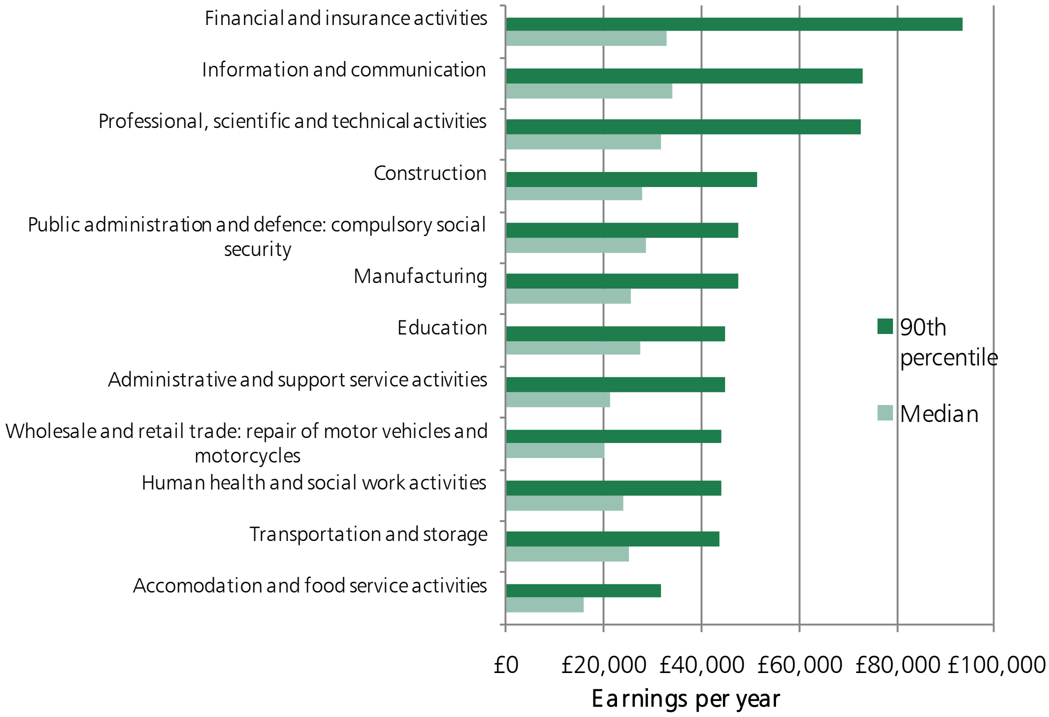
Chart 2.B: Median and 90th percentile gross annual pay of men and women in full time employment

The gender pay gap widens with movement up the income scale



Source: Fair Pay Review analysis of ASHE

Chart 2.C: Median and 90th percentile gross annual pay for full time employees by industry
What constitutes a 'high earner' differs from sector to sector



Source: Fair Pay Review analysis of ASHE, Analysis by Industry: 4 digit SIC 2007. Data is not available for all Industries shown here represent 62% of UK total workforce.

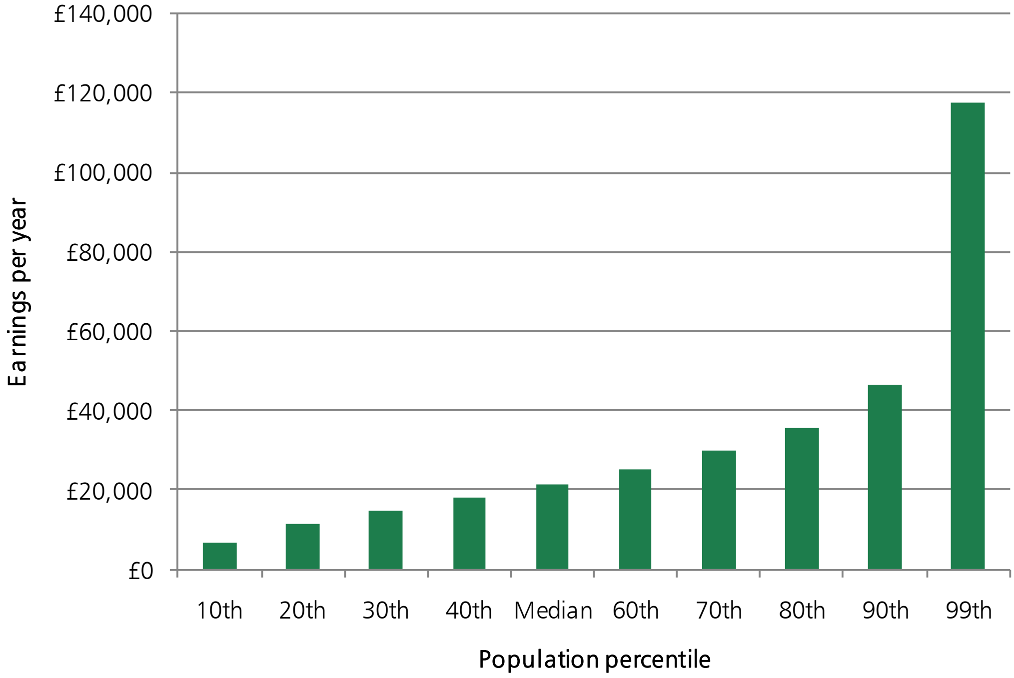
2.8 Pay is unevenly distributed either side of median earnings. The latest figures from the Office for National Statistics Annual Survey of Hours and Earnings on income distribution show that in 2009 the difference between the 90th and 99th percentiles was greater than that between the 10th and 90th percentiles (Chart 2D).

2.9 **The top one per cent of earners number 290,000[50] and earn over £117,523 a year**. This Chapter will use this group as a proxy for top earners throughout this chapter.

[50] Based on 1% of 29 million – *Labour market statistics*, October 2010, Office for National Statistics.

Chart 2.D: Gross annual pay for all employees by percentile, 2009

There is a wide range of income dispersion between high and low earners, but also between high and very high earners



Source: Fair Pay Review Analysis of ASHE

Note that these figures are for all employees and as such include both full and part time workers. Gross pay includes: pay before deductions for PAYE, National Insurance, pension schemes and voluntary deductions. It also includes basic, overtime, shift premium, bonus or incentive pay and any other pay.

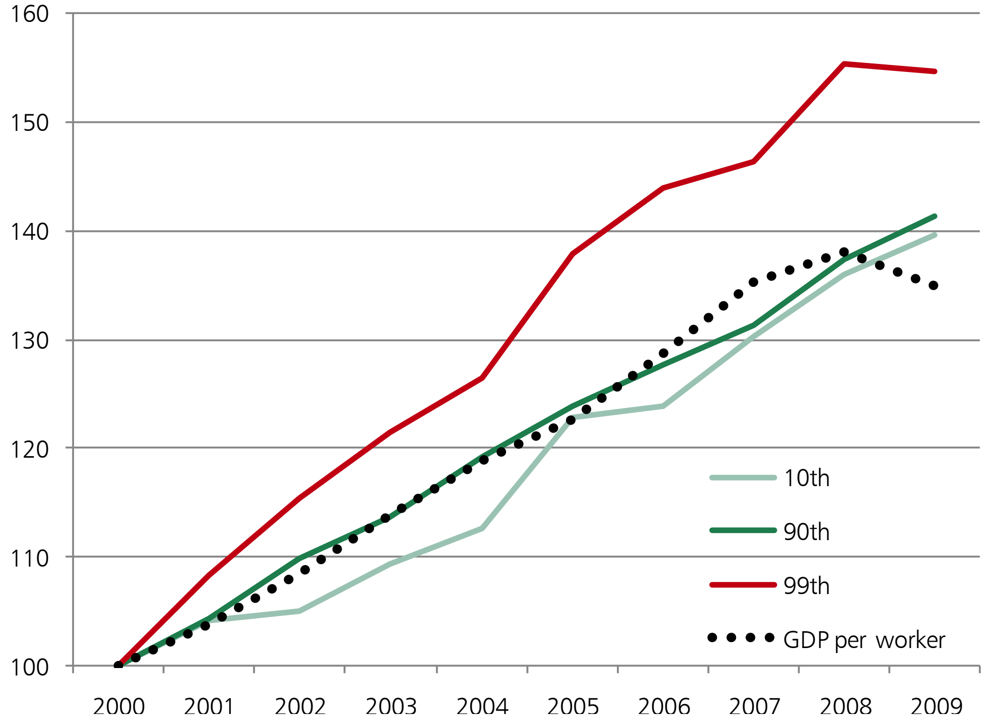
2.10 **Wage distribution has been increasing over time**. In 1979 a person at the 90th percentile (just within the highest ten per cent of workers) earned 2.5 times more than a person at the 10th percentile (just within the lowest ten per cent of workers). By 2009 that person earned 3.7 times more.[51] Over the past decade, there has been a particularly marked movement by the top percentile of earners away from the rest (Chart 2.E): pay inequality has grown between the very highest earners and high earners, as well as the rest.

[51] *Bankers Pay and Extreme Wage Inequality in the UK*, Brian Bell and John Van Reenan (2010) Centre for Economic Performance.

Chart 2.E: The Top Pulling Away

Gross annual earnings of 99th, 90th and 10th percentiles against GDP (indexed, 2000=100)

The top one per cent of earners have seen their incomes grow much faster than other earners, even relatively high earners



Source: Fair Pay Review Analysis of ASHE. GDP figures from HM Treasury

Note that the relationship between earnings and GDP can change over the course of an economic cycle, which can make inference difficult through time. This chart makes no attempt to adjust for these changes. The chart does not attempt to factor in changes in working hours: however according to ASHE the median working week was 37 hours in both 2000 and 2009 for all employees. The chart also makes no attempt to factor in changes in productivity between sectors.

2.11 This Review has not been tasked with explaining all the underlying reasons why the top percentile has been moving away in this fashion. Certainly, the financial services industry has played a key role: **it has been calculated that 60 per cent of the increased income share attained by the top 10 per cent has accrued to workers in financial services, even though they account for only around five per cent of the UK workforce.**[52]

2.12 In addition, the movement could represent a shift in types of jobs and of the balance between industries. Some academics have noted the possible polarising effect of technology in increasing the demand for high skilled, high paid workers, whilst decreasing the demand for routine manual jobs, such as in manufacturing, but maintaining it for non-routine manual jobs, such as cleaning.[53] Others believe that since the 1970s the decline of trade unions as countervailing influences and the deregulation of many industries have also played their part in the disproportionate rise in executive remuneration.[54]

2.13 What is key to this report however is that the increase in the growth rate of the income of the top one per cent is largely down to the private sector. **The share of top percentile wages**

[52] *Bankers Pay and Extreme Wage Inequality in the UK*, Brian Bell and John Van Reenan (2010) Centre for Economic Performance.

[53] 'Lousy and Lovely Jobs: The Rising Polarization of Work in Britain', Maarten Goos and Alan Manning, *Review of Economics and Statistics* (2007) 89(1): 118-133; and 'The Skill Content of Recent Technological Change: An Empirical Exploration', David Autor, David Frank Levy and Richard Murnane *Quarterly Journal of Economics* (2003) CXVIII:1279-1333.

[54] 'Skill-Biased Technological Change and Rising Wage Inequality: Some Problems and Puzzles', David Card and John DiNardo *Journal of Labor Economics* (2002) 20(4): 783-783. See also *Unions And The Labour Market For Managers*, John Dinardo, Kevin F Hallock and Jörn-Steffen Pischke (2000) Centre for Economic Policy Research.

earned by public sector workers has been declining, and now accounts for less than one per cent of those top wages.[55] In other words, while public sector employees represent around seven per cent of the highest one per cent of earners, those seven per cent only receive one per cent of top earnings.

2.14 These trends in overall pay dispersion set the context for executive pay. Of course, not all the 290,000 top earners identified above will be executives. Analysis by the Institute for Fiscal Studies suggests that 24 per cent of the top percentile of earners are company directors.[56] The rest will include well paid workers within financial services, the professions (accountants, doctors, lawyers etc.), but also many others.

2.15 **Relatively few of these top earners are public sector workers.** Taking a broad definition of the public sector (including the BBC, higher education and also GPs, who are strictly defined as private contractors in ONS definitions) recent Freedom of Information requests by BBC's Panorama suggests that there are around 20,000 public workers earning over £117,523. This means that the public sector (in the broadest sense e.g. including Further and Higher Education and GPs) contains a significantly smaller percentage of high earners than the private sector: Approximately one in 85 workers in the private sector are in the top one per cent of all earners, compared to just one in 280 public sector workers.[57]

Executive pay in the public sector

2.16 As set out earlier it is important to note the difficulties in defining the boundaries of the public sector. The analysis below therefore focuses on a definition of the public sector that includes both Further and Higher Education.

2.17 It is also important to note that the analysis that follows aims to give a high level perspective and does not attempt to delve into the details and specifics of subgroups within the broader public sector. Within each workforce there are numerous distinctions such as the civilian workforce within the military, the variation between individual colleges and universities and the range of scale between local authorities.

2.18 Additionally this Review has also chosen to examine Arms-Length Bodies on an individual basis. Whilst comprehensive data has been assembled on over 600 bodies, only the very highest paid have been to construct medians or time series, which would otherwise be meaningless in such a diverse and ever evolving sector.

2.19 **Using a broad definition of the public sector, we estimate that there are over 4,000 managers (and over 16,000 non-managers – mostly medical professionals) within the top 1 per cent of all earners.** The largest numbers of these individuals will be found in the NHS and within arm's length bodies, though these areas cover a very large number of organisations (Chart 2F).

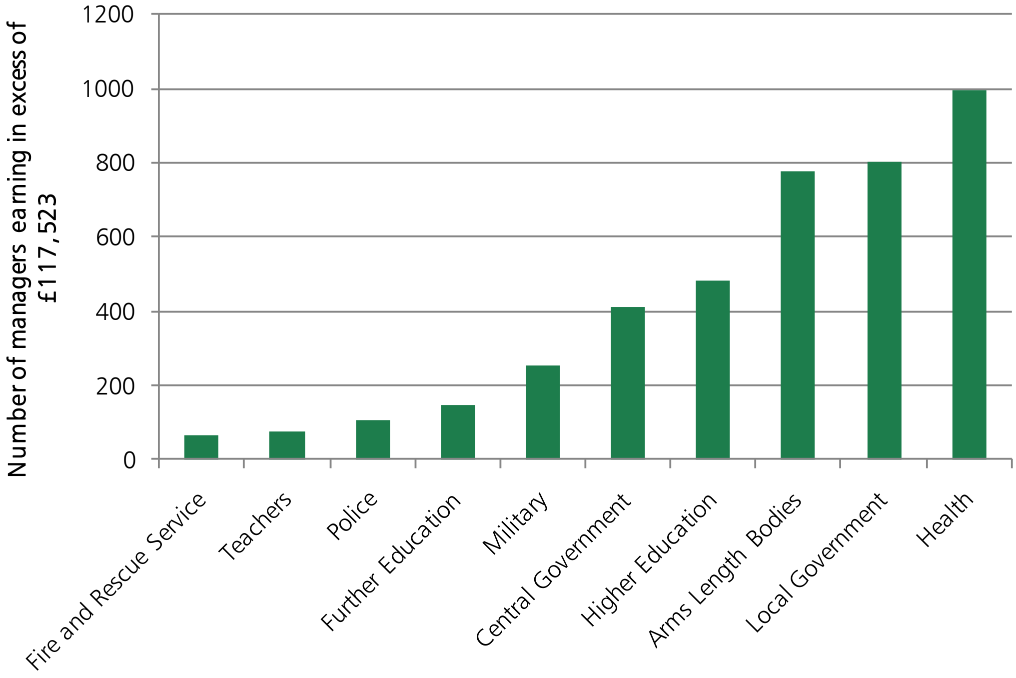
55 *Bankers Pay and Extreme Wage Inequality in the UK*, Brian Bell and John Van Reenan (2010) Centre for Economic Performance.

56 *Racing away? Income inequality and the evolution of high incomes*, Institute for Fiscal Studies, January 2008. This was based on income tax records from 2004-05 so may have changed to some degree since.

57 Calculations are based on Office for National Statistics estimates of a total public sector workforce of 6.069 million (Third Quarter, 2009) and total employment of 29 million. number of public sector high earners taken from BBC Panorama data.

Chart 2.F: Estimated numbers of individuals in managerial roles within the top 1 per cent of earners in the UK by workforce

The greatest numbers of high-earning managers are in the NHS and local government, the two largest public sector workforces



Source: Fair Pay Review analysis of BBC Panorama data and College Finance Reports (for Further Education) taken from Skills Funding Agency website

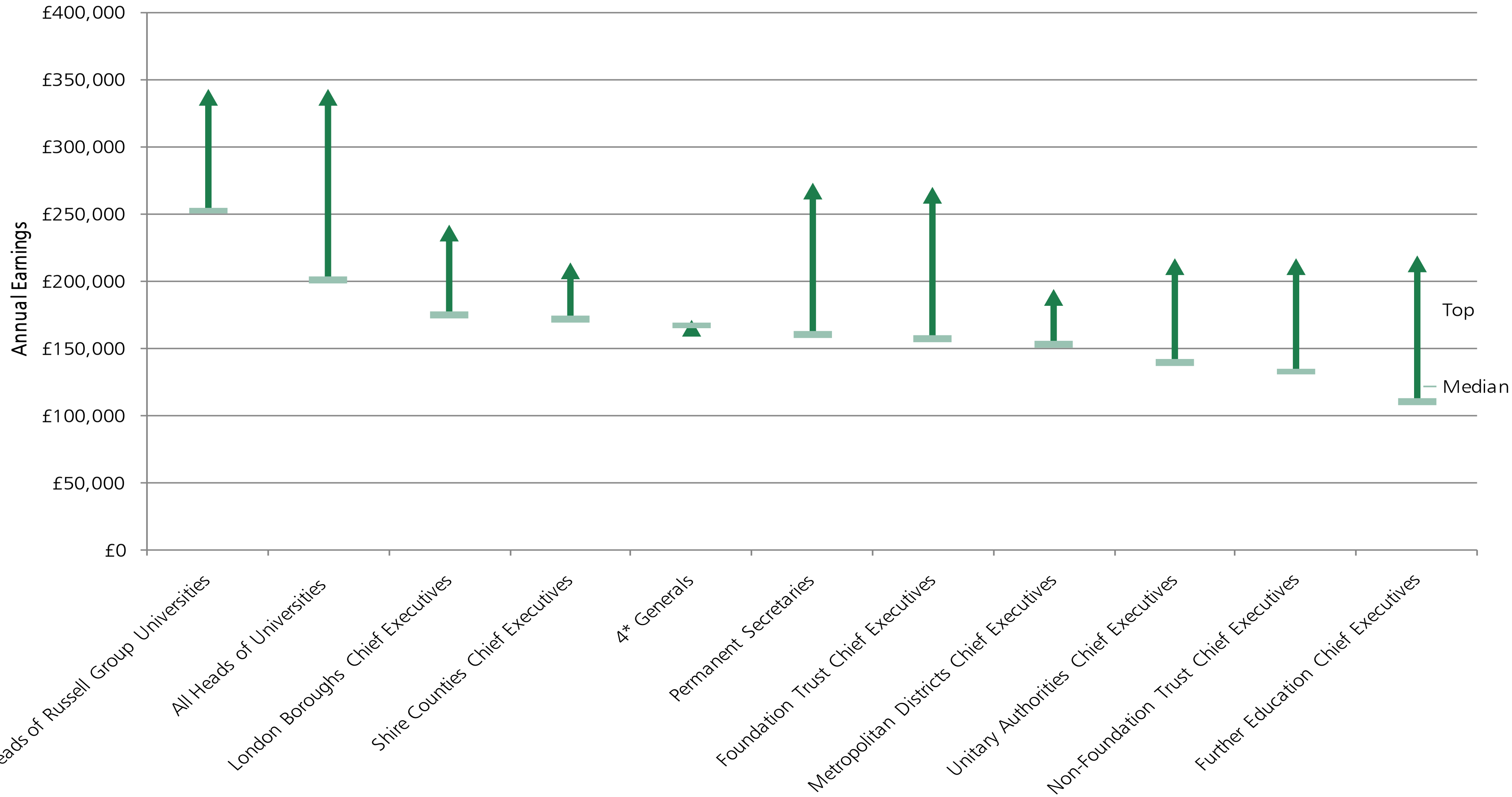
Numbers are indicative not definitive. We have attempted to exclude non-managerial roles and duplicates where possible. Some pay statistics are for 2008-09 and some for 2009-10 - these have not been differentiated. For more detail please see Annex C.

2.20 Chart 2. G shows that there are considerable ranges in top executive pay within different sectors. **Some individuals earn considerably more than the median for their role.** This will partly reflect the range in size and nature of organisations there may be within each sector.

2.21 Chart 2.H identifies some of the highest paid lead executives of arms-length bodies (ALBs), defined as centrally funded public bodies, including Non-Ministerial Departments, Executive Agencies, Non-Departmental Public Bodies, and other public bodies such as NICE.

Chart 2.G: Top pay in the public sector – median and highest salaries of lead executives in selected workforces

Some individuals earn considerably more than the median of others in the same role

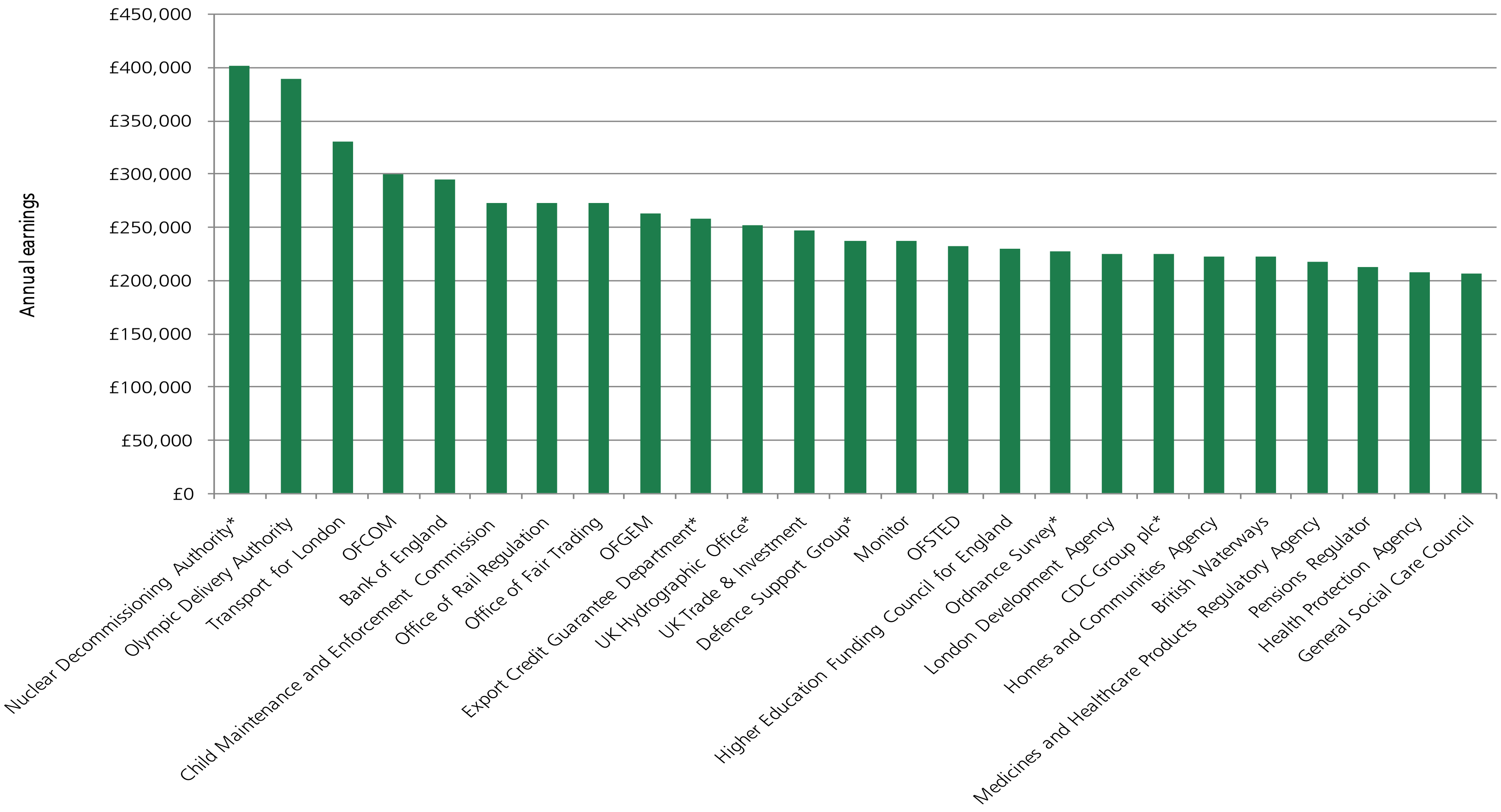


Source: Fair Pay Review analysis of various sources, see notes to Chart 2.I

For a wider discussion of sources and methodology, see Annex C.

Chart 2.H: Remuneration of the 25 highest paid lead executives in Arms Length Bodies, 2008-09

Lead executives earn more than £200,000 per annum in a range of public bodies



Source: Fair Pay Review analysis of annual accounts and data from Incomes Data Services

* Organisations in the Shareholder Executive portfolio. The Government's policy is for these organisations to operate in competitive markets, functioning essentially as if they were private companies. The Government's interest as a shareholder is managed by Shareholder Executive, part of the Department for Business, Innovation and Skills. The Shareholder Executive requires that these bodies adopt private sector best practice in pay governance, and salaries for chief executives of these bodies require Ministerial approval. However, as these organisations operate in competitive markets, the Shareholder Executive acknowledges that as a matter of commercial necessity they must take account of private sector labour markets when recruiting executives and determining pay levels. .

2.22 **As might be expected, executive salaries rise at the boundaries of the public sector.** In public bodies that operate in competitive markets, salaries rise towards private sector levels. For example, in 2008-09 the chief executives of Channel Four and the Tote received £670,000 and £355,000 respectively, while the former chief executive of the Royal Mail received £633,000 in the same year. The same trend can be seen in the public services industry, private companies whose business may often be largely oriented around delivering public services: according to their annual accounts, in 2009 the chief executives of Capita and Serco received £770,000 and £1,578,682 respectively, excluding long term stock options.[58]

Box 2.D: Executive pay at the BBC

The BBC is a unique institution, funded with public money through the TV licence fee yet operating in competitive media markets and editorially independent of Government.

This position has resulted in a unique institutional architecture. The BBC is governed by the BBC Trust, which currently consists of 12 Trustees, including the Chairman, who are appointed and have their remuneration set by Government. Day-to-day management is the responsibility of the BBC Executive Board, headed by the Director-General (currently Mark Thompson). The Director-General is appointed by the BBC Trust, which decides the Director-General's pay, and sets overall remuneration strategy for the Executive Board. Pay for other members of the BBC Executive Board is set by a Remuneration Committee of the Board, chaired by a Non-Executive Director.

According to BBC accounts, in 2009-10 the base salaries of Executive Board members ranged from £310,000 to £668,000, while total remuneration (including extra employer contributions to executives' pension funds) ranged up to £838,000 for the Director-General. As a comparison, ITV's accounts state that in 2009 then Chief Executive Michael Grade received a salary of £825,000 and total remuneration including short-term incentives of £2,126,000. BBC statistics show that 14 employees are currently paid more than £254,600, which is twenty times the lowest non-London-weighted full-time-equivalent salary in the organisation.

In recent years, the BBC has been the subject of widespread criticism on executive salaries, including some accusations that the BBC had 'lost its way' on senior pay. Responding to such criticism, in 2009 the BBC Trust commissioned an Executive Remuneration Review, which reported last October, committing to a reduction in the BBC's senior pay bill of 25 per cent by July 2013. Numbers of senior managers will be reduced, while the salaries of executive directors including the Director-General will be frozen and bonuses suspended indefinitely. BBC Executive Board members have also agreed to forgo one month's salary for each of the next two years, and supplementary payments to their pension funds will cease. Combined, the BBC predict that executive directors' total remuneration will fall by 25 per cent by 2011-12.[59]

Public sector executive pay in comparison to the lowest paid

2.23 The following section explores trends in public sector managers' pay, compared to the lowest paid core worker in each workforce.

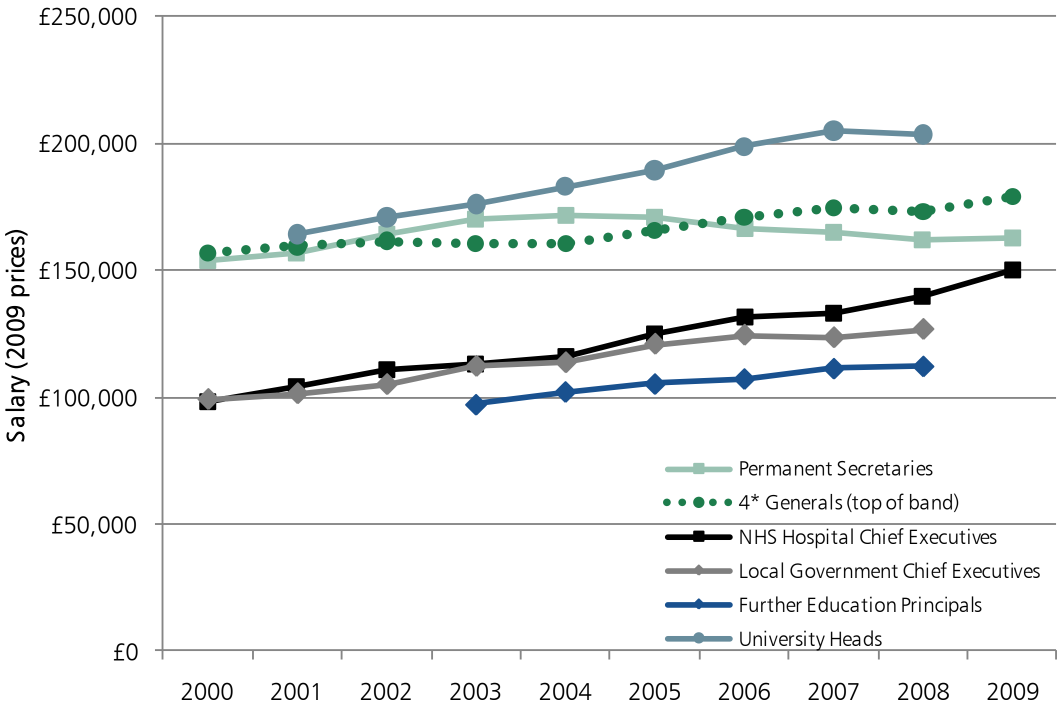
[58] Based on a Fair Pay Review analysis of annual accounts.

[59] BBC Trust, *Executive Remuneration Review*, 2009. See also http://www.bbc.co.uk/aboutthebbc/therealstory/exec_talent_pay.shtml

2.24 The data show that across a range of sectors, median top executive pay has seen steady increases in real terms over recent years (Chart 2.I). The exception to this is the civil service where the median pay of permanent secretaries has declined in real terms between 2005 and 2009.

Chart 2.I: Real average salaries of top public sector managers 1999-2009 (2009 prices)

Most sectors have experienced real term increases to their salaries



Source: Fair Pay Review analysis of various sources (see below). GDP figures from HM Treasury.

Local Government: Top = Average of local authority chief executives provide by LGA, Bottom = Bottom of LGE spinal point. Please note that some authorities may pay more than the bottom of the LGS spinal point as a minimum and that therefore ratios will vary between authorities

Civil Service: Top = 2000 – 2002 is an estimated median of Permanent Secretary pay derived from SSRB reports, 2003+ is for the median of Permanent Secretaries salaries as provided by Cabinet Office Bottom = the minimum pay of a clerical assistant in DSS in inner London for 2000 and for a clerical assistant in DWP in inner London for 2001 onwards taken from IDS's Pay in the Public Services. Please note that DWP are not the lowest paying department and exact ratios vary between Departments. DWP has been used as it is the most consistent time series that we could obtain.

Health: Top = Median salary of chief executives of hospital trusts provided by IDS, Bottom = 1999 – 2004 Starting point of administrative and clerical staff salary provided by NHS Advance Letters provided by the Department of Health and from 2005 onwards the starting point of Band 1 on the Agenda for Change pay scale has been used. Please note that prior to Agenda for Change ancillary staff may have been the lowest paid. Administrative staff have been used to provide a consistent time series.

Further Education: Top = Average salary of Further Education principals provide by the Association of Colleges (AOC) .Bottom = the start of the AoC national recommend pay spine. Please note that the AOC pay spine is voluntary and that actual starting pay could vary.

Higher Education: Top = Median Vice Chancellor salaries provided by the Universities and Colleges Employers Association (UCEA), data based on the total remuneration package (excluding pension contributions and excluding payments made to compensate for a pension cap) as declared in institutions' published annual accounts. Data are not from constant sample but the whole emolument time series data used below are constructed using the same methodology for previous years and the number of institutions for which data are available is high as a proportion of total institutions. Bottom = Starting point of UCEA single pay spine provided by UCEA. Note that UCEA pay spine is voluntary and that actual starting pay could vary.

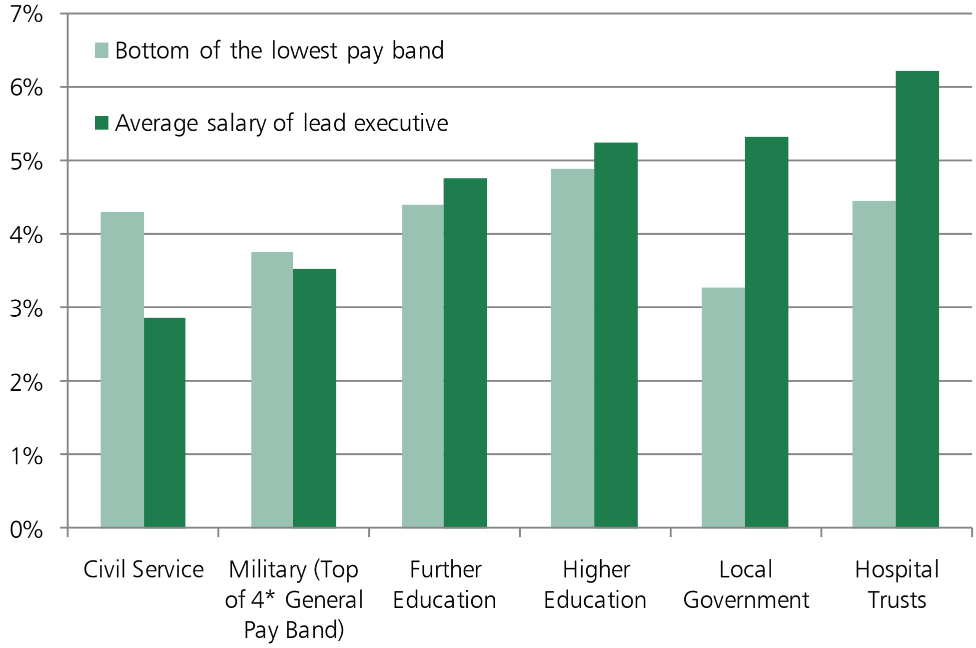
Military: Top = Highest point of 4* General pay scale take from Senior Salary Review Board reports, Bottom = for 2000 the lowest rate for Private III, for 2001 onwards lowest point of Range 1. Please note that Range 1 includes the starting ranks for services. Figures apply to all three military services.

For further details see Annex C below.

2.25 A key issue for this Review is how these senior salaries compares to the lowest pay in their workforces. **In health, local government, further and higher education, rates of pay growth for top managers have exceeded those for the bottom of the pay spine** (Chart 2.J). So the pay of the head of the typical organisation has been moving away from that of a new entrant at the bottom. Exceptions to this pattern are the civil service and the military, where the reverse has been true.

Chart 2.J: Average annual salary growth for top management positions and bottom of pay spine for selected workforces between 2001 and 2008

In the NHS, local government and further and higher education, top salaries have been growing at faster rates than entry level salaries



Source: Fair Pay Review analysis of various sources, see notes to Chart 2.I.

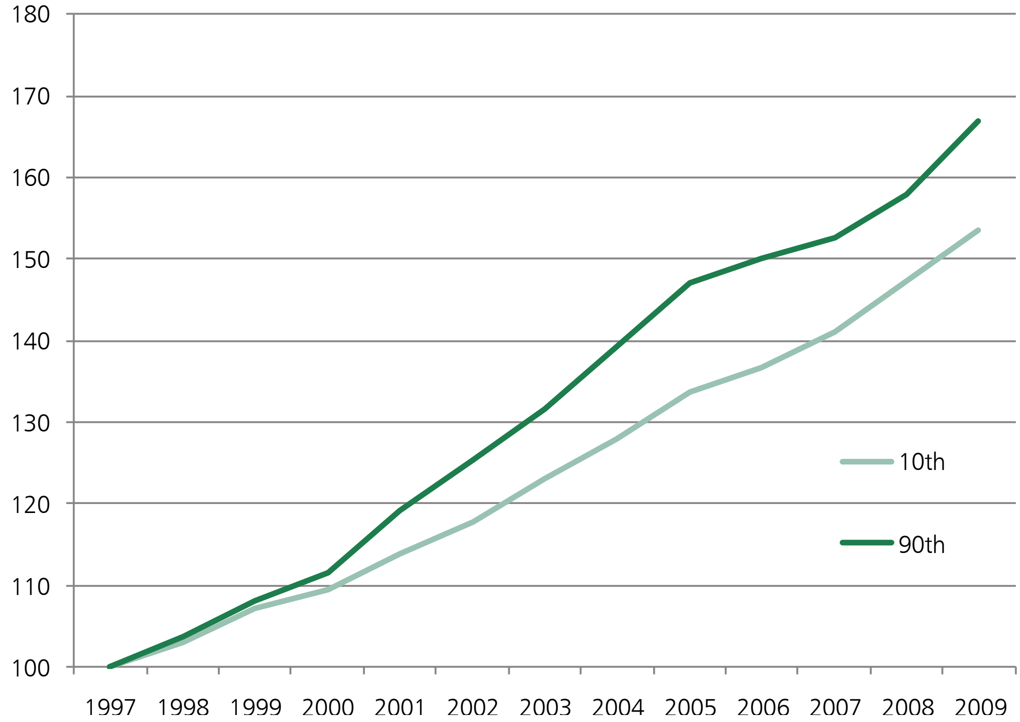
Average annual growth rates for Further Education are for 2003-2008.

2.26 Analysis of public sector pay aggregate figures confirms a wider trend of top earners pulling away from the bottom. Chart 2.K shows the 90th percentile of public sector workers experiencing a larger growth in their earnings than the 10th percentile - though as noted above, aggregate figures can be misleading. In this case the composition of the public sector workforce has not remained static, and aggregate figures may be distorted at the bottom by an increased use of contracting out over this period, and at the top by growth in the number of skilled professionals, such as doctors.[60]

[60] For example, the IFS calculated that the number of doctors increased by 49% and teaching assistants by 260% between 1997 and 2008; Bozio and Johnson, Public sector pay and pensions, IFS Green Budget 2010.

Chart 2.K: Gross weekly earnings of 90th and 10th percentiles of full-time public sector employees (indexed, 1997=100)

Since 2000 earnings the 90th percentile have grown faster than those of the 10th



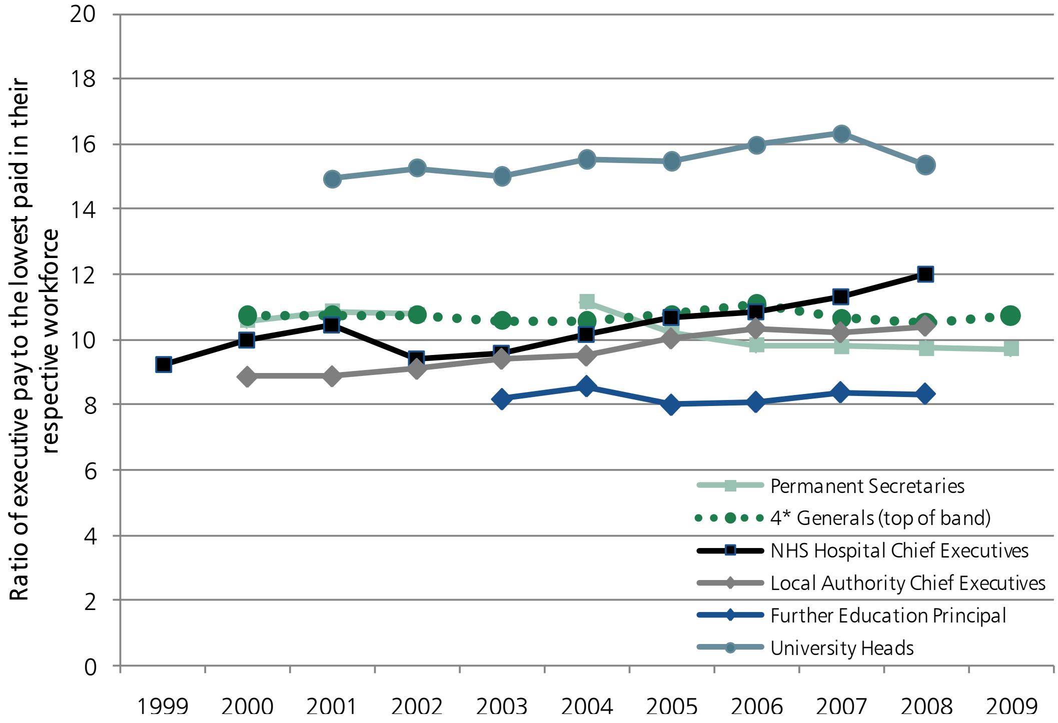
Source: Fair Pay Review analysis of ASHE

Data is for employees on adult rates whose pay for the survey pay-period was not affected by absence.

2.27 Examining pay ratios within each workforce further demonstrates a slight increase in pay disparity (within the exception of the civil service) (Chart 2L).

Chart 2.L: Ratios between average salaries of selected top public sector management positions and bottom of workforce pay spines, 2000 – 2009

Pay ratios have shown a slight increase across sectors in the last 10 years



Source: Fair Pay Review analysis of various sources, see note to Chart 2.I
Ratio calculated using top of pay bands for Permanent Secretaries and 4* Generals

2.28 Pay multiples have increased to some degree in all these workforces except the civil service. The highest ratio was in higher education where the median vice-chancellor's salary was 15.35 times the bottom of the Universities and Colleges Employers Association pay spine for university staff. The lowest was in Further Education where the average ratio of Further Education College Principals to the bottom of the pay spine was 8.3:1. In general, the ratios have only increased gradually although there have been more significant increases in local authorities and hospital trusts.

2.29 However, it is important to note that the figures used here are for sectors as a whole. This disguises the significant differences within sectors: stakeholder evidence to this Review repeatedly noted that many sectors contain significant variation. For example the ratio in the Russell Group universities is 19:1,[61] while in local government the ratio for chief executives of Shire Districts is below 9:1.

2.30 Looking ahead, were top managers to continue to see relatively larger increases in pay than the lowest paid in their workforces, these ratios would rise more sharply over time. For example if the ratios for chief executives of Shire Counties (currently 15:1) or of the largest hospitals (currently 14:1) were to continue to grow at their current rates they would reach 20:1 by 2020, even taking into account a 2 year pay freeze.

2.31 The larger the starting point for any pay ratio, the greater the absolute impact on the ratio of any given increase in top pay relative to bottom pay. Therefore, although most ratios have

[61] Based on a Fair Pay Review analysis of annual accounts and comparisons to the UCEA pay spine.

been growing only gradually in the past decade, were top pay to continue to outpace bottom pay by the same margin, the ratios would increase at exponentially faster rates.

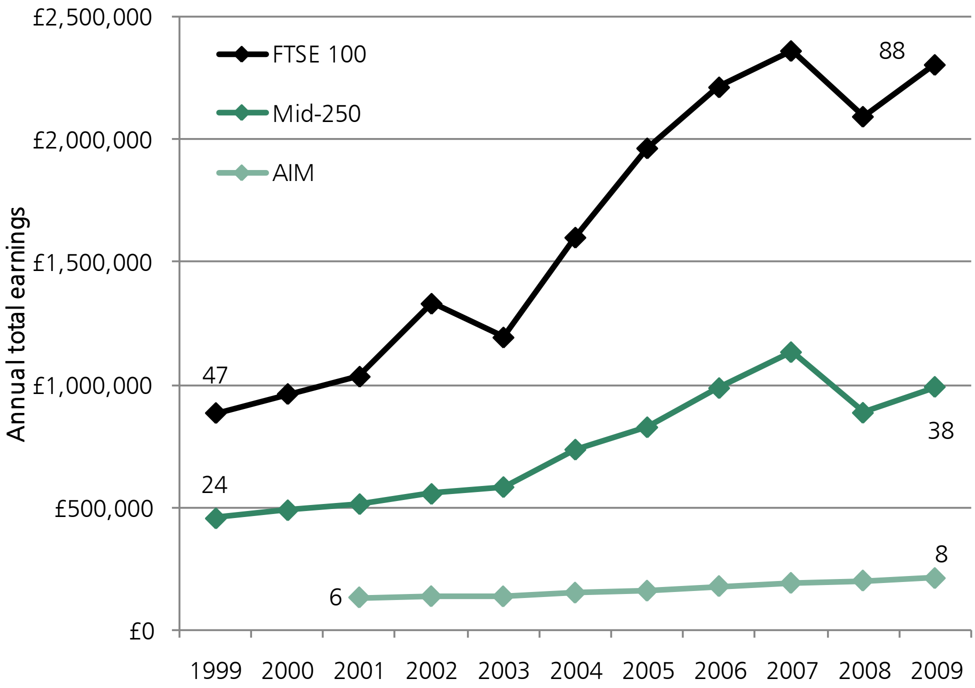
Public sector executive pay in comparison to the private sector

2.32 A recurrent theme in submissions to this Review's call for evidence was the comparison of public sector pay to the private sector. The following section offers an overview of some of the comparative trends in the private sector.

2.33 **Pay disparity has grown in the private sector in recent years. For larger companies this growth has been much greater than in the public sector** as shown in Chart 2.M.

Chart 2.M: Median total earnings for chief executives of FTSE 100, Mid-250 and Alternative Investment Market firms, 1999 – 2009, with ratios to UK median full time earnings overlaid

The period 2004-2008 saw a huge increase in FTSE 100 and 250 CEO remuneration



Source: Fair Pay Review analysis of data from Incomes Data Services

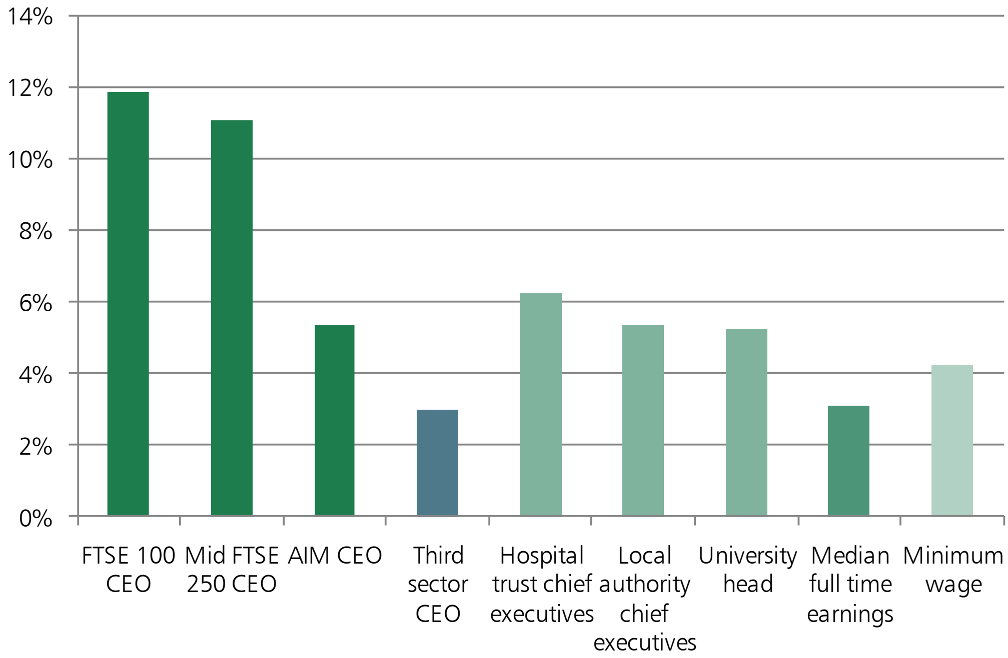
Total earnings includes all payments received during that year and other payment forms that can be vested at that point. For a more detailed explanation of 'total earnings', see Annex C below.

2.34 For the largest firms, the increase in top pay has been extremely substantial: **the ratio of FTSE 100 chief executives' median earnings to UK median earnings increased from 47 in 2000 to 88 in 2009.** FTSE 250 firms have followed suit, if less dramatically, with an increase from 24 to 38 in the same period. It is noticeable that whilst chief executives of both groups of companies saw a drop in earnings in 2008 they rose again in 2009.

2.35 Chart 2.M also highlights the slower rate of growth for chief executives of companies listed in the Alternative Investment Market (AIM). As Chart 2. N below shows, pay for AIM company chief executives has grown at a similar rate to the fastest increasing groups in the public sector.

Chart 2.N: Average annual pay growth across public, private and third sectors with comparators, 2001 – 2008

CEOs of FTSE 100 and FTSE 250 companies have experienced the fastest growth in pay but managers in both the public and private sectors have grown faster than median earners



Source: Fair Pay Review analysis of various sources, see Chart 2.I. Median earnings from ASHE. National Minimum Wage from Low Pay Commission website.
Third sector chief executive pay growth rate is for 2003 to 2009

2.36 Chart 2.N also highlights that whilst FTSE 100 and 250 chief executives experienced a more rapid growth in earnings than both AIM and public sector chief executives, they all experienced faster growth rates than either UK median earnings or the national minimum wage.

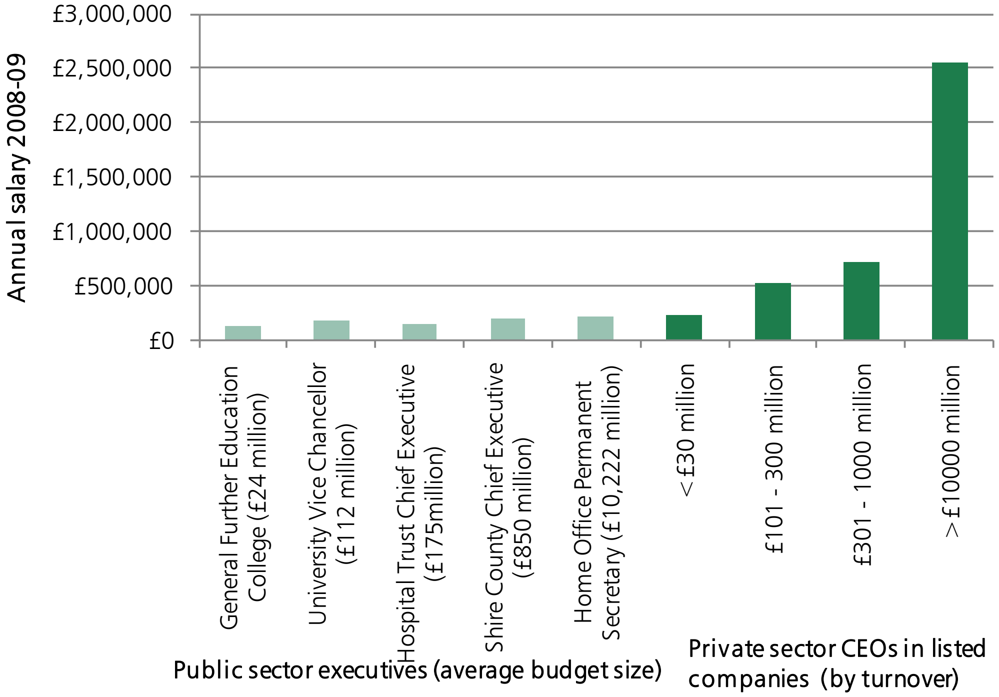
2.37 **The difference in pay growth rates for chief executives of AIM and FTSE firms also highlights the danger of generalising about the private sector as a whole.** For example, the most recent Institute of Directors survey found that the average salary for a medium sized company was £100,000 a year, not including bonuses.[62] As this survey is for non-listed companies it suggests a possible story of a two speed private sector, with listed companies' chief executives experiencing much faster pay increases than those of non-listed firms.

2.38 Another way to compare the difference between top pay in the top of the private sector to the public sector is through organisation size. Chart 2.O below compares median earnings of a range of senior public sector positions to chief executive salaries in the private sector for a variety of different sized companies. Remuneration for chief executives of listed companies is thus higher than for each public sector comparator based on budget/turnover. The difference becomes more marked as organisation budget increases, with permanent secretaries receiving only a fraction of the pay of private sector chief executives controlling organisations of a similar size.

[62] http://www.guardian.co.uk/business/2010/oct/31/institute-directors-executive-pay

Chart 2.O: Average remuneration for selected senior public sector positions with average budget controlled compared to median realised remuneration for chief executives of private sector firms with a range of turnovers

Earning for public sector executives do not compare favourably with those in the private sector, even given size of budget



Source: Fair Pay Review analysis. Various sources for public sector, see Chart 2.I. Private Sector: Manifest/MM&K Executive Director Total Remuneration Survey, September 2009

'Realised remuneration' is the sum of salary, benefits, cash bonuses and the amount of long term incentives 'paid out', i.e. notional gains from options exercised in the year calculated at the date of exercise on options, plus the value of other share schemes that vest in the year and is therefore comparable to the data used in Chart 2.M For more details, see Annex X below.

Executive pay in the third sector

2.39 The pay of chief executives in the not-for-profit or third sector is extremely varied as would be expected in such a diverse group of organisations. The median salary of chief executives of the smallest organisations (with an income below £150,000) was £38,500 in 2009-10; the median chief executive salary for the largest organisations (with an income over £100 million) was £130,000. The overall median salary was £57,974 in 2009-10, having increased rapidly between 2004 and 2006 but remaining steady since.[63] The annual average growth rate over the last 6 years amounts to 3.01 per cent, lower than most of the public sector and level with median earnings (Chart 2.N).

What do Executive Packages look like by Sector?

2.40 **In the public sector senior pay is mostly composed of salary with defined benefit pensions, and then a smaller selection of recruitment and retention premia and performance awards or bonuses.**

2.41 In recent decades, the public sector has adopted pay approaches based on rewarding performance. In theory, employees are held accountable for their performance through appraisal, and can be rewarded against defined measures of success. This trend follows the

[63] The ACEVO Pay Survey 2010/11.

widespread adoption of such practices in the private sector in the 1990s, and is ultimately based on the principal-agent theory (described in more detail in Chapter 3).

2.42 A key distinction to make is that between variable pay and a bonus. Variable pay is pay that is linked to *expected* performance. Pay is set within a framework of minimum and maximum performance expectations: those who meet minimum expectations receive their base salary and those with higher performance (whether in comparison to peers or to an absolute condition) receive incrementally more up to the maximum of their variable salary. A bonus is for *unexpected* performance: a reward for efforts and achievements beyond the scope of the role.

2.43 The extent of variable pay differs across public sector workforces as shown in the table below. It is worth noting that with the exception of Non-Departmental Public Bodies and public bodies operating in competitive markets variable pay does not exceed 20 per cent of base salary: in contrast to bonuses in large private sector firms, which can be in excess of 100 per cent of salary.

Workforce	Average size of variable pay
Senior Civil Service	Only the top 25 per cent of performers can be awarded a bonus. Average value in 2009 was £7,770 for Deputy Directors and £12,704 for Directors General. These equate to approximately 10.5 per cent and 9.4 per cent of salary respectively.
NHS Very Senior Managers	Those rated as having exceeded expectations can receive a bonus of up to 5 per cent of their salary.
NDPB chief executives	Comprehensive data is not published for NDPBs. Typically, NDPB chief executives can receive bonuses of up to 20-25 per cent of base salary, with some exceptions, e.g. CEO of Olympic Delivery Authority received bonus of £210,000 in 2008-09, equivalent to 55 per cent of base salary of £384,000. Bonuses tend to be higher in infrastructure-related NDPBs, e.g. Transport for London (Commissioner bonus £146,440, which is 42 per cent of base salary of £348,444 in 2008-09).
Local Govt chief executives	There is no comprehensive data available, but based on a small sample bonuses typically range from 0 – 20 per cent of base salary.
Chief executives of competitive public sector bodies	Arrangements vary substantially, but can be as much as 100 per cent of salary.

2.44 In contrast, remuneration for chief executives in the private sector is likely to be comprised of some kind of bonus (ranging from a simple cash bonus to complex long term share options) of at least equal worth to salary, with pensions constituting a much smaller percentage of total remuneration. The core elements of the senior executive remuneration package are:

- Salary – An annual payment that reflects factors such as job complexity, firm size, sector and location;
- Bonus – Conditional on meeting financial and nonfinancial objectives and typically capped as a percentage of salary. They are usually paid in cash but some or all can be deferred into shares;
- Equity incentives – These can take a variety of forms but the two main classifications (of which they are a virtually unlimited amount of variants) are:
  - Long Term Incentive Plans (LTIPs) are grants of shares which vest (can be cashed in) after a period of time (usually a minimum of three years) subject to

meeting certain performance conditions such as growth in earnings per share or shareholder returns relative to a comparator group;

- **Share options** (or executive share options or ESOs) are extremely similar to LTIPS and possess many of the same features. However they are likely to vary in terms of the performance measures that they use. The key difference is that whilst LTIPs will only vest after a period of time ESOs can vest within a year.

2.45 It should be noted that due to the potential delay in LTIPs or ESOs being set and being cashed in that a combination of share price movements and failure to meet performance can result in their actual value being substantially less than their initial value on paper.

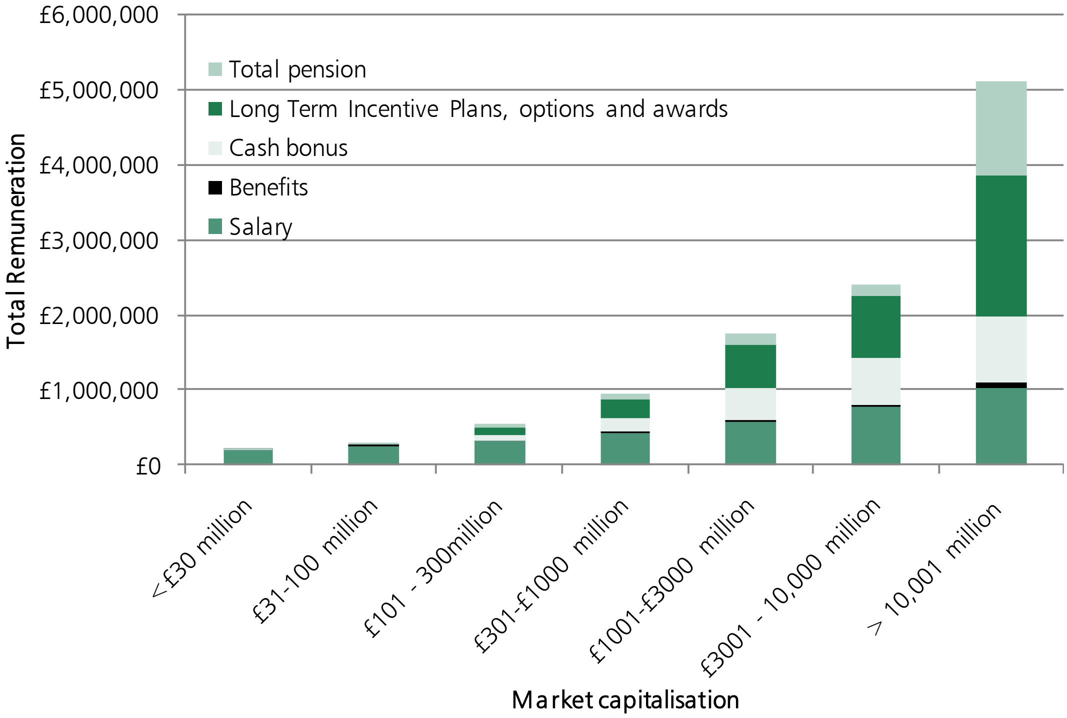
2.46 It is also important to note that rewards differ in their timing: salaries are reviewed towards the start of the financial year while bonus payments are made at the end of the financial year or later. Options and share awards are granted within 42 days of the announcement of results.

2.47 These two issues underpin this Review's decision to use 'realised' remuneration, i.e. actual received earnings, when comparing incomes between the public and private sector but 'total remuneration', i.e. the potential value of a package issued to a chief executive, when examining the composition of overall remuneration (Chart 2.P). This issue is discussed further in Annex C.

2.48 It is also worth noting that the composition of remuneration packages vary by the size of the company. Chart 2.P highlights the differences between firms of different sizes, showing that for chief executives of companies below a capitalisation of £300 million salary still constitutes the majority of their total remuneration.

Chart 2.P: Composition of median chief executive total remuneration by company capitalisation

As company size increases, variable elements constitute a larger proportion of chief executive total remuneration



Source: Fair Pay Review analysis of Manifest/MM&K Executive Director Total Remuneration Survey, 2010

Total remuneration includes the estimated value of those incentives issued but not necessarily cashed. Indeed some incentive schemes will have substantial time delays before they can be realised. For further details see Annex C below.

2.49 Given the difficulties in accurately calculating top pay in the public and private sector, outlined above, making a definitive comparison between the two is problematic. However, comparing the earnings of the head of the civil service, as an example of one of the highest paid members of the public sector who receives one of the most generous packages, to the median of FTSE 100 and 250 chief executives reveals a clear difference. In 2009-10, the Cabinet Secretary received £235-240,000 in salary, benefits-in-kind valued at £16,000 and the cash equivalent cash transfer value of his pension increased by £108,000 giving a total of £364,000.[64] This figure is still well under the median earnings of CEOs of FTSE 100 and 250 companies whose median *salary alone* was £828,000 and £461,000 respectively.[65]

The perception and the reality

2.50 Top pay in the public sector has come under greater media scrutiny in recent years. Newspaper reports including both the phrases 'Public Sector' and 'Fat Cats' increased by nearly 400 per cent between 2004-05 and 2008-09. Articles including all of 'Public Sector', 'Chief Executives' and 'Pay' increased by over 200 per cent in the same period.[66]

2.51 **But public understanding remains divorced from the data set out in this chapter**, particularly on public and private sector comparisons. According to a poll conducted by YouGov and ITV in October 2009, just 36 per cent of those surveyed thought that people who ran public

[64] Cabinet Office Annual Accounts

[65] *Executive Director Total Remuneration Survey*, Manifest/MM&K, September 2010.

[66] Search made using Factiva looking at UK National Newspapers.

sector organisations were paid less than their private sector counterparts, while 25 per cent thought they were paid more: so only **just over a third of respondents reflected the truth of the comparative data**. 72 per cent of people surveyed thought that those running public and private sector organisations should be paid about the same.[67]

2.52 Limited understanding feeds through into the wider debate. Campaign groups such as the Taxpayers' Alliance argue that the public sector must get value for money – which they define as paying the lowest amount to secure a suitable candidate – but that it does not currently achieve this. On the other hand those involved in setting pay, such as the Senior Salaries Review Body, argue that that is precisely the approach that they already adopt.[68]

2.53 A media narrative which over-concentrates on public sector 'fat cats' while not offering the same proper scepticism and focus over what is happening at the top of the private sector does not lead to understanding, and can undermine the desirable move to greater transparency over pay. When the previous Government proposed full disclosure of staff earning over £50,000, some local authorities expressed concern that this could lead to personalised attacks.[69] A fear of media witch hunts of high earners – without a frame of reference by which to judge fairness – makes transparency less appealing. It can also perversely drive pay up, with candidates for particularly exposed jobs demanding 'danger money' to compensate them for the risk of coming under intense media scrutiny. Some of these concerns are overdone: media scrutiny is proper in a free society and everybody in high public office should accept it is part of the job. However, there is no doubt that the concerns exist and are growing.

2.54 One telling example of the lack of a frame of reference is the way in which the public discourse has increasingly focused on the Prime Minister's salary as a benchmark for all senior public sector pay. This measure has one key advantage: it is immediately understandable to everyone. Unfortunately, its simplicity masks that it is a benchmark with profound flaws. Firstly, £142,500 does not accurately represent the value of the Prime Minister's total compensation package, which is very much higher than just his base salary. More importantly, the Prime Minister's salary is not in any way linked objectively to the value of the job. The Prime Minister's salary is not set by any need to recruit and retain, and thus is hardly a valid comparator for almost every other job where this is a vital consideration. With over 9,000 individuals earning more than this benchmark across the public sector,[70] its widespread use would risk damaging a wide range of public organisations' ability to function (Box 2.E).

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[67] YouGov, 2009.

[68] *Top Pay in the Public Sector*, Sixth Report of the 2009-10 Session, House of Commons Public Administration Select Committee, December 2009.

[69] http://www.telegraph.co.uk/news/uknews/7259289/Councils-afraid-to-say-how-muchthey-pay-chiefs.html

[70] According to data compiled by BBC Panorama.

Box 2.E: The Prime Minister's Pay – a Suitable Benchmark?

In the wake of the scandal over MPs' expenses, the pay of politicians has become an important part of the elite pay debate. The base salary for Members of Parliament currently stands at £65,738 per annum. Government ministers in the House of Commons earn between £26,624 and £79,754 per annum on top of this salary to reflect their extra responsibilities.

The Prime Minister's salary currently stands at £142,500, and there has been an increasing trend to compare the pay of public sector executives to that of the Prime Minister. This has its attractions: it is a simple measure, easily understandable by the public. But it has two major flaws:

Firstly, it does not capture the Prime Minister's total remuneration – not least because David Cameron has chosen not to take the full salary to which he is entitled (£198,660). If the value of the Prime Minister's living arrangements and allowances are included, his total remuneration would be significantly greater than even this higher salary: one estimate put it as high as £581,651.[71].

Secondly, and more importantly, the Prime Minister's salary is a crude benchmark that takes no account of the very different nature of the Prime Minister's job, a politician's job, from that of public sector managers. The Prime Ministers' pay is not objectively linked to the value of his job, or to the need to recruit and retain individuals. As one recruitment expert noted 'Prime Ministers pay themselves at a rate determined by politics more than by responsibility, and their earnings in retirement can if they wish vastly exceed their earnings in office.'[72] The Prime Minister's salary has no relation to labour markets. There is not a shortage of applicants and no job specification and there is no market or recruitment process for Prime Ministers.

Hence any comparison with a job for which pay is set by reference to a need to recruit and retain in a market is an invalid one. Making comparisons with public sector labour markets is as spurious as making comparisons with private sector labour markets. The argument that because the Prime Minister is running the country he should earn more than any public sector manager holds no greater weight than an argument that because the Prime Minister is the head of 'UK Plc', with a 'turnover' of hundreds of billions and a workforce of millions, his salary should somehow set a benchmark for chief executives of private firms.

[71] Radio 4's 'More or less' calculated that the PM's total package could be worth £581,651, including an estimate of the annual cash value of the pension (£45,651), a nominal rental value of accommodation at Downing Street and Chequers of £338,000.

[72] *Top Pay in the Public Sector*, Sixth Report of the 2009-10 Session, House of Commons Public Administration Select Committee, December 2009.

3 The private sector context

Chapter summary

Since the 1980s **there has been a revolution in executive pay in public corporations**, here and in the United States. Chief executive remuneration in FTSE 100 firms has increased by 160 per cent in the last ten years, driven by greater use of equity-based incentives.

The increased use of equity-based incentives has explicitly tied pay to performance, and has required executives to accept more personal risk. In theory, this risk justifies a higher level remuneration. But **there are good reasons to question whether equity-based incentives as currently formulated represent fair pay**: they can be a poor proxy for a manager's personal performance, they can be manipulated, and they are often geared towards value-destroying short-term performance.

In an age of larger and more complex firms, the role of the executive has undoubtedly become more complex, and executives' contribution larger. But executive pay has continued to grow as firm size has levelled off; **it is hard to believe that greater job size justifies the realised growth in pay.**

Recent decades have also seen the rise of generalist managers, able to move between sectors and demand higher pay to stay where they are. Yet the supply of generalist managers has risen with demand. There are justified concerns that **boards set too much store on recruiting big name executives, overlooking other candidates and limiting the pool of talent unnecessarily.**

Counter-intuitively, the revolution in pay has been accompanied by great improvements in corporate governance and transparency. **Corporate governance has only served to limit pay at the margin.** Remuneration committees do not want to send the signal that they are comfortable with below average CEOs, and benchmark their pay accordingly. With firms benchmarking each other, the system is only as strong as its weakest link. Executives can still exert influence over the pay-setting process, and shareholder activism has been limited in its impact. Ultimately, **excessive executive pay inflation is a collective action problem.**

Introduction

3.1 Chief executive pay has been rising fast for more than two decades (Chart 3.A). This Review has been tasked with understanding what has been happening in the private sector, to what extent there are distortions and market failures in senior executive private sector pay determination and whether they create upward pressure on public sector pay multiples – also to assess to what extent change in the public sector might help shape broader social norms on pay fairness.

3.2 This chapter sets out a brief history of executive remuneration, showing a revolution over recent decades in its level and composition, both in the United States and UK. The remainder of this chapter explores and challenges some of the reasons given for this revolution:

- That higher pay has been fair compensation for executives taking on greater personal risk;

- That higher pay reflects greater complexity and size of firms;
- That higher pay has been necessary because executives have more outside options;
- That higher pay has been reasonable because it has been controlled through corporate governance.

Executive remuneration – a history

3.3 The emergence of large complex organisations ever since the beginning of the twentieth century in both the private and public sector has raised the fundamental issue of how the principals – the owners of organisations (shareholders or taxpayers) – can get the best from the agents they hire to manage and direct the enterprise. Senior executives (agents) exercise considerable discretion over their input, effort and actions, which in turn have a substantial impact on the performance of the organisation as a whole; but the shareholder or owner (principal) cannot directly control or measure this input or effort. This is the famous separation between ownership and control first identified by Adolph Berle and Gardiner Means in the 1930s.[73] The family owned firms of the nineteenth century had evolved into the public corporations of the twentieth century. Scale demanded that they raise capital from a myriad of shareholders. These dispersed owners could no longer directly control the enterprise, but rather subcontracted control to a new and increasingly powerful class of managers.

3.4 As western economies grew well in the years after 1945 the new managerial class was considered to be performing well. But over the stagflationary 1970s, there was growing criticism that companies had grown slow and sclerotic and managers indifferent to the concerns of shareholders. Michael Jensen and Kevin Murphy prominently argued that chief executives were being primarily rewarded for increasing the size of their organisations, and that their pay was not tied tightly enough to performance.[74]

3.5 Over the 1980s and 1990s the executive remuneration package was revolutionised, in the United States and then in the UK, as shareholders employed greater use of share-based incentives that sought to tackle head-on the principal-agent problem. This was accompanied by a major rise in the level of total remuneration.

- In the United States, chief executive remuneration saw a 500 per cent increase above inflation from 1980 to 2003.[75] For S&P 500 chief executives, share-based components of the remuneration package, relatively unimportant until the late 1970s, formed approximately 80 per cent of the average package by 2008.[76]
- The UK has followed a similar trend, though one that has lagged behind the United States in its timing.[77] Historical remuneration data for the UK is poor in the period prior to the mid-1990s, when disclosure requirements were improved. But survey data suggests major above-inflation rises from the late 1980s, with bonuses and long-term incentive elements becoming much more important from the mid 1990s onwards. (Chart 3.A). More comprehensive data covering all of the FTSE 100 begins in the late 1990s, and shows UK chief executive remuneration rising rapidly to follow the trend set in the US in the decade before (Chart 3.B). By 2007 share-based components comprised 50 per cent of the average package (Chart 3.C:).

[73] *The Modern Corporation and Private Property,* Adoph Berle and Gardiner Means (1932: 2nd revised ed. 1991), Transaction Publishers.

[74] 'Executive Compensation: A New View from a Long-Term Perspective, 1936–2005', Carola Frydman and Raven Saks, *Review of Financial Studies,* 2010.

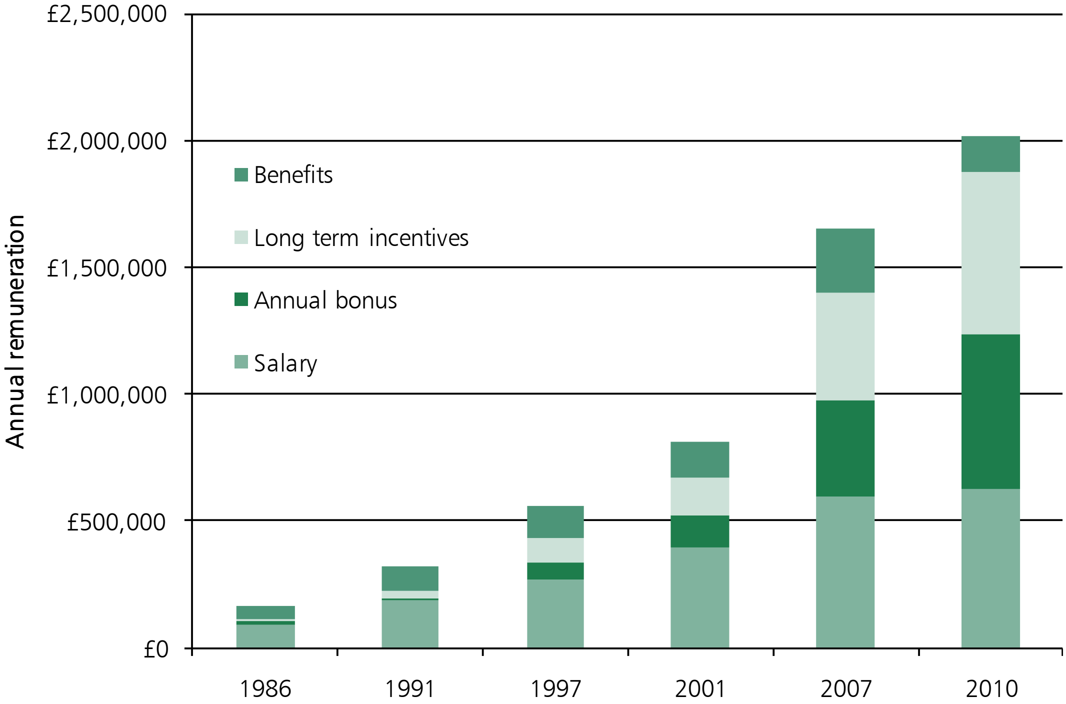
[75] *Why has CEO pay increased so much?*, Xavier Gabaix and Augustin Landier, MIT, May 2006.

[76] Fair Pay Review calculation based on data in *CEO Compensation*, C. Fyrdman and D. Jenter, 2010.

[77] There is evidence that total compensation in UK firms increases with their exposure to the US market: 'Do US Market Interactions affect CEO Pay? Evidence from UK Companies'. Joseph Gerakos, Joseph Piotroski and Suraj Srinivasan (2010) mimeo.

Chart 3.A: Remuneration packages of chief executives of large corporations since 1986

Chief executives have received large above inflation increases in remuneration since the 1980s; bonuses and long-term incentives have featured since the mid-1990s

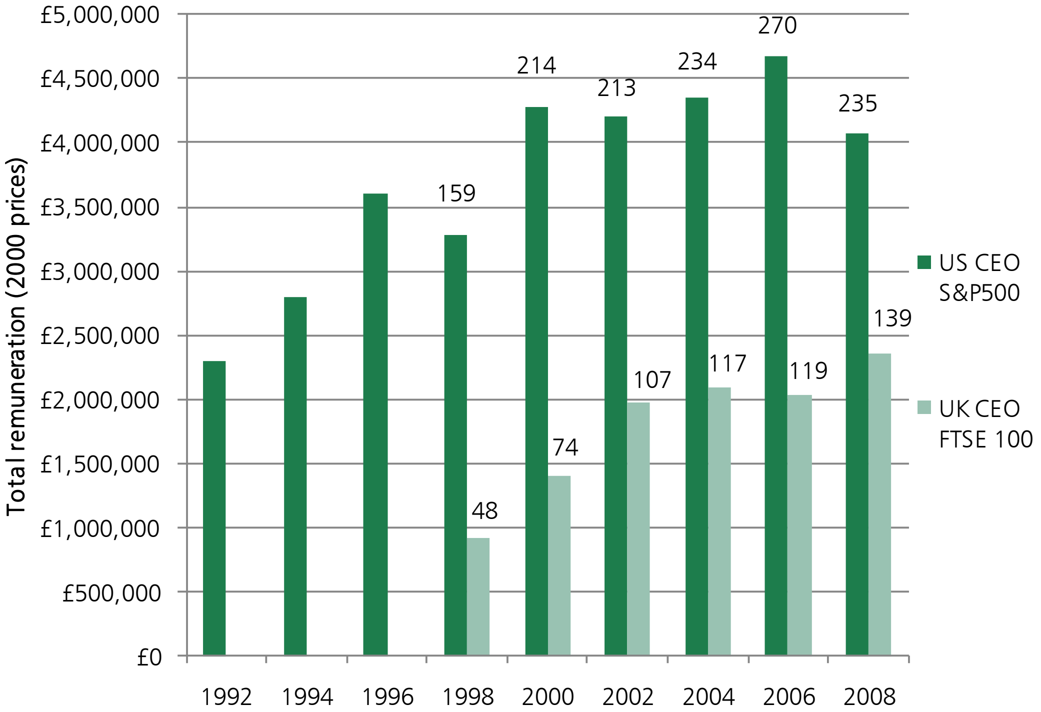


Source: Hay Group

Based on a sample of chief executives matching Hay reference level 30. This is broadly equivalent to a Group chief executive of a listed company with turnover of around £4 billion in today's prices, equating to a typical firm in the lower half of the FTSE100. Data based on a sample size of approximately 20 firms; actual sample size varies from year to year

Chart 3.B: Median total remuneration of chief executives of S&P 500 and FTSE 100 firms (in 2000 Sterling), with ratios to US and UK median earnings overlaid

Chief executive remuneration at large UK firms is catching up with that at large US firms

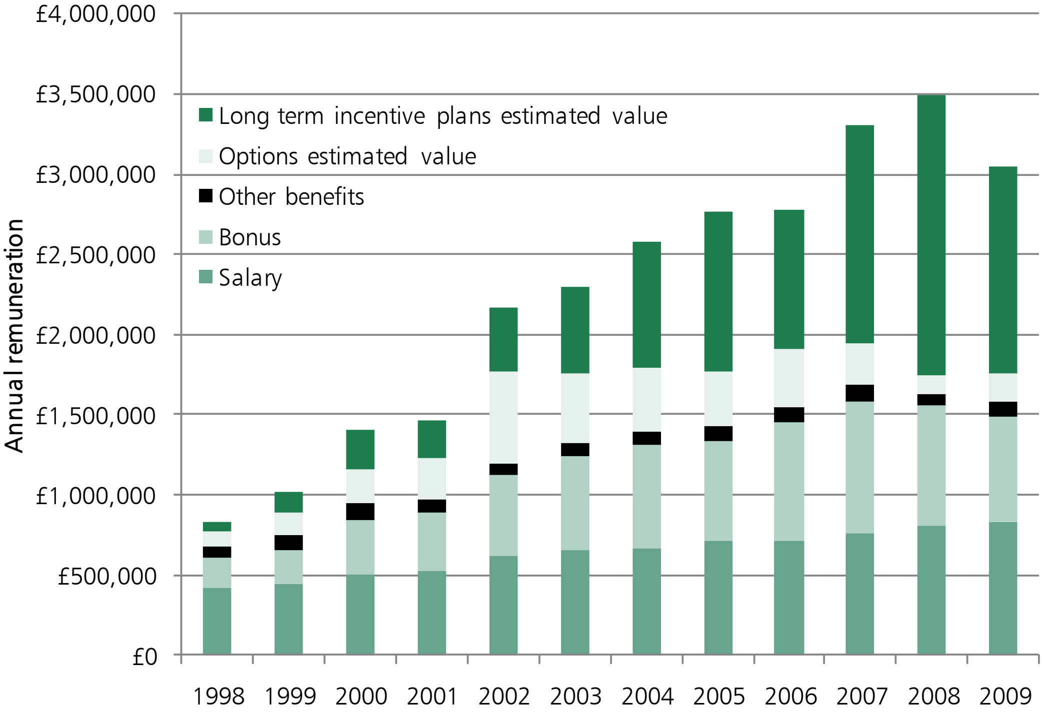


Sources: FPR analysis of data taken from C. Fyrdman and D. Jenter, *CEO Compensation, 2010, Bureau of Labour Statistics, The Manifest/MM&K Executive Director Total Remuneration Survey – 2010, Annual Survey of Hourly Earnings, ONS, HM Treasury GDP figures*

US data depicts total compensation and its main components: salaries, bonuses and payouts from long-term incentive plans, the grant-date values of option grants (calculated using Black-Scholes), the grant-date values of restricted stock grants, and miscellaneous other compensation (perquisites, contributions to benefit plans, discounts on stock purchases, etc.) Conversion to Sterling is at the exchange rate as of June 2000. UK chief executive data is also for' total' remuneration and includes an estimated yearly value of long term bonuses awarded, but not necessarily cashed, in a given year. For further information see Annex C below.

Chart 3.C: Median FTSE 100 chief executive total remuneration (excl. pension) composition 1998 – 2009

The importance of LTIPs has grown dramatically in the last decade



Source: The Manifest/MM&K Executive Director Total Remuneration Survey – 2010

In order to best capture the changing nature of CEO compensation figures given are for 'Total Remuneration' and as such include awards that may have not been cashed that year. This explains the apparently larger size of remuneration compared to other charts. For further information see Annex C below.

Has higher pay been fair compensation for executives taking on greater personal risk?

3.6 . The greater use of equity-based incentives has introduced more personal risk for executives, as a smaller proportion of their remuneration is guaranteed income. Proportionally more of their remuneration is exposed to business cycle conditions and technological shocks: convulsions that are a growing reality in the emergent knowledge-based economy. [78] Assuming executives are risk-averse, they will have demanded higher pay overall as compensation for taking on this greater personal risk. [79] The need to compensate managers for holding more equity incentives is identified by some as an important driver of differences in chief executive pay between nations (for example, remuneration packages in the UK and United States are more risky than some other nations, hence are in total higher).[80]

3.7 So, is this fair? On the one hand, equity-based incentives should be consistent with the principles of fair pay, as they tie remuneration to performance. If remuneration overall rises to reflect executives' due desert through their greater contribution, then so be it. But, if the heart of the case for equity incentives is that they help resolve the principal agent problem, then by creating risk in compensation that has to be mitigated by yet more share grants they are a costly way of going about it. Moreover, there are good reasons to question whether equity incentives

[78] Firms will pay managers more as they tend to pursue riskier growth opportunities – for instance, investing in R&D that frequently bears scant fruit. See "The Structure and Performance Consequences of Equity Grants to Employees of New Economy Firms" Christopher Ittner, Richard Lambert and David Larcker (2003) *Journal of Accounting and Economics* 34:89-127.

[79] This also suggests that knowledge economy firms will pay managers more as they tend to pursue riskier growth opportunities – for instance, investing in R&D that frequently bears scant fruit. See "The Structure and Performance Consequences of Equity Grants to Employees of New Economy Firms" Christopher Ittner, Richard Lambert and David Larcker (2003) *Journal of Accounting and Economics* 34:89-127.

[80] 'Are U.S. CEOs Paid More Than U.K. CEOs? Inferences from Risk-adjusted Pay', Martin Conyon, John Core and Wayne Guay (2010), *The Review of Financial Studies*.

are an illuminating indicator of performance, and so whether rises in executive pay have been justly deserved.

- **Changes in share price can be a poor proxy for a manager's own performance**. Falling interest rates can cause share prices to increase significantly without the CEO batting an eyelid (brute good luck). Though executives are equally subject to downturns (brute bad luck), the tendency for the market to rise over time means that volatility typically adds value to their remuneration. Moreover it is not obvious in terms of proportionality, that only executives and not the whole of the organisation's workforce should be deemed to have any influence on the totality of the organisation's performance which the share price reflects. Some incentive schemes are calculated as a function of raw returns rather than on the basis of relative performance evaluation. chief executives are thus sometimes rewarded even when their firms are not outperforming, but sometimes underperforming, the rest of the market.[81] In fairness, this problem is less pronounced in the UK, where incentive schemes are designed with these issues in mind, than the United States.[82]

- **Equity-based incentives can be manipulated**. A number of practices – the use of the current share price as the strike price and the ability of managers to unload their options once they vest – sit uneasily with the dictates of optimal contracting and pay for performance.[83] The propensity of managers to manipulate firm earnings is shown to increase when managers receive a larger proportion of compensation in conventional stock options and even performance-vested stock options that are assumed to be more exacting. [84] Such manipulation is made easier by the complexity and opacity of incentive schemes.[85]

- **Equity incentives interacting with short-term price movements can produce value destroying behaviour.** For a number of reasons, including myopia, short-term stock prices can depart from fundamental prices for an extended period. Moreover there are periods, especially during technological change and economic uncertainty, when such price movements are accentuated by genuine uncertainty over the value of future earning streams – and some investors will be more optimistic than others. LTIPS may not be long enough to prevent managers from having the opportunity to exacerbate investors differences of opinion and exploit bubbles or near bubbles in company share prices, even while some of their shareholder base, notably pension funds will take a longer-term view. They can take actions that give the impression of value-creating growth without actually doing so: for example by manipulating earnings, originating risky loans, delaying investment and R&D expenditure and embarking on extravagant mergers, so that they can 'cash out' early and 'flip' the firm to the group of more optimistic but short term investors.[86] The dot-com bubble

81 'Executive compensation', Kevin Murphy in Orley Ashenfleter and David Card (eds.) *Handbook of Labor Economics*, Vol. 3. (1999) North-Holland, Amsterdam.

82 'Explicit relative performance evaluation in performance-vested grants', Mary Carter, Christopher Ittner and Sarah Zechman, *Review of Accounting Studies* 14 (2/3). See also 'Discussion of 'Explicit relative performance evaluation in performance-vested equity grants', Fabrizio Ferri (2009), *Review of Accounting Studies* 14:307–313. The authors observe that factors suggested by economic theory are more closely associated with specific features of the RPEs where they are used.

83 *Pay Without Performance,* Lucien Bebchuk and Jesse Fried (2004) *Harvard University Press.*

84 'CEO incentives and earnings management: evidence from the 1990s', Daniel Bergstresser and Thomas Philippon (2006) *Journal of Financial Economics.* 80:511–29. Similar issues have been found for non-traditional stock options: 'Performance-vested Stock Options and Earnings Management', Yu Flora Kuang, 2008 *Journal of Business Finance and Accounting* 35(9/10):1049-1078.

85 "Executive Pay, Hidden Compensation and Managerial Entrenchment" Camelia Kuhnen and Jeffrey Zwiebel *(2009) Rock Center for Corporate Governance Working Paper No. 16.*

86 "Executive Compensation and Short-Termist Behaviour in Speculative Markets" Patrick Bolton, Jose Scheinkman and Wei Xiong (2006), *Review of Economic Studies,* 73: 577–610.

and recent financial crisis are stark testaments to the pain and disappointment that can result from structurally-induced, short-term behaviour. [87]

3.8 **In sum, it is not clear that these incentives represent fair reward for performance. It is also unclear whether the significant rises in overall remuneration unfairly over-compensate for the increased risks of being paid through allocations of shares or share options.**

Has higher pay been merited because firms have become larger and more complex?

3.9 Recent decades have seen ever larger firms competing across a global economy. The average size of firms has grown in real terms over the last twenty years. It would be reasonable to assume that the executive role has become more difficult during this period: executive directors are overseeing larger, more complex operations. It should therefore follow that executives are due greater reward as compensation. [88]

3.10 It has been established that growth in executive pay in the United States is closely correlated with the growth in the size of firms. In the US the six-fold nominal increase in chief executive pay over the period 1980 to 2003 (in real terms a five-fold increase) has largely tracked a six-fold increase in market capitalisation.[89] This has been justified by reference to the so-called 'superstar' effect: scarce talents of the most capable managers should gravitate towards the largest organisations where their abilities are best deployed by being spread over the largest amounts of capital and labour. In this way the very best managers, even if they only improve firm performance by a very small percentage, create massive value because small percentage increases still equate to very significant absolute gains for the largest firms, whose value may run into the billions of dollars.[90]

3.11 However, it does not necessarily follow that larger firm size should be matched by proportionally larger executive remuneration. Firstly, the models that underpin the 'superstar' arguments have been questioned on methodological grounds: for instance, there are real doubts whether it is possible to identify the very best managers in a scientific way.[91] Secondly, the correlation may reflect executives engaging in 'empire building' in order to swell their remuneration, rather than being fairly rewarded for performance in a more complex role.[92] In general remuneration is set by reference to other peer group companies, so that the larger the company the greater pay tends to be, giving managers an incentive to scale up their enterprise.[93]

3.12 Most crucially, a firm that has grown in size by a certain percentage has not necessarily grown in complexity by the same proportion, nor has the contribution of the executive role grown by the same proportion. A firm that is double the size will not necessarily have double the strategic decisions to make. So some of the growth in chief executive pay may be their due

87 On the general tension between the long-term goal to maximize firm value and the short-term goal to meet or exceed earnings, see 'The Economic Implications of Corporate Financial Reporting' John Graham, Campbell Harvey and Shivareem Rajopal *Journal of Accounting and Economics,* Vol. 40: 3-73.

88 Studies suggest that firms that are more complex to manage and/or have greater agency costs require stronger incentives, leading to higher pay. See 'Has Moral Hazard Become a More Important Factor in Executive Compensation', George-Levi Gayle and Robert Miller (2009) *American Economic Review* 99:1740-1969.

89 'Why Has CEO Pay Increased So Much?', Xavier Gabaix and Augustin Landier (2008), *Quarterly Journal of Economics* 123(1):49-100.

90 Ibid. In the Gabaix and Landier model, replacing the 250th best chief executive with the number one in the ranking raises the value of the 250th biggest company by 0.016 % - hardly a trivial figure when magnified by market capitalisations that can run into the billions.

91 The Gabaix-Landier argument has its critics. The models assume that mangers are smoothly and instantaneously matched with firms; that the best managers are easy to identify; and that a league table of ability with clear-cut rankings is readily available. In reality the chief executive labour market – like labour markets in general- are full of frictions and information asymmetries. Their model also works less well for example in a different time period like the 1970s, or if chief executive pay is co-related against a different variable – total sales revenue rather than market capitalisation. 'The effect of Labor Market Demand on US CEO Pay since 1980)', Gregory Nagel (2010) *Financial Review* 45(4):931-950.

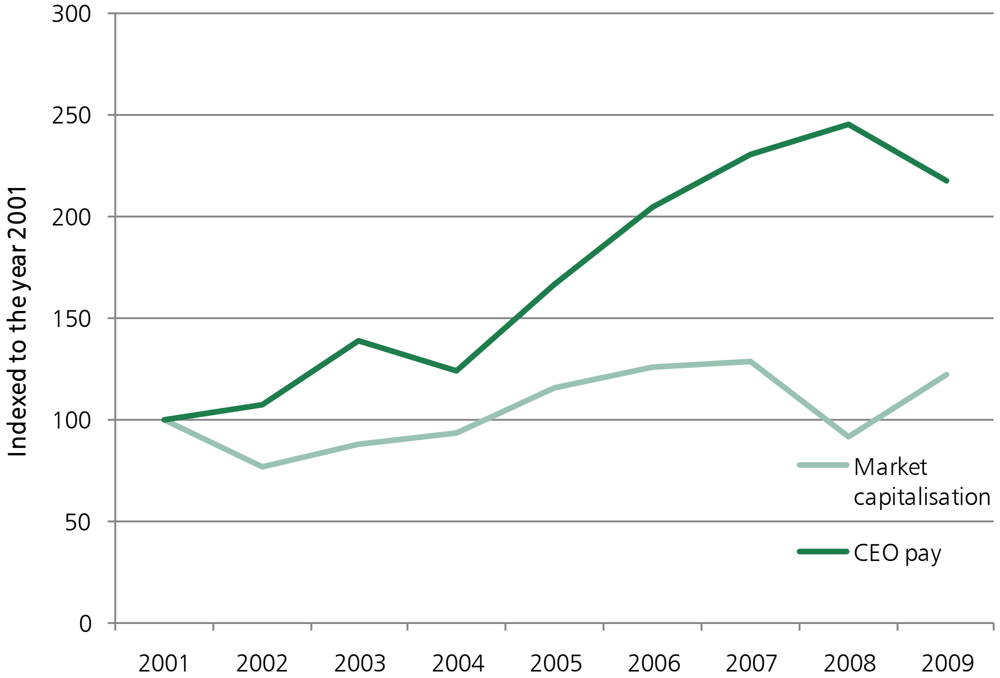
92 'On the Theory of Oligopoly', William Baumol (1958) *Economica* 25(99):187-198.

93 There are limits to how far executives can get away with this behaviour: the market for corporate control e.g. the stock market generally undervalues large companies and increases the chances that it will get taken-over and the manager will lose his job.

desert for managing larger and more complex firms, but not all. Indeed, the average size of firm in the FTSE 100 in terms of market capitalisations is not much changed from ten years ago, yet chief executive remuneration has continued to rise (Chart 3.D).

Chart 3.D: Remuneration of chief executives at FTSE 100 firms compared to firms' market capitalisation (indexed, 2001=100)

FTSE 100 chief executives' remuneration has grown even as firms' market capitalisation has remained largely constant



Source: Fair Pay Review analysis of data from Incomes Data Services and Bloomberg

3.13 **In conclusion, some of the growth in executive pay may be their due desert for managing larger and more complex firms, but it is hard to believe that this justifies anything like the growth in pay seen recently.**

Has higher pay been necessary because executives have more outside options?

3.14 Another, related, explanation for the rise in pay is that executives now have more portable skills. They have more outside career options so can demand higher remuneration from their employer in return for staying in their current job. In the United States, externally recruited chief executives represented 14.9 per cent of all newly appointed S&P 500 chief executives in the 1970s, 17.2 per cent in the 1980s, and 26.5 per cent in the 1990s. In the past, technical degrees in science, engineering or law as pathways to the top in specific industries were more commonplace, and managerial skills were seen as more specific to the firm. The rise of management as a formal academic discipline, an increasingly diversified business landscape and the IT revolution has increased the scope, span and complexity of the firm, and thus created the demand for general skills and the generalist manager.

3.15 The idea that high-performing individuals can pick up and take their skills into any environment and consequently that firms must compete on pay in a war for talent has gained powerful traction. With skills increasingly portable, executives are in a semi-permanent bidding war from rival suitors. Executives today make their last major company move when they are nearly 50 whereas in the 1930s the average age was around 37. Occupational divides are also bridged with greater ease than in the past: executives in the 1930s typically had worked in only one sector on average (1.16 sectors) but by the end of the century, they had worked in close to two (1.92 sectors). It would seem reasonable to argue that greater movement of executives between sectors should bring benefits to firms from their wider experience and understanding.

3.16 But is it necessary for such movement to have been accompanied by so much higher pay? If demand for the executive with portable skills has risen, so has supply, and if there are more external candidates to choose from, there should be less upwards pressure on pay. In the United States the share of executives with MBAs, a generalist qualification, rose from 10 per cent in 1960 to more than 50 per cent by 2000.[94]

3.17 The explanation for continuing pay inflation may lie in the concept of the superstar or charismatic chief executive. Rakesh Khurana, Marvin Bower Professor of Leadership Development at Harvard University, argues that the business stresses and uncertainties of the last thirty years have transformed the role of the chief executive from capable administrator into that of a leader, a visionary and even a saviour.[95] He shows how the candidate pool for chief executives has been artificially reduced by myopic investors, poorly deployed recruitment consultants and the celebrity obsessed business media, who combine to create an environment where impressing them is as important as doing the job. The result is that perfectly suitable candidates from smaller firms or below board level have been overlooked. And insofar as the media, financial analysts and investors are easily wooed by individuals from high performing or distinguished firms (irrespective of what the director in question may have contributed), firms end up scrambling after the same clutch of candidates, inflating pay. In theory remuneration consultants should open up the pool of potential candidates, discovering and introducing fresh blood into the search process. However, Khurana suggests that instead their role is principally ceremonial: to signal to outsiders that the process by which succession choices have been made is objective and impartial, even though boards already have a good idea what and who they want.

3.18 Employers often confuse individual talent for organisational talent: the productivity derived from the capabilities, culture and colleagues that mesh together as an organisational whole. A number of studies covering an impressive range of professions from surgeons through sportsmen to equity analysts have confirmed that when 'stars' move between organisations, their performance suffers relative to those who stay put.[96] It has been shown that executives who move to new firms perform well or poorly in relation to the extent that their skills match their new environment.[97] Remuneration packages that focus so much weight on the role of the leader are out of touch with contemporary practice which stresses the value of dispersed decision-making and the initiative of front-line workers to drive performance.[98]

3.19 **Boards set too much store on recruiting big name executives, overlooking other candidates, limiting the pool of talent available and so paying unnecessarily large remuneration.** Those recruiting executives need to do more to consider the circumstances in which such moves do and do not work, and the risks they carry not only for pay and performance but also to the morale and cohesion of the host firm and its employees.[99] Rather than ask *whether* chief

94 'Rising Through the Ranks: The Evolution of the Market for Corporate Executives, 1936-2003', Carol Frydman (2007), MIT Working Paper.

95 *Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs*, Rakesh Khurana (2010), Princeton University Press.

96 *Chasing Stars: The Myth of Talent and the Portability of Performance*, Boris Groysberg (2010) Princeton University Press.

97 'Are Leaders Portable', Boris Groysberg, Andrew McLean, and Nitin Nohria (2006) *Harvard Business Review*. Groysberg et al. followed the trajectories of twenty former GE executives who were hired as chairman, CEO or CEO-designate by other companies between 1989 and 2001. The executive For instance, where the priorities of the company meshed with the strategic experience of the former GE executive –for instance, a financially bloated or stretched company seeking out a manager with cost-cutting acumen, it experienced annualised abnormal returns of 14.1 per cent while poorly paired matches experienced returns of a disastrous-39.9 per cent. Likewise when former GE executives moved within the same or a related industry, their new companies had annualised abnormal returns of 8.8 per cent. Those who entered a new industry saw abnormal returns of -29.1 per cent.

98 'Technology, Information and Decentralisation of the Firm', Daron Acemoglu, Philippe Aghion, Claire LeLarge, John Van Reenan and Fabrizzio Zilibotti (2007) *Quarterly Journal of Economics* 122(4): 1759-1799.

99 *Chasing Stars: The Myth of Talent and the Portability of Performance*, Boris Groysberg (2010) Princeton University Press.

executives matter, it is more fruitful to understand instead *when* they matter.[100] Increasingly, the chief executive's job entails using more indirect levers of influence: getting the most from their workforce and setting the strategic direction of the organisation. But this matters most when opportunities are scarce since a lost or missed opportunity is unlikely to return again (by contrast, when opportunities are plentiful, chief executives can fail, pick themselves up and try again). But capitalising on these opportunities requires sufficient resources and organisational slack (something, for example, that is difficult when firms are burdened by debt and leverage).[101] Understanding these conditions is crucial for any organisation attempting to assess whether the benefits of employing any particular individual are likely to outweigh the costs.

Has higher pay been reasonable because it has been controlled through corporate governance?

3.20 A final question is that of the role of corporate governance. Since the early 1990s corporate governance in British firms has improved significantly, and more than in the United States.[102] The last two decades have witnessed an impressive series of mandatory and voluntary regulatory initiatives aiming to strengthen boardrooms against executive capture. From the landmark Cadbury Report of 1992, which crystallised 'comply or explain' as the bedrock of the UK system, to the reformulation of the UK Corporate Governance Code in 2010, there have been a series of reforms, which have been supplemented by a series of best practice documents issued by industry association groups such as the Association of British Insurers (ABI) and National Association of Pension Funds (NAPF) (Table 3.A:).[103] Important innovations include the separation of the positions of chairman and chief executive, the introduction of remuneration committees, formalising the position of non-executive directors (NEDs) and 'say on pay'. Concern about excessive executive remuneration has provided the backdrop for many of these initiatives: the Greenbury report was a direct response to concern about excessive executive pay at British Gas, while the Walker Review took place against the background of a widespread consensus that excessive bonuses had helped create the recent financial crisis.

100 For macro and micro evidence on the role of leaders, see 'Do Leaders Matter? National Leadership and Growth since World War II', Ben Jones and Ben Olken (2005) *Quarterly Journal of Economics* 120(3): 835-864 and 'Do CEOS matter?' Morten Bennedsen, Francisco Perez-Gonzalez and Daniel Wolfenzen (2009) NYU Stern Working Paper. That CEOs have an impact on management styles, see Marianne Bertrand and Antoinette Schoar (2003) 'Managing with style: the effect of managers on corporate policy', *Quarterly Journal of Economics* 118(4):1169–208.

101 'When does Leadership Matter: A Contingent Opportunities View of Leadership', Noam Wasserman, Bharat Anand and Nitin Nohria in Nitin Nohria and Rakesh Khurana eds. (2010) Harvard Business School Press.

102 'Returns to Shareholder Activism. Evidence from a clinical study of the Hermes UK Focus Fund', Marco Becht, Julian Franks, Colin Mayer and Stefano Rossi (2008) *Review of Financial Studies*, 22(8): 3093-3129.

103 Key reforms and reviews have been the Cadbury Report, 1992; Greenbury Report, 1995; the Hampel Report, 1998; the Turnball Report, 1999; Directors' Remuneration Report Regulations, 2002; the Higgs Report, 2003, the Tyson Report, 2003; the Smith Report, 2003; Redraft Combined Code (2003, revised 2006); the Myners Review, 2001 and 2004; the Walker Review, 2009; the UK Corporate Governance Code, 2010.

Table 3.A: Developments in UK corporate governance

	Standard Practice in 1995	Standard Practice in 2010
Board	At least two NEDs on Board Nomination Committee established No limit on directorships	Separate chairman and chief executive At least half independent NEDs (excluding the chair) with one appointed Senior Independent Director Nomination Committee – majority of independent NEDs Annual performance evaluation Maximum of 1 FTSE 100 directorship
Remuneration	3 year service contracts Remuneration Committee established Voluntary disclosure of remuneration No vote on remuneration report Parachute clauses	12 months service contract Wholly independent Remuneration Committee Mandatory disclosure of remuneration and advisors Mandatory but non-binding vote on remuneration report Options subject to performance and time-pro rated
Audit	Audit Committee established	Wholly independent Audit Committee Financial expertise on the Audit Committee Whistle-blowing procedures
Stakeholders	Non-voting shares not rare Institutions cast votes with management Active investment funds rare	Audit, remuneration and nomination committees should be available for AGMs as well as all directors Typically one share, one vote Some active investment funds

Source: Fair Pay Review

3.21 Yet these reforms have coincided with the revolution in executive pay. Studies examining different arrangements between firms suggest that the existence of remuneration committees and independent non-executive directors have made little difference to levels of remuneration.[104]

3.22 There are a number of reasons why improved corporate governance has had a limited effect.

- **Firms do not want to admit to having below average chief executives, and benchmark pay accordingly.** According to a range of commentators, the main reason compensation increases every year is that most boards want their chief executive to be in the top half of the chief executive peer group, because they think it makes the company look strong (this ties in with the idea of the superstar chief executive described above).[105] Hence remuneration committees are encouraged to reward their own chief executive with an above average increase, leading to a continual upward pay spiral, as every year the pay benchmark gets higher.[106] This effect is specifically referred to in the 2010 corporate governance code.

- **The system is only as strong as its weakest link.**[107] Given these benchmarking effects, it may only take one firm giving a huge pay rise to its chief executive to set off ripple effects that impact on the entire executive labour market. Frequently, it is firms with the weakest governance that are the greatest source of these negative

[104] 'Corporate governance and executive compensation', Martin Conyon (1997) *International Journal of Industrial Organization* 15: 493–509; 'An empirical examination of the role of the CEO and the compensation committee in structuring executive pay,' Ronald Anderson and John Bizjak (2003) *Journal of Banking & Finance*, 27(7): 1323–1348. See also 'Board control, Remunerartion Committees and Top Management Compensation', Martin Conyon and Simon Peck (1998) *Academy of Management Journal*, 41(2): 146–157.
[105] 'CEO pay and the Lake Wobegon effect', Rachel Hayes and Scott Schaefer, *Journal of Financial Economics*, Dec 2008.
[106] 'Compensation Benchmarking, Leapfrogs, and The Surge in Executive Pay', Thomas DiPrete, Gregory Eirich and Matthew Pittinsky (2010) *American Journal of Sociology,* 115(6): 1671-1712.
[107] 'From weakest-link to best-shot: The voluntary provision of public goods', Jack Hirshleifer (1983) *Public Choice* 41: 371-386.

spillovers.[108] Other firms find themselves having to pay their managers more to stay.[109] In theory, this may also weaken incentives to invest in corporate governance.

- **Executives still exert some influence over the pay-setting process**.[110] Executives rightly have the opportunity to make their case for higher pay. There is evidence that they are extremely adept at doing so, and are able to manage the boardroom process (for example, by appointing directors to the board and showering other perks on favourites, or by offering 'repeat business' opportunities to remuneration consultants).[111] Boardroom activity is embedded in a strong social setting. Even independent directors may be susceptible to psychological pressures – returning favours and holding back from challenging norms on pay – that are difficult to observe directly. These are more likely to exist when the chief executive is able to shape the board's agenda, control information available to board members and is seen as central to the functioning of the board or when the chief executive is in a position to bestow 'gifts' such as seats on the board through serving on the nomination committee. Having more independent directors is associated with lower pay when chief executive influence over the board is low but less so when chief executive influence is high.[112]

- **Shareholder activism on remuneration remains limited in its impact**. Past reforms have assumed that better shareholder involvement is the key. Calls to turn shareholders into vigilant hawks on pay and performance issues have been central to the ethos that has driven reform in the UK, as expressed in the Hampel Review (1998) and the Myners Reviews (2001, 2004). The costs of activism have fallen with the emergence of professional proxy voting and advisory firms for shareholders, and recent years have seen steadily rising levels of voter turnout at shareholder meetings (currently 68 per cent among FTSE 350 companies) with shareholders voting more frequently on executive pay. However, any resolution on the directors' remuneration report is non-binding: shareholders can signal dissatisfaction (and be seen to reflect public concern) about executive pay safe in the knowledge that the consequences may only be some marginal changes to the remuneration package. Overall, less than 10 per cent of shareholders abstain or vote against the mandated Directors' Remuneration Report resolution, though problems are often ironed out beforehand through shareholder consultations.[113] Analysis suggests that shareholder outrage only constrains pay under specific and extreme circumstances: typically when pay is in the top quintile of chief executives and levels of prior dissent are already high. Even then the results have been quite small.[114]

3.23 Even if all these issues could be resolved there is a still a collective co-ordination problem. For any individual firm it still makes sense to pay the going rate for chief executives, so the

[108] 'Corporate governance externalities', Viral Acharya and Paolo Volpin, *Review of Finance* (2010) 14(1):1-33. The relationship between weak governance, pay inflation and wider spillovers can be understood from a number of perspectives: (i) managerial power (ii) shirking models (iii) and gift exchange models.

[109] 'Corporate governance externalities', Viral Acharya and Paolo Volpin, *Review of Finance* (2010) 14(1):1-33.

[110] While very weighted to the US, Bebchuk and colleagues work remains very influential: *Pay Without Performance,* Lucien Bebchuk and Jesse Fried (2004) *Harvard University Press.*

[111] 'Executive Pay and 'Independent' Compensation Consultants.'Kevin Murphy and Tatiana Sandino (2009) *Social Science Research Network.* Available at *http://ssrn.com/abstract=1148991*. On the other hand, there is stronger evidence that chief executives who use compensation consultants are paid more: 'Compensation Consultants and Executive Pay (CRI 2009-010)' Martin Conyon (2009), *Compensation Research Initiative.* Paper 6. http://digitalcommons.ilr.cornell.edu/cri/6

[112] 'Economic and psychological perspectives on CEO compensation: a review and synthesis', Charles O'Reilly III and Brian Main, *Industrial and Corporate Change*, 19(3):675-712.

[113] 'Say on Pay Vote and CEO Compensation: Evidence from the UK', Fabrizio Ferri and David Maber (2009) *Harvard Business School and SSRN*.

[114] 'Outrage or Mild Irritation: Don't Shareholders Care about CEO Pay', Ian Gregory-Smith, Steve Thompson and Peter Wright (2010), mimeo. The authors looked at the impact of Say on Pay regulations and votes on directors' remuneration reports at FTSE 350 firms between 1998 and 2008.

process of sheer competition produces an upward ratchet. The process is analogous to a military arms race: from any one country's perspective, it must keep pace with its rivals' spending on their military arsenals; not to do so risks being overwhelmed in battle. But if all nations build up arms at the same pace, none are safer than before. Nations would spend much less on weapons if they could take spending decisions in unison. This lack of coordination is also a feature of the markets for chief executive pay: firms end up overpaying for executives in order to establish a short lived advantage that is neutralised by rivals paying more as well. As pay-setting freedom is devolved to public sector organisations under quasi-market conditions, the risk is that similar forces will emerge in the 'freed-up' parts of the public sector.

3.24 In a debate that goes far wider than the issue of remuneration, there remain concerns that the contemporary public company is lacking in proper ownership, with many diverse shareholders who are often 'owners' for only a short period. Institutional investors are typically managers of portfolios of assets constituting many companies. They are paid to manage the assets according to their assessment of prospective risk and value rather than intervene actively in managerial decision-making of individual companies. Meanwhile individual shareholders have comparatively tiny holdings and have neither the resource nor power to deliver any change.[115] On the other hand, long term institutional investors like public or independent pension funds are more likely to intervene in managerial decisions than funds run by industrial companies or financial institutions.[116]

3.25 **Taken together, corporate governance has probably only served to limit pay at the margin.** Of course, it is impossible to say what the situation would have been without these reforms. And corporate governance has clearly had an impact on managing executive performance overall. There is evidence that across the FTSE 350, firms with smaller boards, greater turnover amongst directors and non-executive directors and a greater proportion of independents are more likely to dismiss their chief executives for poor performance; one reason why chief executive dismissals may have become more frequent in the last decade.[117] Why good governance should be better at dismissing poor performers rather than restraining pay is unclear: it may be that when it comes to pay, shareholders and independent directors feel less able to exercise their discretion and more circumscribed by norms and benchmarks.

Implications for the public sector

3.26 Some of the recent rise in chief executive pay has been driven by justifiable market factors: the proper drive to align the shareholder and manager interest through equity-based incentives, the growth of larger and more complex firms, the shift from firm-specific skills to general skills. But there is worrying evidence of market failure enabling executives to extract economic rent. Too many boards fall for the doctrine of the charismatic chief executive and attribute too much success to him or her rather than the wider organisation; there is too little attempt to broaden the talent pool from which chief executives are recruited. And while there is a good case for equity incentives, there has been too little attempt to insulate incentivisation from an upward ratchet via pay benchmarking courtesy of the remuneration consultancy industry. Greater transparency and greatly improved corporate governance have only served to limit the growth of executive pay at the margin, though of course the counterfactual of what would have happened in the absence of governance reform is not available. Ultimately, where is the measurable and comparable rise in performance to match the rise in the pay of top directors over the past decade or so?

[115])'Takeover bids, the free rider problem and the theory of the corporation,' Sanford Grossman and Olivier Hart (1980), Bell Journal of Economics 11(1):42-64.

[116] 'Pension Reform, Ownership Structure, and Corporate Governance: Evidence from a Natural Experiment', Mariassunta Giannetti and Luc Laeven (2007) *ECGI - Finance Working Paper No. 181*

[117] 'Outrage or Mild Irritation: Don't Shareholders Care about CEO Pay', Ian Gregory-Smith, Steve Thompson and Peter Wright (2010), mimeo.

3.27 This matters to the public sector directly and indirectly. The public sector has a long history of adopting private sector pay practices, and managers moving in from the private sector have expected the same sorts of packages. The public sector has to match the rate for skilled professionals and executives if it is not to become a second or third best employer: even though parts of the public sector operate as relatively closed labour markets for executives. But the more boundaries are broken down between it and the private sector – one of the aims of public service reform – the more the public sector will be exposed to private sector competition for scarce managerial talent. Nor can it entirely rely on high quality corporate governance alone to hold the line, if this is not doing the job in the private sector. Finally, the side-effects associated with equity incentives should inform a more balanced and hard-headed discussion of the benefits of performance-related pay in the public sector. Chapter 4 sets out evidence that parts of the public sector are already experiencing the upward movement in senior executive pay seen in the private sector, albeit from much lower levels.

4 Executive Markets in the Public Sector

Chapter summary

It is largely futile to attempt to define precise boundaries for the public sector; rather **it is important to understand that executive pay is being set in an increasingly complex environment of public, private and third sector provision of services.**

The public sector ethos is part of the reward of working in public services. However, this does not render concerns over pay irrelevant or illegitimate, and public servants' sense of public duty should not be exploited in an effort to avoid paying fair reward.

The public sector has not been strong enough on managing and rewarding performance. The public sector could explore more options for using variable pay to incentivise and communicate that pay reflects performance.

Greater complexity and risk in senior roles have exerted upwards pressure on pay. In some areas the size of the executive role has increased, where remits, commissioning arrangements and autonomy have risen. **Additionally, where failure is not dealt with in a fair way, risks are exacerbated and greater upwards pressure on pay has been the result.**

Markets for public sector executives are relatively closed. In some areas, **an excessive focus on experienced candidates from within sectors has led to pay inflation.** Recruiting from too narrow a pool of candidates also limits the extent to which the public sector can benefit from new ideas and expertise. The public sector also faces real challenges in nurturing talent to supply senior positions.

Recruitment from the private sector is limited, but where it does occur it has contributed to senior pay inflation. Clearly, recruitment of private sector skills will bring benefits, but it is important that organisations are hard-headed and ensure that higher pay is justified by performance.

Autonomy from central Government control is associated with higher levels of executive pay. **Greater autonomy brings a risk of further inflation in senior pay. This may be justified, as roles may be more complex. But it is doubtful whether governance arrangements alone will be sufficient to assure the public that senior pay is fair across the board.**

Introduction

4.1 This chapter explores what is meant by the public sector, and emphasises that its boundaries are hard to define, but that there is a distinctive public responsibility and ethos. It then addresses:

- what impact complexity and risk in senior roles have on senior pay;
- whether there is enough competition for executive roles;
- what influence private sector rates of pay may have; and
- whether executive pay in the public sector is adequately controlled.

What is 'the public sector'?

4.2 It is very important to recognise that there is not one single public sector or public sector workforce, but rather many different public sectors, with a rich diversity of different organisations serving different public functions. Reflecting this heterogeneity, senior pay varies significantly across the range of public bodies, which operate within many different labour markets, experiencing different trends and drivers for senior pay. **There is unlikely to be a single explanation for all the patterns in senior pay that have been observed in the public sector in recent years.**

4.3 The boundaries of the public sector are blurred (Box 4.A:) and are likely to become more so given the Government's ambition, announced in the recent spending review, to increase diversity of provision in public services. This will have consequences for pay practices and levels. For instance, executive remuneration in firms within the contracted-out public services industry reflects private, rather than public, sector norms. Remuneration committees in such firms appear to apply private sector benchmarks without considering that much of their business is more comparable with the public sector. There have already been reports that the higher pay for managerial positions within contracted-out services is attracting talent from public sector organisations – potentially making recruitment and retention harder.[118] Similar complaints have been made by local authorities regarding losing staff to higher paying housing associations. In this context, **the attempt to define precise boundaries for the public sector is self-defeating and largely meaningless; rather it is important to understand that executive pay is being set in an increasingly complex environment of intertwined public, private and third sector provision of services.**

[118] http://www.guardian.co.uk/politics/2010/jul/16/civil-servants-lucrative-roles-private-sector

Box 4.A: The boundaries of the public sector

Public sector organisations vary along a number of dimensions informing definitions of what is public, quasi-public or private:

- Funding. Not all bodies routinely considered 'public' receive all, or even the majority, of their revenues from the taxpayer. Regulatory bodies in particular often raise funds from fees on the bodies they oversee: the Financial Services Authority, for example, is entirely funded by levies on the institutions it regulates. Meanwhile, many parts of the private sector receive all or nearly all of their income from public funds in return for providing public services on contract or in partnership arrangements.
- Legal Status and Government Control. A range of public bodies operate independently, 'at arm's length' from Government, including over pay and remuneration: for example, the BBC is autonomous from Government, even though publicly funded through the TV licence fee.
- Market Context. Some public bodies operate in competitive markets, competing with other public and even private sector organisations, for example the Queen Elizabeth II Conference Centre. Meanwhile, some private firms are natural monopoly providers, e.g. Network Rail, which is why it is run as a not for dividend company regulated by the Office of Rail Regulation. Markets may also vary in size, being local, national or global: for example, in the higher education sector students move freely across borders, and there are emerging signs of a global market in university leaders.

The boundaries are made more porous by the public services industry, the most developed in the world and second in size only to the US, with turnover (from taxpayer funds) in 2007-08 of £79 billion. The industry has more than doubled in size since 1995-96.[119] There is also the Private Finance Initiative. There are £58 billion of outstanding PFI contracts in which private contractors deliver privately financed public infrastructure but at public direction.

Many voluntary sector organisations have become increasingly dependent upon public funding: it is estimated that some 27,000 voluntary organisations, most of them larger in size than the sector average, receive over three quarters of their income from statutory sources.

No sector stands wholly apart from government. Even organisations that are situated at the outer reaches of the public-private continuum are constrained or empowered by government authority. Decisions to encourage or discourage certain behaviours can cut and divide the cake in different ways – the generous tax treatment of debt, for instance, could be seen as a subsidy to particular firms and sectors.

History shows that definitions and perceptions of the public sector change over time, challenging the idea that there is a wholly public sector job or activity. Tax collection and defence – two venerable functions of the state, seen through a contemporary lens – were contracted out to private agents and mercenaries in the past.

[119] The Public Services Industry Review (2008)

Public Responsibility

4.4 **Public activities entail a distinctive public responsibility. This places those delivering public services firmly in the public eye.** This responsibility has three key elements:

- When public bodies fail in their tasks, the consequences of this failure more commonly fall on wider society than failure by a private firm. For example, public bodies misusing or abusing the state's unique power to regulate and compel can result in individuals losing their property, liberty or even lives. Public bodies are engaged in delivering public goods, for example macroeconomic stability, climate change mitigation or the prevention of terrorism: any mistakes can be catastrophic for entire populations and industries.

- Nor is it just a question of mistakes. The public sector is a co-creator of wealth and an important source of social well-being.[120] Much of the hard and soft infrastructure that supports wealth generation – for example transport, science, education and skills, the protection of intellectual property, law and order – is created by the public sector. Individual and public health is underwritten by the National Health Service. It is an imperative that these tasks are discharged as well as possible within whatever budget constraints, and they properly attract public scrutiny.

- The nature and funding of public activity also creates expectations that public organisations will abide by norms of accountability, due process, equity and rationality. Public bodies thus acknowledge a legitimate public interest in their activities that applies less to private firms, and subject themselves to binding constraints and scrutiny. This scrutiny can come either via elected bodies such as Parliament or through the courts, for example through the process of judicial review.

4.5 Many individuals are inspired to work in the public sector because of the chance to further the public good – the so-called public service 'ethos' or mission. Effectively, **the public service ethos is part of the overall public sector reward package**. Public sector employees may accept lower pay than their private sector counterparts, as they are partially compensated by the knowledge they have the opportunity to discharge a public purpose. But although this is true, it does not mean private and public sector pay can occupy two different universes. Private pay is still an influential benchmark, whatever the discount that public sector pay may represent.

4.6 There has been growing concern that attempts to incentivise improved performance by linking pay to rigid systems of inspection and reporting risk has eroded public servants' sense of mission. It could also be argued this has created upward pressure on pay as the ethos component of reward has been undermined. Flexible and decentralised public services may be better suited to nurturing a public service ethos among staff, and may raise productivity by allowing individual employees greater scope to find roles that better match their personal sense of mission. Paradoxically, however, this can also introduce rigidity and conservatism into public organisations, with employees becoming emotionally attached to current practices and programmes. This is offered as one reason why public services have proved difficult to reform.[121]

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[120] *Growing Public: Volume 1 The Story, Social Spending and Economic Growth since the Eighteenth Century,* Peter Lindert (2004), Cambridge University Press.

[121] 'Shirking or work morale? The impact of regulating', Bruno Frey (1993) *European Economic Review*, 37(8):123-132 and 'Incentives, Choice and Public Accountability in the Provision of Public Services', Timothy Besley and Maitreesh Ghatak (2003), *Oxford Review of Economic Policy* 19(2):235-249.

4.7 It is clearly in the public interest that the public service ethos be valued and celebrated however the public sector is structured and organised. Public bodies need to be staffed by able and well-motivated individuals if the quality of service provision is not to suffer. As the Public Administration Select Committee has noted, if public service is not publicly valued – or worse, if it is actively denigrated, for example by portrayals of the public sector as 'parasitical' upon the wider economy – then individuals are increasingly unlikely to volunteer to work in public sector organisations, which may find themselves being forced to increase levels of pay in order to recruit. **Public servants' sense of public duty should not be exploited in an effort to avoid paying fair reward; the existence of a public sector ethos does not mean that concerns to achieve fair pay relativities with the private sector can be dismissed.** Past experience suggests that allowing public sector pay to fall too far behind private sector pay can lead to reductions in the quality of the public sector workforce,[122] or to difficulties in recruitment and retention whose consequences can in some cases even be a matter of life and death.[123]

Does senior pay reflect public sector performance?

4.8 One way of approaching the question of whether increases in pay have been fair is to look at how pay maps on to performance. This Review cannot of course look at individual cases of whether pay has matched performance. But the question can be approached by looking at:

- the macro evidence for performance across the public sector; and
- evidence for whether pay is suitably linked to performance.

Macro evidence on public sector performance

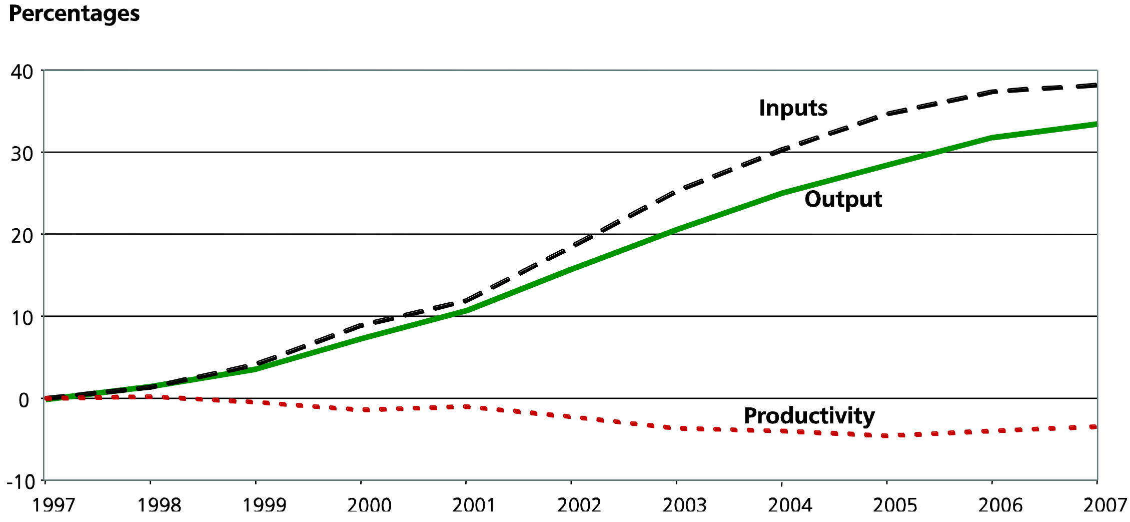
4.9 There is widespread public concern that levels of productivity in public services are low, and that recent private sector productivity gains have not been matched in the public sector. Official statistics for public sector productivity appear to confirm such perceptions (Chart 4.A).

[122] 'The Consequences of the Decline in Public Sector Pay in Britain: a little bit of evidence', Stephen Nickell and Glenda Quintini (2002) *The Economic Journal*, 112(447):107-118.

[123] 'Can Pay Regulation Kill? Panel Data Evidence on the Effect of Labor Markets on Hospital Performance' Emma Hall, Carol Propper and John Van Reenen (2008), LSE CEP Discussion Paper No 843.

Chart 4.A: Public sector productivity since 1997 – Cumulative change in output, input and productivity in publicly funded services

Official measures suggest outputs did not keep up with inputs



Source: Office for National Statistics

4.10 Such headline figures for public sector productivity need to be treated with considerable caution, due to difficulties of measurement – far more so than in the private sector with its more tangible metrics of profit, return on investment and so on. In the public sector, incorporating changes in quality as well as output is highly challenging. Further difficulties include time lags, a lack of benchmarks, the absence of counterfactuals, measuring the quality of inputs and choosing an appropriate quality adjustment metric.[124] Clearly, some metrics such as crime rates, exam results and hospital waiting times have improved. But whether they have improved to the extent that would have been hoped for from greater public spending, and whether they have improved at the expense of other measures where fewer targets were focused, have and will continue to be the subject of much debate between the political parties and in society more widely.

4.11 And even without these issues, there remains the difficulty of pinning down the extent to which good outcomes are the result of action by senior executives, as opposed to action by their workforces, changes in government policy, investment levels, structural changes and so on.[125] For instance, within the schools sector, there is strong evidence that teachers and getting the right people to become teachers lead to the greatest improvements in outcome.[126] Even in cases where better management practices are associated with positive outcomes, it is hard to separate the role of managers from wider drivers. In the NHS financial and clinical outcomes, such as survival rates from emergency heart attack admissions, appear to be driven by more intense competition between hospitals, which itself has had the effect of forcing hospital to adopt

[124] Problems in measuring and interpreting public sector productivity can arise for the following reasons:

- Lack of data in some areas, such as hours worked by police forces
- Lack of markets by which to determine 'price' or value and quantity
- Difficulties in measuring quality of outputs, which may be overestimated or underestimated
- Difficulties in measuring quality of inputs – impact on outputs may not be captured by the data
- Changes in population can distort recorded output trends
- Time lags – the impact of improved performance in e.g. education or healthcare may only be revealed later
- Lack of benchmarks – what is "best practice"
- Lack of counterfactuals – what would have happened otherwise

More information on public sector productivity can be found at http://cep.lse.ac.uk/_new/research/productivity/public_sector.asp

[125] 'The Impact of Headteachers on the Performance and Attitudes of Pupils', Jeff Searle and Peter Tymms (2007) in *The Leadership Effect: Can Headteachers Make a Difference* James O'Shaughnessy ed. (2007), Policy Exchange.

[126] *How the World's Best-performing School Systems Come Out on Top* McKinsey & Company (2007).

better management practices.[127] Overall, it is very difficult to conclude whether pay has been matched by performance at a macro level.

The link between pay and performance

4.12 Given these difficulties of measuring performance at a macro level, it is vital that public sector organisations are, and are seen to be, strong on managing and rewarding performance at the organisational and individual level. Yet there is widespread agreement that the public sector currently does not manage staff performance well. To take but one example, only one third of senior civil servants think performance is managed well in their organisation.[128]

4.13 There are also widespread concerns that poor performance is not dealt with adequately. For example, evidence suggests managers in local government are uncomfortable in establishing what 'poor performance' means and confronting staff where such behaviour is exhibited.[129] NHS staff survey results from 2009 indicate less than a third of staff believe that performance reviews are well-structured and resulted in real improvements.

4.14 Performance pay has also been the subject of much criticism. Performance pay arrangements vary from workforce to workforce, as covered in Chapter 2. The Senior Salaries Review Body has summarised the problems as having occurred because:

- bonus schemes have been applied across the board, regardless of context;
- the size of the bonus has looked out of scale with the measurability of the outcome;
- the rationale for awarding bonuses and levels that are set has not been made clear; and/or
- the prevalence in some areas of the public sector of enforcing top-down appraisal distribution quotas ('tranching'), which over-ride individual performance outcomes, militates against motivation and perceived fairness.[130]

4.15 Given the Senior Salaries Review Body's criticisms, it is doubtful whether pay arrangements across the board do relate sufficiently to performance. Furthermore, it is clear that many public sector executives debate whether performance pay has any place in the public sector at all, arguing that additional financial reward is not a necessary incentive for those who have chosen a career in public service.

4.16 However, there is some evidence that complaints about public sector performance pay often have more to do with aspects of implementation rather than the principle.[131] Recent academic work suggests public sector workers do respond to financial schemes, particularly in the field of education and possibly also in health.[132] However, levels of performance pay (in the workforce at large) are often so low that it can be hard to ascertain their impact. Research conducted has been limited to workforces in general, and more work may need to be done to ascertain its impact on motivation at executive level.

[127] 'The Impact of Competition on Management Quality: Evidence from Public Hospitals', Nicholas Bloom, Carol Propper, Stephan Seiler and John Van Reenen (2010) *CEP Discussion Paper* No 983.

[128] Referenced in *Senior civil service workforce and reward strategy: report of the steering group to the Cabinet Secretary*, Sir David Normington, November 2008.

[129] http://www.hrmagazine.co.uk/news/1023184/Local-government-compares-badly-private-sector-maximising-use-staff/

[130] *Initial report on Public Sector Senior Remuneration 2010*, Senior Salaries Review Body, March 2010.

[131] See for example the evidence gathered by the Wright Review of the NHS Very Senior Management framework. *The NHS Very Senior Managers' pay framework: an independent evaluation*, June 2008.

[132] 'Performance pay in the public sector: A review of the issues and evidence', Graham Prentice, Simon Burgess and Carol Propper (2007) Paper commissioned by Office of Manpower Economics.

4.17 Part of the problem is one of terminology. 'Bonus' has become a dirty word (at least in part thanks to the debate on bankers' pay), and one that the Government and other public bodies are increasingly keen to avoid. Often 'bonus' is an inaccurate term too. In many areas, performance pay is actually variable pay, paid out of a pot set aside for that use: so 'bonuses' are not really additional. In their rush to avoid being seen to award bonuses, public sector organisations may be throwing out an important tool to help link pay to performance.

4.18 Furthermore, there are many ways to link pay to performance, and it is arguable that the public sector has not used the full range of options. For example, it is possible to design team-based incentives that reconcile the importance of due desert with the reality that outcomes are collectively produced. The NHS has trialled team pay and an evaluation study by the Hay Group identified benefits associated with the scheme (though it was more successful in some conditions than others).[133]

4.19 It is thus understandable that a public perception has arisen of public sector managers who have seen their own remuneration increase, but failed to deliver commensurately improved services to the public. **The public sector has not been strong enough on managing and rewarding performance. The public sector could explore more options for using variable pay to incentivise and communicate that pay reflects performance.**

Is greater complexity and risk in senior public sector roles driving up pay?

4.20 In evidence submitted to the Fair Pay Review, higher pay for senior executives has been defended on the grounds that public sector leadership roles are becoming more complex, as demands on public services proliferate. For example, managerial roles within the NHS may now comprise elements of risk management, strategic financial planning, competitor analysis and partnership management to a far greater degree than in the past.

4.21 Looking ahead, the present tight fiscal climate will require an intense focus on cost reduction from public sector executives, while delivery structures could be transformed by the Government's agenda for public service reform. These reforms look set to include greater personalisation of services and budgets, more widespread procurement and commissioning from private sector and not-for-profit organisations, and in some areas service delivery by mutual or co-operative bodies. Adapting to this changing policy and financial environment will create new challenges for public sector executives. Senior leaders could find themselves no longer administering traditional public service delivery organisations but standing at the centre of a web of contracts with a range of providers and other commissioning partners. A good example of this trend can be seen in higher education, where private sector funding increased by 42.1 per cent in real terms between 2004-05 to 2008-09, a trend that will accelerate with the proposed increase in tuition fee caps and reduction in direct Government grants. University revenue streams have thus become more complex, with Universities becoming more active in forging links with private sector companies (by commercialising research or offering new training and services to private firms). Faced with these changes, Universities are requiring that Vice-Chancellors possess stronger financial and business skills than previously, as well as the academic credibility they have always needed to sustain.

[133] 'Team Based Pay in the UK', Peter Reilly, Jane Phillipson and Peter Smith (2005) *Compensation Benefits Review,* 37(4):54-60. Success did not depend on the size or composition of the team – small and large teams (one team had more than 3,000 employees) saw benefits. Stable groups fared worse as did teams whose boundaries were difficult to draw, leading to tensions between insiders and outsiders. In part, these effects were moderated by the choice of reward,: groups with fuzzier boundaries responded more positively to improvement funds than cash. Finally, success was more likely when goals set tangible service goals and when they gained employee acceptance, though too much involvement resulted in a loss of focus and unwieldy compromises.

4.22 Of course, increasing challenge and complexity is not confined to the public sector. Given the ongoing economic uncertainty, many firms and industries will be working to improve their operational resilience and adjusting to radically changed assumptions and expectations.

4.23 It is difficult to quantify this complexity, which will be a product of a wide range of factors. These include: an organisation's remit and level of autonomy to decide how that remit is fulfilled, the size and nature of an organisation's budget, the diversity, size and skill-sets of an organisation's workforce and the range of different stakeholders with which an organisation is required to interact.

4.24 Representatives of local government argue that the roles of local authority chief executives have increased significantly in recent years, as the number of statutory responsibilities of local authorities has grown, and as delivery structures have become more complicated, for example by requirements for partnership working with other organisations operating in their geographical areas. The Hay Group has offered a more nuanced view: that **complexity has increased in some areas, where remits, commissioning arrangements and autonomy have risen.** Elsewhere, though budgets may have risen, the size of the executive's role has not really changed.

4.25 Another way of assessing complexity is by comparison to the private sector. Arguably, private sector executives have room for manoeuvre and freedoms that are generally unavailable to their counterparts in the public sector, amplifying the consequences of good and poor performance. On the other hand, public sector executives are often required to deliver on a number of different objectives while operating within political constraints that may not apply to private firms.

4.26 However, the evidence does support the claim that public sector managers are not overpaid when compared to people in roles of similar complexity in the private sector. The Hay Group found that median total remuneration for civil service directors (SCS Pay Band 2) was just 53 per cent of median remuneration for comparable private sector jobs. Hay Group job evaluation of senior military roles rated 3* officers (top of 3* pay band: £151,609pa) as comparable to the chief executive of a smaller FTSE 250 company (Bottom-quartile FTSE 250 chief executive pay: £662,000). Job evaluation of local authority chief executive roles conducted by PwC also found that total remuneration for local authority chief executives was just 51 per cent of that for comparable private sector roles – and still 25 per cent lower than private sector comparators if bonuses were ignored.

Risk in senior public sector roles

4.27 The general public may be of the view that public sector jobs are low risk, as they are 'jobs for life' sheltered from the 'creative destruction' that occurs in the private sector. Unlike private firms, public bodies do not go bust. There is also a perception that the public sector manages failure poorly, for example by moving poor performers on to new roles rather than dismissing them as a private sector employer might.[134]

4.28 However, there are specific risks derived from expectations of public accountability and from the potentially catastrophic consequences of public service failure attached to senior public service roles that rarely apply in the private sector.[135] **In some senior public roles there is a risk of sudden national media exposure, even vilification if things go wrong**: a prominent recent example was Sharon Shoesmith, the Director of Children and Young People's Services in Haringey, following the 'Baby P' case. Individuals may understandably be reluctant to take the risk of finding themselves in such a position, and higher pay ('danger money') may be required

[134] See for example, *Top Pay in the Public Sector*, Public Administration Select Committee, December 2009, Evidence from the Taxpayers Alliance.

[135] 'Public Service Risks: What's Distinctive and New?', Christopher Hood and Peter Miller in *Risk and Public Services* (2009) Centre for Analysis of Risk and Regulation and The Public Services Programme, LSE/University of Oxford.

to induce candidates to put themselves forward for such roles: Sharon Shoesmith's successor now earns approximately two thirds more than she did.[136]

4.29 Given the risk of sudden public scrutiny, it is vital that failure is well managed: for example, there should be clear and fair grounds and procedures for dismissal. Yet this is not always the case. Following an outbreak of hospital acquired infections at Maidstone and Tunbridge Wells NHS Trust, the chief executive resigned. Following the intervention of the Secretary of State for Health, she did not receive her contractually agreed severance pay. But this decision has now been overturned in a legal case reported to have cost the public purse £1million. This case shows the importance of having clear grounds for dismissal, and the potential consequences of political interference.

4.30 Indeed, contract termination can have nothing to do with performance. In local government, the Audit Commission has highlighted that amongst Single Tier County Councils, 39 per cent of chief executive departures from January 2007 to September 2009 were solely motivated by a breakdown of relationships with politicians, and a further 27 per cent by a combination of relationship breakdown and performance issues. The Audit Commission also note that severance payments can be made to secure contract terminations where there is a personality clash between Council leaders and the chief executive, or when a new administration wishes to replace a chief executive associated with a previous leadership.[137]

4.31 Perhaps unsurprisingly, **length of tenure is a concern**. Average tenure for local authority chief executives is approximately four to five years, and there are real concerns in the NHS, where the average tenure of NHS acute trust chief executives is just two years and four months.[138] Such short tenures not only compare unfavourably with the private sector (average tenure for FTSE 100 chief executives is currently 5.9 years),[139] but are also not conducive to successful management: business management research suggests that most chief executives need an average of 30 months to complete their learning curve upon taking up a new role.[140]

4.32 The combined result is that those stepping up from middle to senior management positions are taking on a considerable degree of extra personal risk. This Review has heard evidence from a number of sectors arguing that the increase in reward that comes from such a move up to executive positions does not sufficiently compensate individuals for that increased personal risk. This cannot but create pressure for higher pay for senior roles.

4.33 **Senior roles in the public eye will always carry heightened personal risk. Additionally, where failure is not dealt with in a fair way, risks are exacerbated and greater upwards pressure on pay is the result.**

Are executive labour markets sufficiently competitive?

4.34 There are concerns, similar to those about private sector executive recruitment discussed in Chapter 3, that the pool of candidates from whom some public sector organisations recruit for senior roles is being unnecessarily restricted.

Recruiting from a sufficiently wide pool

4.35 Executive labour markets in the public sector are relatively closed affairs. In some sectors this is not surprising: it is to be expected that senior leaders in the police and armed forces

[136] Haringey's annual accounts 09-10 record their director of children's social services as earning a salary of £230,000. Sharon Shoesmith was reported to have earned in the region of £133,000 - £140,000 according to newspaper reports (she is not named in previous years' accounts).

[137] *By mutual agreement: severance payments to council chief executives*, Audit Commission, March 2010.

[138] *NHS Chief Executives: Bold and Old*, Hoggett Bowers, June 2009.

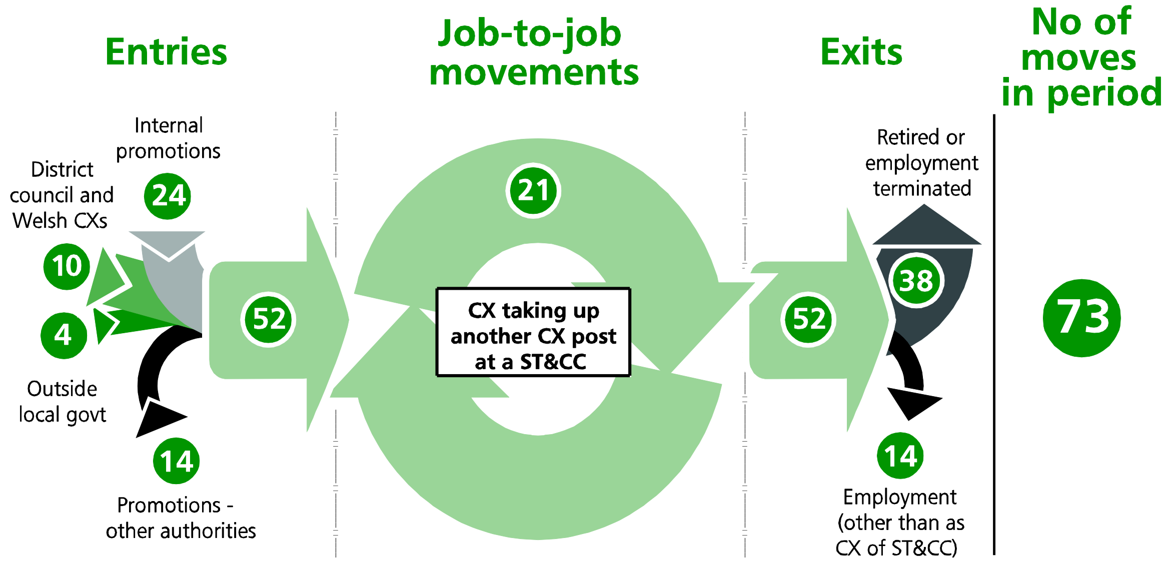
[139] Data on FTSE 100 CEO tenure as published in the survey by Accountancy Magazine, November 2010.

[140] *Dynamics of executive succession*, Kakabadse and Kakabadse, Cranfield School of Management, 2001.

should be recruited from within the sector. But even in areas where general managerial skills are more important (for example in running a local authority, a government department or a hospital trust) recruits from outside the sector are in a minority, even a rarity. From 2005 to 2007, just 4 out of 73 Single Tier and County Council chief executives appointed were recruited from outside local government, while 21 were existing chief executives moving from one local authority to another (Chart 4.B:).[141] In the senior civil service, over two thirds of entrants come from within the civil service (67 per cent of entrants from 2004 to 2009).[142] In 2007-08 305 of the 771 competitions for senior civil service posts were open to applicants beyond the civil service. Similarly, the majority of NHS executives have spent their careers in the NHS.

Chart 4.B: Movements within the market for local authority chief executives, 2005-2007

Of 73 appointees to chief executive roles, 21 were already chief executives in other authorities, 48 were promoted from within local government and only 4 came from outside the sector



Source: Audit Commission, Tougher at the Top, July 2008

4.36 It may be perfectly reasonable that fewer entries come from outside the sector. Internal candidates will have more direct experience. There are clear differences between running a hospital, a local authority, and a government department, not least in the nature of the political environment in which the executive has to operate.

4.37 However, unnecessary restrictions on the pool of candidates will lead to pay inflation. There are some signs that the focus on a small pool of talent seen in public corporations (Chapter 3) may be beginning to appear in local government. The Audit Commission has found that the rate of job-to-job movement in local government (that is one chief executive replaced by another current chief executive) more than doubled between the periods 1999-2001 and 2005-2007.[143] According to the Audit Commission, a major contributor to this trend were moves by poorly performing authorities (as measured by the now redundant Comprehensive Performance Assessment (CPA)) to recruit executives with a proven track record (also as measured by the CPA). Competition among local authorities for experienced top managers has therefore placed an upward pressure on salaries, via a focus on a small pool of recruits.[144]

141 *Tougher at the Top*, Audit Commission, July 2008.
142 Cabinet Office data.
143 *Tougher at the Top*, Audit Commission, July 2008.
144 *Leading Lights*, New Local Government Network, April 2008.

4.38 It is easy to overstate the importance of the chief executive: there may have been many other factors underlying other councils achieving successful CPA scores. Changing chief executives may be seen as a quick fix – but is not always the best solution. The Audit Commission found little evidence that authorities that brought in new chief executives saw improvements over those that did not.

4.39 It is not clear whether other areas of the public sector are also beginning to see a trend towards a greater focus on a smaller pool of candidates. Certainly, many public sector organisations are making greater use of executive searches and recruitment consultants to bring in the best potential applicants.[145] There should be many benefits to using headhunters, not least to widen the pool of candidates; yet some have argued that headhunters may not be doing enough to encourage employers to widen their specifications.[146]

4.40 **Markets for public sector executives are relatively closed. In some areas, an excessive focus on experienced candidates from within sectors has led to pay inflation. Recruiting from too narrow a pool of candidates also limits the extent to which the public sector can benefit from new ideas and expertise.**

Development of internal talent

4.41 One way in which the pool of potential recruits for senior executive roles could be widened is through more effective development of talent within public sector organisations. There are concerns that the public sector has not been effective at nurturing management talent internally, a problem that the Public Administration Select Committee recently highlighted with regard to the senior civil service.[147] Weaknesses in talent management have also been compounded by demographic and structural changes. In local government the impending retirement of the 'baby boomer' generation will see large numbers of senior managers leaving in the coming years, yet recent structural changes may have reduced the supply of potential internal replacements coming through.[148] Reductions in the number of middle management, director-level and deputy chief executive positions, along with the shift toward cabinet-style government, have denied more junior managers opportunities to gain the experience (particularly of working closely with elected politicians) needed to step up to executive level.

4.42 A parallel issue is the equal opportunity for promotion. Progress has been made in this area, with the latest report by the Senior Salaries Review Body noting that in the civil service it 'appears that the Senior Civil Service comes close to achieving equal pay between men and women, with a pay gap well below the average for the whole economy'.[149] This report also showed that the senior civil service was making progress in increasing the representation of people from ethnic minority background (4 per cent in 2009) and those with a disability (3.2 per cent in 2009). The Equality and Human Rights Commission's submission to this Review's call for evidence observed that the 2010 Equality Act extended the duty of the Government to ensure that pay systems are fair and non-discriminatory to include age, sexual orientation, religion and belief, pregnancy and maternity and covering gender reassignment more fully. It is to be hoped that as progress towards greater representation continues so should the size of the internal talent pool.

4.43 Throughout the public sector, numerous initiatives have sought to encourage organisations to think more imaginatively about succession and planning and talent management. These

[145] This has been noted previously (*Top Pay in the Public Sector*, Public Administration Select Committee, December 2009, p.45) but has been confirmed by interviews conducted as a part of this Review.

[146] *Top Pay in the Public Sector*, Public Administration Select Committee, December 2009, pp.46-47.

[147] *Outsiders and Insider: External Appointments to the Senior Civil Service*, Public Administration Select Committee, February 2010, p.25.

[148] *Leading Lights*, New Local Government Network, April 2008.

[149] *32nd Report on Senior Salaries- 2010*, Senior Salaries Review Body.

include the Professional Skills for Government programme in the civil service, the National Graduate Development Programme in local government, Fast Track Teaching in education and the Graduate Management Training Scheme and Breaking Through programmes in the NHS. As many of these endeavours are in their infancy, it is not possible to assess their effectiveness, but they start from a low base, as public sector workforce management has suffered from a range of historical weaknesses.

4.44 The public sector therefore faces real challenges in nurturing talent within. This is a key concern as **growing the next generation of public sector leaders internally would widen the pool of potential candidates for senior posts, and ease upwards pressure on executive pay.**

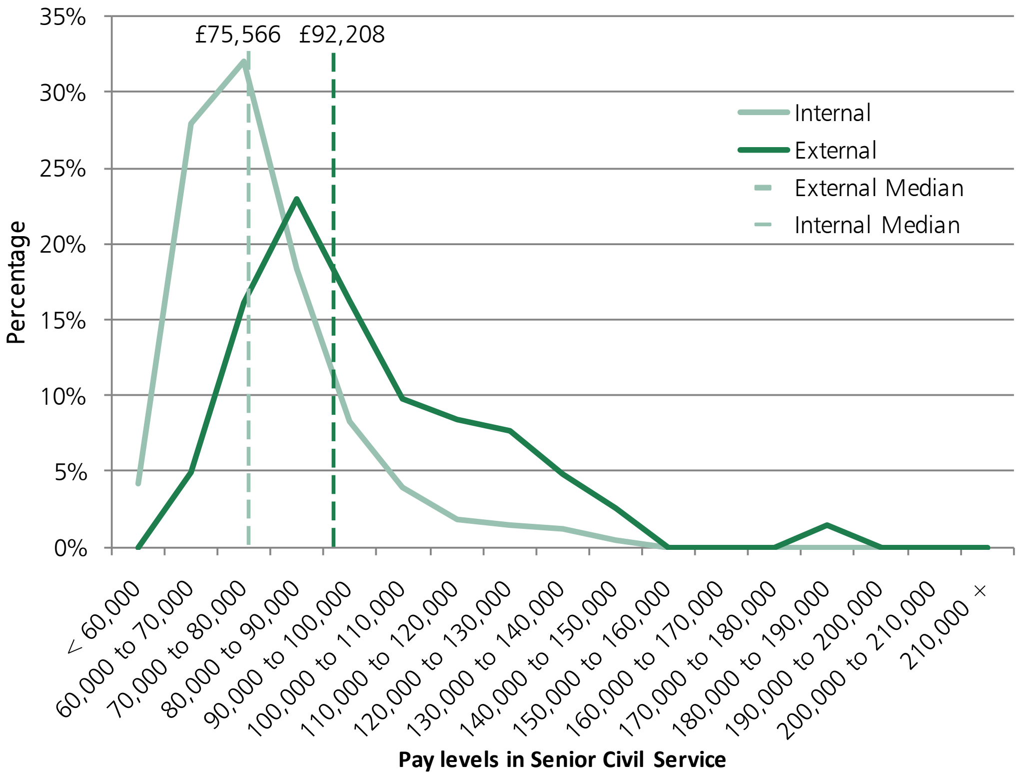
Does the public sector pay more to recruit from the private sector?

4.45 As discussed above, only a minority of senior executives in the public sector are recruited externally, limiting the influence of private sector pay levels on the public sector. However, there are specific areas where recruitment to senior roles from the private sector has increased significantly in recent years. During the 2000s, a political drive to 'professionalise' public service led to efforts in local government, the civil service and elsewhere to recruit experts in fields such as Finance, Human Resources, IT and commercial services.

4.46 Executives with portable skills are typically able to demand high remuneration, and in the civil service there is clear evidence that external recruits do command higher salaries than internally-recruited colleagues (Chart 4.C:). With a majority of external recruits coming from the private sector, this to some extent reflects the premium needed to attract such candidates (it also reflects the fact that a premium is needed to attract candidates from elsewhere in the public sector, as pay levels in the senior civil service are generally lower).

Chart 4.C: Pay Levels for Internal and External Recruits to the Senior Civil Service

External recruits to the senior civil service command higher salaries than internally recruited colleagues



Source: Cabinet Office

Differences in earnings between internal and external recruits are seen at all grades of the Senior Civil Service

4.47 Private sector recruits to chief executive posts are more common amongst Arms Length Bodies than elsewhere. Nevertheless, externally-recruited lead executives remain in a minority, with most being drawn from within arms-length bodies, the civil service or the wider public sector. But where they are recruited, higher salaries can result. For example, the current chief executive of the Forensic Science Service was recruited from the private sector in 2009 on a salary of just over £200,000. This was a significant increase over the salary of the previous, internally-recruited, chief executive who received a salary of £132,000 in 2008. Similarly, when the Met Office recruited its current chief executive from the private sector in 2007, he was granted a salary of £155-160,000, about two thirds more than the £90-95,000 salary of his internally-recruited predecessor.

4.48 Externally-recruited public sector executives do not necessarily perform better. In the senior civil service external recruits are slightly less likely to be rated as high performers than internal recruits.[150] This may be the result of poor induction or socialisation of external recruits into public sector organisations, or that individuals from the private sector are poorly prepared for working in a highly political environment. Another explanation may be that even when paying a premium to recruit externally, public sector bodies can never hope to match the pay levels on offer for the very top jobs in the private sector. Large, complex public sector organisations, such as government departments whose budgets may run into the billions of pounds, could thus find themselves paying more to recruit externally but still failing to attract candidates with experience of jobs of comparable weight.

[150] *Outsiders and Insiders: External Appointments to the Senior Civil Service*, House of Commons Public Administration Select Committee, 2009, p. 16.

4.49 In conclusion, **recruitment from the private sector is limited, but where it does occur it has contributed to senior pay inflation.** Clearly, recruitment of private sector skills will bring benefits, but it is important that organisations are hard-headed about what they are buying.

Is there sufficient control over senior remuneration?

4.50 It is clearly important that organisations receiving taxpayer funds can account for how effectively this money is used. This applies to pay as much as any other area of spending. **The issue of insufficient corporate governance and controls over senior pay is one that has already been highlighted** by previous reports on public sector top pay, including most recently by the Senior Salaries Review Body and the House of Commons Public Administration Select Committee.

4.51 As both reports have emphasised, governance arrangements for senior pay in the public sector are considerably varied, and do not always have a consistent rationale behind them. The extent of this variation is shown in Table 4.A:

Table 4.A: Arrangements for controlling senior pay

Population	Who sets top salaries?	Who appoints the pay setters?	Extra payments above base salaries?	Notes
Senior Civil Service	Government, advised by SSRB	SSRB appointed by Government after open competition	Total performance award bill capped at 5% of total salary bill. Performance awards for top 25% only, capped at 7% of base salary.	
NDPB and Public Corporation Executives	Organisation Board, usually subject to Ministerial approval for chief executive	Ministers appoint Board	Varies between organisations – Boards decide bonuses and benefits	All salaries above £142,500 and bonuses above £50,000 require CST approval where under Ministerial control
Maintained Schools	Government, advised by STRB	STRB appointed by Government after open competition	Individual school Governing Bodies free to set Recruitment and Retention Premium	
Academy Schools	Academy Governing Body	Academy Trust	Vary between Academies, all set by Academy Governing Body	Majority of Governors appointed by Academy sponsor, Governors must include the head teacher and at least one LA representative and one parent
NHS Managers (non-Foundation Trusts)	Government, advised by SSRB	SSRB appointed by Government after open competition	Performance award total capped at 5% of total pay bill. Performance awards for top 25% of VSMs only, capped at 5% of base salary	
NHS Foundation Trust Managers	Foundation Trust Board	Foundation Trust Governors	Vary between Foundation Trusts, all set by Foundation Trust Boards	
Senior Military	Government, advised by SSRB	SSRB appointed by Government after open competition	Performance awards based on annual appraisal and subject to Ministerial approval	
Senior Police (Chief Officers)	Government, advised by PNB	PNB brings together Government, Police Authorities, and Unions	Performance awards decided by Police Authorities, up to maximum of 15% of salary for Chief Constables	All Police pay subject to terms of PNB agreements.
Local Authority Executives	Local Authorities, advised by Local Government Employers	Local Councillors elected by local voters	Vary between LAs, decided by Local Councillors	

Source: *Fair Pay Review*

4.52 Variation is not in itself a problem, provided that control systems in each organisation function effectively, though such variety can hardly help assuage public concern over executive pay in these organisations. It might be expected that arrangements would be the same amongst the same type of organisation – yet, for instance, among local authorities, there is substantial inconsistency in the use of remuneration committees to set executive salaries.

4.53 In the view of the Senior Salaries Review Body, pay control is patchy. They highlight the following main issues:

- the lack of a clear remuneration framework of pay principles and guidance for the public sector as a whole, to help different institutions determine what level of pay is reasonable;
- variable use of independent decision-making structures in setting senior executive pay; and
- the lack of a clear system for assessing exceptional cases, for example for determining how much of a premium could be paid to recruit particular skills in from the private sector.[151]

Autonomy over pay

4.54 Across the diverse range of public sector institutions, the degree of control that central Government currently has over top pay varies considerably. Senior public servants' pay is sometimes entirely, and sometimes partially, set by Ministers. In other cases Ministers do not set top pay themselves, but instead appoint organisation Boards and must approve Boards' decisions over pay. In yet other cases, Ministers have no control at all over top pay. The result is a wide spectrum of Ministerial power or influence over senior pay across the public sector.

Chart 4.D: Degrees of Central Control over Senior across Public Sector Organisations

Central Control vs. Autonomy	Example Populations	Summary of Pay-Setting Process
Strong Central Government Control	*Civil Service, Judiciary, Military*	Ministers decide on all elements of senior pay, advised by independent Pay Review Bodies (e.g. SSRB)
	Maintained School Head Teachers, NHS VSMs, Police	Ministers decide salary, advised by independent Pay Review Bodies; Local autonomy over extra payments (e.g. RRPs)
	Chief Executives of NDPBs and Public Corporations	Ministerial approval required for pay set by organisation Board; Ministers appoint Board members and Chair
	Other Executives of NDPBs and Public Corporations	Pay set by organisation Board, usually no requirement for Ministerial approval; Ministers appoint Board members
	Local Authority Chief Executives and other LA senior staff	Elected Local Authorities set pay, autonomously of central Government, advised by Local Government Employers (LGE)
Complete Autonomy of Government	*FE Colleges, Universities, Academy Schools, NHS Foundation Trusts*	Individual organisations have complete autonomy over senior pay

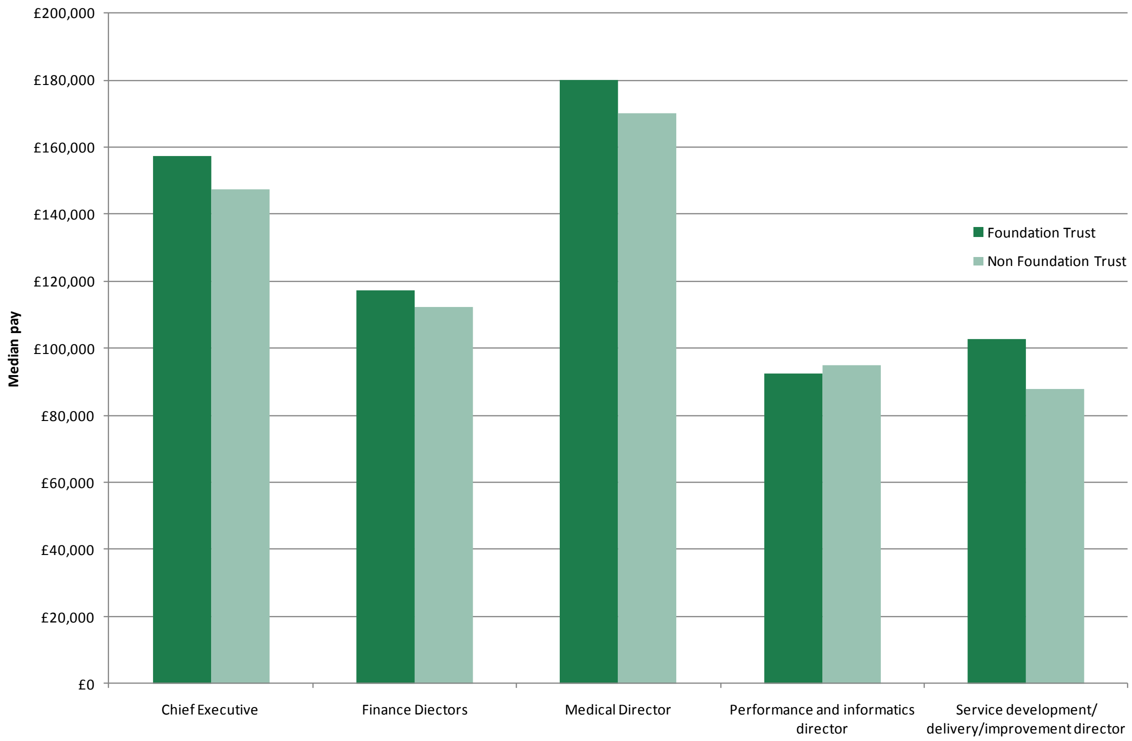
4.55 Where Ministers do directly set top pay levels, this is usually done on the basis of recommendations from independent Pay Review Bodies. For example, the Review Body on Senior Salaries (SSRB) recommends on pay for, amongst others, senior civil servants, judges and top military officers, and the School Teachers' Review Body (STRB) for headteachers in maintained schools.

[151] *Initial report on Public Sector Senior Remuneration 2010*, Senior Salaries Review Body, March 2010.

4.56 Since 2008, the approval of the Chief Secretary to the Treasury has been required for all salaries above £150,000pa and all bonuses above £50,000 where these are under Ministerial control. In 2010, the salary threshold for this extra approval requirement was lowered to £142,500 (the Prime Minister's base salary). The bonus threshold was kept at £50,000, and approval from the Chief Secretary is still only required for those salaries and bonuses that are under Ministerial control.

4.57 The two sectors where ministerial control is most complete – the civil service and armed forces – have not seen the relatively higher increases in top pay over bottom pay seen in other sectors (Chart 2J). And within sectors, there appears to be correlation between autonomy over pay and higher levels of executive remuneration. This pattern can be clearly seen in the NHS, where pay for senior executives in Foundation Trusts (which have full autonomy over senior pay) is consistently higher than for their counterparts in non-Foundation Trusts (where the pay of Very Senior Managers is set centrally) (Chart 4.E:). Similarly in education, the National Audit Office have found that 50 per cent more senior leaders per school earn over £80,000 in the academies sector than in maintained secondary schools.[152]

Chart 4.E: Percentage difference in median pay levels of foundation vs non-foundation trust executive directors 2008/9



Source: Fair Pay Review analysis

4.58 There is some evidence that this has created market distortions. Where two different approaches to pay setting exist in the same sector, notably in the NHS, the risk is that bodies subject to centrally imposed controls will find it difficult to recruit and retain staff. Indeed the parts of the NHS subject to the Very Senior Manager framework see regular use of additional payments agreed locally to supplement the centrally-determined salaries. Nearly 90 per cent of managers receive pay that is above the relevant centrally-set rates. Chief executives, finance directors and public health directors regularly receive salaries 20 or 30 per cent in excess of levels

[152] *The Academies Programme*, National Audit Office (2010).

recommended by the Senior Salaries Review Body.[153] This may be a coping mechanism to loosen the inflexibilities of the framework, but its *ad hoc* nature is likely to cause public concern.

4.59 More autonomy is associated with higher pay. The Government is committed to further devolution of power to individual institutions as part of its public service reform programme, yet there is the risk that this will generate further pay inflationary trends. Higher remuneration might be a price worth paying for the benefits that autonomy may bring.[154] The guiding principle behind Government policy of greater decentralisation is that the innovative culture of autonomous organisations and the expertise and energy that local stakeholders bring are superior to the rigidities of a centralised command and control regime. However the executive roles in these autonomous organisations are likely to be bigger, and so may warrant higher reward.

4.60 Many of these institutional innovations are still at an early stage of evolution, so it is not possible yet to reach firm conclusions on whether higher pay in autonomous institutions such as academy schools and foundation trusts is justified. It is difficult to assess performance of executives in these areas across the board, reflecting a variety of difficulties in assessing organisational performance.[155]

4.61 What is vital is that there are strong internal controls and accountability in place to ensure that pay and performance are related; that pay is due desert. Yet, while some measures have energised governance processes, there remains a gap between rhetoric and reality in this area. The National Audit Office has observed that the desire to roll out academies to very diverse environments along with the pace of expansion may strain the capacities of relevant monitoring bodies such as the Young Persons Learning Agency.[156] The experience of foundation trusts is that some measures – a wider mix of nonexecutive directors, self-certification for regulatory purposes – have certainly energised governance processes; but there remain doubts over whether they have genuinely impacted on core rather than routine issues.[157] Moreover, the aspiration to promote 'social ownership' of autonomous organisations remains work in progress.[158]

Greater autonomy brings a risk of further inflation in senior pay. This may be justified, as roles may be more complex. But it is doubtful whether governance arrangements will be sufficient to assure the public that senior pay is fair across the board.

[153] Fair Pay Review analysis of IDS NHS Boardroom Pay reports.

[154] For instance, research by the think tank Bruegel found that performance in international university rankings is correlated with institutional autonomy is one (though not the main) reason for the persistent performance gap between European and US universities. 'Why Reform Europe's Universities', Philippe Aghion, Mathias Dewatripont, Caroline Hoxby, Andreu Mas-Colell and Andre Sapir (2007) *Bruegel Policy Brief,* Issue 2007/04. The evidence is that budgets exert the largest influence on performance, though autonomy enhances the bang-for-the-buck universities get from their investments.

[155] For instance, one difficulty of interpreting improvements in GCSE results in Academies is that the schools that are the most likely to convert to academy status are the worst-performing schools; yet they are also the most likely to benefit from mean reversion, a bounce or return to the average that holds for all under-performing schools irrespective of their status.[155] Similarly, efforts to assess the impact of foundation trusts are complicated by selection bias and the difficulty of separating out the effect of becoming a foundation trust from the fact that only the best trusts have granted foundation status. "A Note on Academy School Policy" Stephen Machin and James Vernoit (2010) *Centre for Economic Performance Briefing;* "Does School Autonomy Improve Educational Outocmes? Judging the Performance of Foundation Secondary Schools in England", Rebecca Allen (2010) *Institute of Education Working Paper No.1002.* "Foundation Trusts: A Retrospective Review" York University (2010), Centre for Health Economic s

[156] *The Academies Programme*, National Audit Office (2010).

[157] *Taking It On Trust: A Review of how Boards of NHS Trusts and Foundation Trusts get their Assurance*, Audit Commission (2009).

[158] *Foundation Trusts: A Retrospective Review*, York University (2010), Centre for Health Economic.s

5 The role of a maximum pay multiple

Chapter summary

A maximum multiple between low and high earners has a range of advantages in tackling the issues outlined in this report: demonstrating fairness, combating incorrect perceptions, addressing the collective action problem, and benefiting productivity. It can be easily disclosed by any organisation.

But if not defined and implemented carefully, a multiple could harm recruitment and retention, present perverse incentives, fail to take account of organisational differences and even become a target.

Before a maximum multiple could be implemented in the public sector, four key **issues of definition would need to be resolved**. These are: what elements of reward would be included within the multiple; how the base of the multiple should be defined; at what level to set the maximum multiple; and what flexibility to exceed the multiple should be allowed.

At this interim stage two extreme options can be ruled out. Using the national minimum wage as a base for the multiple is too unresponsive to particular organisations' varying skill bases and differences in regional wage levels and patterns. And using the mean salary is too far divorced from the lowest paid, and is not independent of the top salary levels.

A pay multiple disclosure could be a helpful way of cutting through the current discourse, combating incorrect perceptions and enabling comparability. It would not be an absolute cap – there would be exceptions disclosed on a 'comply or explain' basis. How the base of the multiple is defined would determine the optimum ratio. It may be more appropriate that different multiples are adopted as the norm for different kinds of organisation.

Introduction

5.1 Chapter 3 suggested that excessive executive pay is a collective action problem, and that corporate governance has only served to limit top pay at the margins. Chapter 4 suggested that parts of the public sector may have begun to see the overly narrow focus on a limited pool of candidates also witnessed in large public corporations. And it questioned whether governance arrangements are sufficient to assure the public that senior pay is fair across the board, particularly in the context of greater autonomy and diversification of public services provision. The risk is that a reliance on good governance still allows the upwards ratchet effects seen in the private sector to develop in the public sector.

The role of a maximum pay multiple

5.2 A maximum multiple between low and high pay could have a key role to play in solving the collective action problem. A maximum ratio would be one way of limiting public sector pay dispersion, and of preventing top executives' pay from becoming too far detached from the value of their actual work efforts. A maximum pay ratio could also support procedural fairness on pay, by reassuring all staff that bounds had been placed on parallel pay dispersions within their organisations. Chapter 1 set out some of the history of pay ratios and their advocates.

5.3 A pay multiple could have a range of advantages in tackling the issues outlined in this report:

- **A pay multiple could demonstrate fairness**. Chapter 1 noted that proportionality is important to people's concepts of fairness. According to the 1999 British Social Attitudes Survey, the public at large believe that the ratio between highest and lowest earners in society should be around 6:1, a preferred ratio that has been notably stable over time. Hence a maximum pay ratio that placed clear limits on pay dispersion could help ensure that the public understands that top pay in the public sector is fair.

- **A pay multiple could combat incorrect perceptions**. Chapter 2 demonstrated a clear gap between the public perception of top public sector pay and reality. A pay ratio is an easily understandable reference point, and could give the public confidence that public sector pay is being kept in check. Defined appropriately, this can have more flexibility than merely using the Prime Minister's salary as a benchmark, which Chapter 2 suggested is a flawed measure.

- **A pay multiple addresses the collective action problem.** A coordination problem requires a coordinated solution – and a ratio bridges the gap between private rationality and collective unreasonableness. If all local authorities, arms length bodies or foundation trusts know that there is an upper boundary to pay this would stop the upward ratchet effect in its tracks.

- **A pay multiple could benefit productivity.** Chapter 1 noted quantitative evidence that organisations with lower pay dispersion are more productive. A pay ratio would keep dispersion in check, and could help ensure public sector workforces feel their bosses' pay is fair. Fairness fosters employee engagement, and engagement supports productivity.

- **A pay multiple could be disclosed easily.** As it should be easily understandable, a ratio could also provide a reference point against which public bodies can explain their pay levels when challenged, and use in annual disclosure.

- **A pay multiple could be applied to any organisation.** Finally, a ratio, defined appropriately, could have the flexibility to cover any type of body that is delivering public services or receiving public funds, and could be applied across the public sector despite the definitional issues and 'blurring of the boundaries' discussed in Chapter 4. Indeed, in theory it could be applied in the private sector too. Legislation recently passed in the United States requires public corporations there to publish the ratio between chief executive and medium employee remuneration as part of wider disclosures. In their response to the Fair Pay Review Call for Evidence, the Confederation of British Industry also noted that when private sector firms are setting senior pay 'it is appropriate that decision makers should be aware of internal multiples of the value of reward packages for senior staff relative to other employees as part of the process.' Similarly, the Institute for Employment Studies has argued that to be successful, organisations need to establish a balance in setting pay between responding to external markets, rewarding performance and maintaining internal equity and fairness. In the Institute's opinion, firms have paid insufficient attention to internal fairness in recent years.

5.4 However, implementing a maximum pay multiple as part of a fairness framework for public sector pay would pose a range of practical difficulties, many of which were highlighted by responses to the Review's public Call for Evidence. These could include:

- **Adverse impacts on recruitment and retention of senior staff.** A maximum pay multiple that significantly restricted top pay could create difficulties in recruiting and retaining individuals of sufficient calibre for senior posts. This is especially relevant in the current context of radical public service reform and constrained budgets, when arguably the need for high quality public sector leadership has never been greater.

- **Perverse incentives for outsourcing.** Tying top pay to bottom via a maximum pay multiple could create perverse incentives in favour of contracting out low-paid roles, in order artificially to increase the bottom wage used in a given organisation to define the maximum pay ratio.

- **The ratio becoming a target.** A maximum pay multiple could be seen as a norm or target for senior pay, establishing an expectation that all top public servants should be paid a given multiple of the lowest pay in their organisation. This could lead to senior managers currently paid less than this multiple calling for their pay to increase up to the maximum permitted ratio, pushing up top public sector and increasing the total public sector pay bill. Chapter 2 showed that it is typical for top public sector managers to earn around 10 to 12 times those of their lowest paid staff, although these ratios will swell if increases in executive pay continue to outstrip increases for lower paid staff.

- **Perverse incentives for executive remuneration.** A maximum pay multiple that applied only to some elements of overall remuneration, for example to base pay but not bonuses, could encourage 'gaming'. For example, base salaries could be held down to comply with the ratio but overall remuneration increased 'by stealth' through a greater proportion being paid in discretionary payments or other benefits.

- **Inflexibility.** A centrally-mandated maximum pay multiple could restrict individual organisations' autonomy to set their own pay levels. This would both be contrary to the principle of operational devolution, and could lead to inefficiencies as organisations may be unable to respond to their specific market conditions. A single ratio applied across the board would fail to take account of the very different pay structures in different organisations: for example organisations with a large number of low paid staff might find it harder to comply.

- **Definitional issues.** Firstly, a particular multiple has to be decided upon, and this decision could appear arbitrary if insufficient reasoning lay behind it. Secondly, there would be a number of ways of defining a multiple, each with different results. These issues are discussed below.

5.5 It is also the case that a pay multiple would not act as a single 'silver bullet' to solve all the issues outlined in the conclusions above. It would not do anything by itself to improve governance, or performance pay arrangements, for instance. Rather, its strength would lie in promoting fairness and assisting transparency and understanding.

Options for defining a pay multiple

5.6 Before a maximum pay ratio could be implemented in the public sector, four key issues of definition would need to be resolved. These are:

- what elements of reward would be included within the ratio;

- how the base of the ratio should be defined;

- at what level to set the ratio; and

- what flexibility to exceed the ratio should be allowed.

Defining elements of reward

5.7 Total reward for employees' labour can encompass a wide range of benefits, both tangible (e.g. cash pay, bonuses or benefits-in-kind) and intangible (such as job security, interesting work or a pleasant working environment).

5.8 A pay multiple need only concern itself with tangible elements of reward. Intangible elements are difficult to measure and compare, as the values ascribed to them will inevitably be subjective, varying between different individuals. But in theory they should be reflected in the level of tangible benefits: all things being equal an individual will accept a lower level of tangible benefits in a role where they consider they are getting intangible benefits.

5.9 To be most effective, a maximum pay ratio should apply to all elements of remuneration that can accurately be valued. A ratio that applied only to some elements of reward would risk creating perverse incentives for high earners to re-arrange their incomes to avoid the restrictions imposed by the ratio. For example, a ratio that applied only to base pay could lead to salaries being restricted but bonus payments expanding or employers providing much greater benefits-in-kind so as to keep as much of an individual's total earnings outside the scope of the ratio.

5.10 However, there are challenges in including all of the various elements of remuneration:

- Performance-related pay. To reward effort and performance fairly, such payments should to some degree be proportional to that additional effort and performance. Inclusion within a pay multiple would restrict the ability of such payments to provide proportional reward. In practice, this would not be an insurmountable problem, as performance payments in many sectors are already capped. Base salary would need to be set at a level that would still leave scope for a range of performance payments, especially team performance pay, within an overall ratio.

- Recruitment and retention premia and 'golden parachutes'. Consideration would have to be given to whether and how to include one off payments, which may well be necessary and fair in particular market conditions.

- Pension contributions. Plainly the value of defined benefit pension schemes in the last year of service have been valuable to public sector executives, are part of the overall compensation package and should be included in any assessment of the upper pay limit. However, as outlined in Box 2.C defined benefit schemes do not make for easy comparison, so consideration must be given to how to account for them within a ratio.

Defining the base of the multiple

5.11 In setting any maximum pay ratio, such as 20:1, the pay level used as the base (the '1') must be defined. Options could include:

- The national minimum wage. This is currently £5.93 per hour. So adopting a ratio of 20:1, would result in a top threshold of £228,186 (assuming a 37 hour working week).

- A living wage (the London Living Wage is currently £7.85).

- The pay of the lowest-paid individual in each organisation.

- The pay of the lowest-paid full time 'core' employee, defined by making a distinction between core business (in a public sector organisation this would typically be delivering a service or formulating policy) and ancillary services such as cleaning and catering.

- The median pay of a lowest-paid percentage (e.g. the bottom 10 per cent) of each organisation's workforce.
- The median of all employees' pay in each organisation.
- The mean of all employees' pay in each organisation.

5.12 Advantages and disadvantages of each option are summarised in Chart 6.A: below.

Table 5.A: Advantages and disadvantages of options for defining the base of a pay multiple

Option for the base	Advantages	Disadvantages
National Minimum Wage	Sets consistent pay expectations for all senior public sector managers Avoids incentives to outsource low-paid jobs	Takes no account of the actual composition of an organisation's workforce Takes no account of regional wage levels and patterns
Living wage	Sets expectations that senior pay will reflect wider regional pay conditions	Difficult to apply to organisations operating in many areas, or workers that commute to work across boundaries from one region to another
Lowest-paid employee	Easily understood expectation on pay dispersion Clearly links top pay to bottom pay for each organisation	Could create incentives to outsource low-paid jobs Not responsive to workforce size or skills base
Lowest-paid 'core' employee	Avoids incentives to outsource ancillary roles, whilst maintaining pay relationship among 'core' workforce	Difficult to distinguish 'core' and 'ancillary' staff Creates incentive to 're-brand' core workers
Median of bottom percentage of employees by pay	Allows ratio to reflect more of the workforce mix Keeps some link from lowest to highest pay	Not so easily understood Calculation potentially difficult, opaque and could be subject to manipulation Could create incentives to outsource low-paid jobs Could be distorted by the skill mix
Median of all employees	Allows ratio to reflect more of the workforce mix May be more relevant comparator for more staff	Not so easily understood Calculation potentially difficult, opaque and could be subject to manipulation Could be distorted by the skill mix Loses link to the lowest earners.
Mean of all employees	Allows ratio to reflect more of the workforce mix May be more relevant comparator for more staff	Measure is not independent of senior salaries Calculation could be subject to manipulation Loses link to the lowest earners.

Setting the level of the multiple

5.13 One of the main arguments made against a maximum pay ratio is that a restriction on overall pay dispersion within an organisation would hamper organisations' ability to recruit, retain, incentivise and reward senior staff by imposing too egalitarian a pay structure.

5.14 The level of constraint depends on the ratio chosen. Taking a 20:1 ratio, as recommended by theorist Peter Drucker (see box 1.A in Chapter 1) would give an organisation with 8 pay bands (the ideal number as he saw it) considerable flexibility. Pay could be increased by just over 50 per cent from band to band and still stay within his 20:1 ratio. Public Sector organisations currently tend to have up to 15 pay bands [e.g. civil service: 11, NHS: 9+VSMs; Military: 14].

With 15 pay bands in an organisation, pay could increase by 23 per cent from one band to the net, and still produce an overall top:bottom pay ratio of just over 18:1. An illustrative organisation with ten bands is set out in Table 5.B: Substantial variations in proportional pay increases – and hence substantial flexibility for organisation managers – can still be maintained.

Table 5.B: The relationship between pay levels and ratios in an illustrative organisation

Pay band	Salary (£)	Increase from previous band (%)	Ratio to base level
1 – Staff	13,000	-	1
2 – Staff	16,000	23	1.2
3 – Staff	20,000	25	1.5
4 – Staff	25,000	25	1.9
5 – Staff	32,500	30	2.5
6 - Management	44,000	35	3.4
7 – Management	61,500	40	4.7
8 – Executives	92,000	50	7.1
9 – Executives	143,000	55	11
10 – Chief Executive	240,000	68	18.5

Allowing flexibility in the multiple

5.15 A ratio such as 20:1 could be set as a strict cap on pay. This is has the advantage of simplicity, and would enable a very clear statement to be made that no public sector manager does earn over 20 times more than the lowest paid person in their organisation.

5.16 However, there would be considerable limitations in imposing such a cap.

- Most importantly, a strict cap would deny organisations the ability to pay higher rates even where they had a clear justification for doing so. This could have severe impacts on recruitment in exceptional but vital roles: it might be argued that the chief executive of the Olympic Delivery Authority would be one instance.
- In addition, a strict cap would go against the grain of the Government's desire to give greater autonomy to public organisations.

5.17 An alternative could be to use a pay ratio as a basis of disclosure over senior pay. A certain multiple, such as 20:1, could act as a standard by which disclosed pay ratios are considered fair or otherwise. Disclosure requirements could take the form of a 'comply or explain' rule. Any organisation paying over the multiple would have to set out adequate justification for doing so, and confirm that the process by which the decision was made was fair and subject to proper independent scrutiny.

5.18 Such an approach could get around at least some of the disadvantages of strict pay multiples outlined above: issues of inflexibility and adverse impacts on recruitment and retention. Issues of perverse incentives may remain, but could be mitigated if the elements of reward covered, and the bottom of the ratio, are carefully defined.

Interim conclusions on the pay multiple

5.19 On balance, **a pay multiple disclosure could be a helpful way of cutting through the current discourse, combating incorrect perceptions and enabling comparability. It would not be an absolute cap – there would be exceptions disclosed on a 'comply or explain' basis.**

5.20 At this interim stage we can rule out two extreme options. Using the national minimum wage as a base for the multiple is too unresponsive to particular organisations' varying skill bases and to the differences in regional wage levels and patterns. And using the mean salary is too far divorced from the lowest paid, and is not independent of the top salary levels.

5.21 The Review's Terms of Reference asked for recommendations on a 20:1 ratio against the lowest paid member of the organisation. How the base of the multiple is defined would determine the optimum ratio. As shown in Chapter 2, median top salaries in much of the public sector currently average around 10:1 against entry-level salaries, though there are notable outliers higher than this. So 20:1 against entry-level salaries would not impact a great number of executives. On the other hand, if current trends continue we will expect ratios to rise faster, and 20:1 may serve to limit future increases.

5.22 A remaining concern is that any multiple would become a target, pulling up the entire pay scale of public sector organisations in its wake. In practice, this is unlikely to happen. Public sector organisations are obliged to have transparent pay differentials across grades which are internally coherent and map on to what the labour market requires. This should constrain the ability of senior executives to game the ratios.

5.23 A more valid challenge is that applying a single ratio – such as 20:1 – can never take account of the nature of different organisations. The relationship between the pay of the lead executive and the workforce in a small, highly skilled operation (such as the Met Office) and a large organisation with many administrative staff (such as the Department for Work and Pensions) will necessarily be different. So it may be more appropriate that different ratios are adopted as the norm for different kinds of organisation.

5.24 The Review's Terms of Reference also asked it to consider the impact on broader social norms. In this regard, if disclosure of ratios in the public sector became the norm, the very flexibility in how a pay multiple can be introduced and interpreted could encourage private sector companies to adopt similar measure. Companies could publish their pay ratio each year and explain why it has varied from year to year. It would be open to shareholders to set limits and require boards to comply or explain why the chosen limit had been exceeded. This would at the very least provide some countervailing check to the present upward ratchet. Boards would have to explain in advance to shareholders and the wider public what performance improvement would justify what proportional increase in remuneration. It would bias compensation more towards relative performance improvements and away from peer benchmarking.

6 Conclusions and next steps

Chapter summary

With the economy under pressure, how society distributes its benefits and burdens has become more salient. It is all the more important to ensure fairness. At this interim stage, the Review's key conclusions are:

- Fair pay is pay that is due desert: proportional reward for an individual's contribution, supported by fair process;
- Pay for high earners has been increasing faster than pay for low earners – begging the question of whether this has been proportional. Public listed companies have led this trend, but pay dispersion has also increased in the public sector. The public needs assurance that high pay has been deserved;
- Yet it is difficult for the public to be assured that senior pay in the public sector matches performance;
- Restricted labour markets for senior positions are unnecessarily fuelling pay inflation;
- Misconceptions about senior public sector pay risk undermining the relationship between public servants and citizens;
- The risks of unfair pay increases may rise as the public sector is reformed.

Care is needed in adopting 'best practice' from the private sector, where pay arrangements and corporate governance have not delivered proportionality in pay. The Senior Salaries Review Body has recommended a Code of Practice on senior pay. This has much to recommend it, but more will probably be needed to give the public real assurance over senior pay. A way forward may be to develop **a framework for fairness in senior remuneration,** including but going further than the draft Code of Practice. The framework will cover better governance and transparency; disclosure requirements based on a pay ratio; better use of performance pay; and a renewed emphasis on the competitiveness of executive labour markets.

A pay multiple has much to recommend it: it links directly to fairness, it combats incorrect perceptions, and it addresses the collective action problem. But there are a range of difficulties and unintended consequences if the ratio is not defined carefully. At this stage we can rule out ratios based on the national minimum wage or mean salary levels.

How the base of the multiple is defined would determine the optimum ratio. In its final report, the Review will recommend on definition and implementation of a pay multiple. It will also develop other aspects of a framework for fairness.

Conclusions

Fair pay is pay that is due desert: proportional reward for an individual's contribution, supported by fair process

6.1 The heart of fair pay is the proportional alignment of due desert with monetary reward, determined by a fair process. As outlined in Chapter 1, this definition is supported by behavioural studies that suggest that the distinction between deserved and undeserved gains is crucial to human understanding of what is fair.

6.2 Fairness in pay thus demands both that individuals are paid proportionately to the real value of their efforts, not rewarded for brute luck or the efforts of others, and that pay be set according to a process that meets the standards of procedural fairness. A properly competitive market is a fairness process that ensures that individuals are in receipt of their due desert. But market failures that enable executives to extract rents, rewards depart from due desert. Fair pay does not mean equality of outcomes, but it does imply that with very few exceptions, pay levels will remain within bounds.

Pay for high earners has been increasing faster than pay for low earners – begging the question of whether this has been proportional

6.3 Chapter 2 showed that pay dispersion in the UK is characterised by an increasing disparity between the top one per cent of earners (about 290,000 people, earning over £117,523) and the rest. This movement is largely a private sector story. The share of top percentile wages earned by public sector workers has been declining, and now accounts for less than one per cent of those top wages. Even so, estimates suggest that there are at least 20,000 individuals earning over £117,523 in the public sector (out of a total public sector workforce of over six million). This includes over 4,000 people in public managerial roles.

6.4 Over the past decade, and in a range of public sector workforces, the pay of top executives has risen at faster rates than those of the lowest earners. The ratio between top and bottom pay in these public sector workforces has been increasing gradually. The public needs assurance that these increases have been deserved.

Yet it is difficult for the public to be assured that senior pay in the public sector matches performance

6.5 Pay setting arrangements vary considerably, and do not benefit from a consistent rationale underpinning them. Transparency of pay and of the pay setting process could be considerably improved. The public sector has not been strong enough on managing and rewarding performance.

6.6 In short, there is a patchwork quilt of pay arrangements, which may not be controlling senior pay sufficiently, nor supporting public scrutiny adequately. A better framework is needed to assure the public that pay fairly reflects performance, including through governance, transparency and use of variable pay.

6.7 It is widely accepted in the private sector that some proportion of remuneration for senior executives should be variable and linked to above average performance: due desert over and above expectations. This is both fair and an incentive. In the public sector attempts to introduce variable pay under the guise of bonuses or special payments have aroused controversy. Written and oral evidence to this Review was very hostile to performance pay, as delivering perverse results and contrary to an ethic of public service. However given the deep seated performance issues, and the results that can been delivered with well-designed performance pay, to exclude performance pay *a priori* from the public sector would be ill-considered. It may be that individual performance pay may be impossible to introduce given the current difficulties of measuring public sector productivity let alone individual contributions. But group or team performance pay could combine the best of both worlds: public sector commitment to team working along with private sector approaches to fair incentives. There may even be scope to explore deferred payment for performance, as was recommended by David Walker for use in the financial services sector.[159]

Restricted labour markets for senior positions are unnecessarily fuelling pay inflation

6.8 Despite greater complexity and risk in the roles, rises in senior public sector pay may also reflect limitations in the extent and nature of competition in the markets for executives. In a number of sectors the Review heard concerns about the adequacy of internal talent coming through to senior roles; it is also questionable whether there is enough focus on recruiting from a sufficiently wide pool of candidates. These create avoidable pressures on pay. Recruiting direct from the private sector, though comparatively rare, contributes to upwards pay pressure, making it even more important that recruiters widen the pool sufficiently, and are hard-headed in making their decisions.

The risks of unfair pay increases may rise as the public sector is reformed

6.9 It is notable that those areas that have seen the lowest growth in senior pay (and levels of growth most close to bottom pay) are those where Ministers, supported by the Senior Salaries Review Body, have greatest influence over all aspects of the pay package. And there is direct evidence from the NHS and from academies that greater autonomy over pay is linked to higher pay levels. These may or may not be justified, but it is unclear how the public is to be reassured.

6.10 The more boundaries of the public sector are broken down, the more it risks being exposed to private sector competition for scarce managerial talent. Greater flow of managerial experience, expertise and mutual understanding between sectors may well bring great benefits to the country. But there are serious risks of further pay inflation, unless senior pay is carefully monitored.

Misconceptions about senior public sector pay risk undermining the relationship between public servants and citizens

6.11 Public sector executives are right to want the public to understand and value what they do; without that understanding the legitimacy of much public sector activity will remain under constant fire. But the public will be readier to offer that appreciation the better they know whether public sector managers have performed or not and thus whether they are receiving their due desert. As Chapter 1 observed, the public is ready to regard pay packages of £200,000 or more as deserved when they can see for themselves that the individual in receipt of such remuneration has really made a difference. But the general mood is sceptical, vastly overestimating how much public sector executives are paid and doubting that they are worth it.

6.12 Public sector executives have clearly been swept up in wider concerns about elite pay, notably bankers' bonuses, MPs' expenses and FTSE chief executive remuneration. In some cases the catch-all coverage is justified. But if the media story is that the public sector is disproportionately awash with 'fat cats' (when it is not), then the distinctive public service ethos, which induces public sector employees to work at a discount, will be eroded. If top professionals no longer feel valued, the public sector is likely to have to pay more, rather than less, to encourage talented people into senior roles.

[159] *A review of corporate governance in UK banks and other financial industry entities*, David Walker, July 2009.

6.13 Government responses (both the previous and current administrations) have not been sufficient to quell public outrage. Rather, there is an irrational trend to compare the salaries of all public servants with that of the Prime Minister. As pointed out in Chapter 2, the Prime Minister's formal salary considerably underestimates the value of his full benefits package, and reflects a heavy 'discount' intrinsic to the nature of a political career. With some 9,000 individuals earning more than this across the public sector, widespread use of this benchmark would risk damaging a wide range of organisations' ability to recruit and retain talented individuals.

Care is needed in adopting 'best practice' from the private sector, where pay arrangements and corporate governance have not delivered proportionality in pay

6.14 Large private sector corporations have seen the pay of their chief executives rise to unprecedented levels, dwarfing anything seen in the public sector. Some of these rises are to a degree justified, driven by the growth in size and complexity of firms, the shift from firm-specific to general skills and the proper drive to align shareholder and manager interest. But there are real concerns that boards are not recruiting from a wide enough pool of candidates, and could do better in designing performance pay that truly incentives long term sustainable performance.

6.15 The Senior Salaries Review Body has set out three areas where it believes that the public sector could apply private sector experience more systematically.

- 'The first is governance. It is now a long established principle of corporate governance that remuneration decisions should be made, and be seen to be made, independently of the executives concerned.
- The second is how remuneration is set. The Combined Code stipulates that companies should pay no more than is necessary, and should be prepared to refuse excessive demands.
- The final area is transparency. It is more established practice in the private sector that remuneration policies and the full remuneration packages of senior executives are placed in the public domain. Public sector practice is well behind this, with less justification.'

6.16 The Senior Salaries Review Body is no doubt right that private sector practice could be applied more widely in the public sector, with positive results. Yet a thorough examination of the experience of large listed companies suggests that greater transparency and corporate governance may only have served to limit the growth of executive pay at the margin. More needs to be done – in both the public and private sectors – by those charged with representing taxpayer or shareholder interests, to ensure executive pay appropriately reflects due desert.

A framework for fairness in senior remuneration

6.17 A clearer framework is needed that will cover all the factors acting to push up pay unnecessarily. This must be clearly understood by the public, so that it can better challenge public bodies about executive pay, and that can equip those same bodies with a clear frame of reference through which to respond to criticism.

6.18 In their recent reports on senior pay in the public sector, both the Senior Salaries Review Body and the Public Administration Select Committee highlighted the current incoherence in top pay arrangements across the public sector, and called for clearer and more consistent pay principles to be established.

6.19 The Senior Salaries Review Body has recommended that this be delivered through a Code of Practice on senior pay that all public sector bodies should be required, as far as possible, to follow on a 'comply or explain' basis. The draft Code of Practice that the Senior Salaries Review Body has proposed requires in particular that in all public institutions executive pay should be set by bodies that are both independent of management and competent to assess reasonable remuneration, and insists that procedures for setting senior pay be transparent and subject to regular audit.

6.20 This approach has much to recommend it, and the principles behind its proposed Code of Practice should certainly form part of a wider public sector pay framework. However, the Senior Salaries Review Body's recommendations focus primarily on issues of pay governance and process (which while important are not the whole of the problem on top pay) and still allows some scope for inconsistencies between different public bodies in the extent to which they abide by the spirit or the letter of the proposed code.

6.21 A framework for ensuring fairness in senior remuneration would certainly include the Senior Salaries Review Body's code, but would say more about the measures needed to ensure sufficient competition for roles, including the role of talent management, and the opportunities for better use of performance pay. The Senior Salaries Review Body concedes that a better frame of reference for pay levels is also needed. Finally, it leaves the question of the increasingly porous boundaries of the public sector unaddressed.

6.22 The Public Administration Select Committee has also noted the need for a consistent pay framework for the public sector. Its answer is the establishment of a Top Pay Commission, which it conceives as charged to develop pay principles and guidance, and then police those principles, investigating potential breaches and 'naming and shaming' public bodies that cannot adequately justify their pay decisions. The proposal has merits, but a centralised solution of this kind would run counter to the Government's broader policy of devolving power while opening up public bodies to greater scrutiny from citizens. The Committee also fail to define what the pay principles should be, and to what extent they might be efficiently policed by the current apparatus.

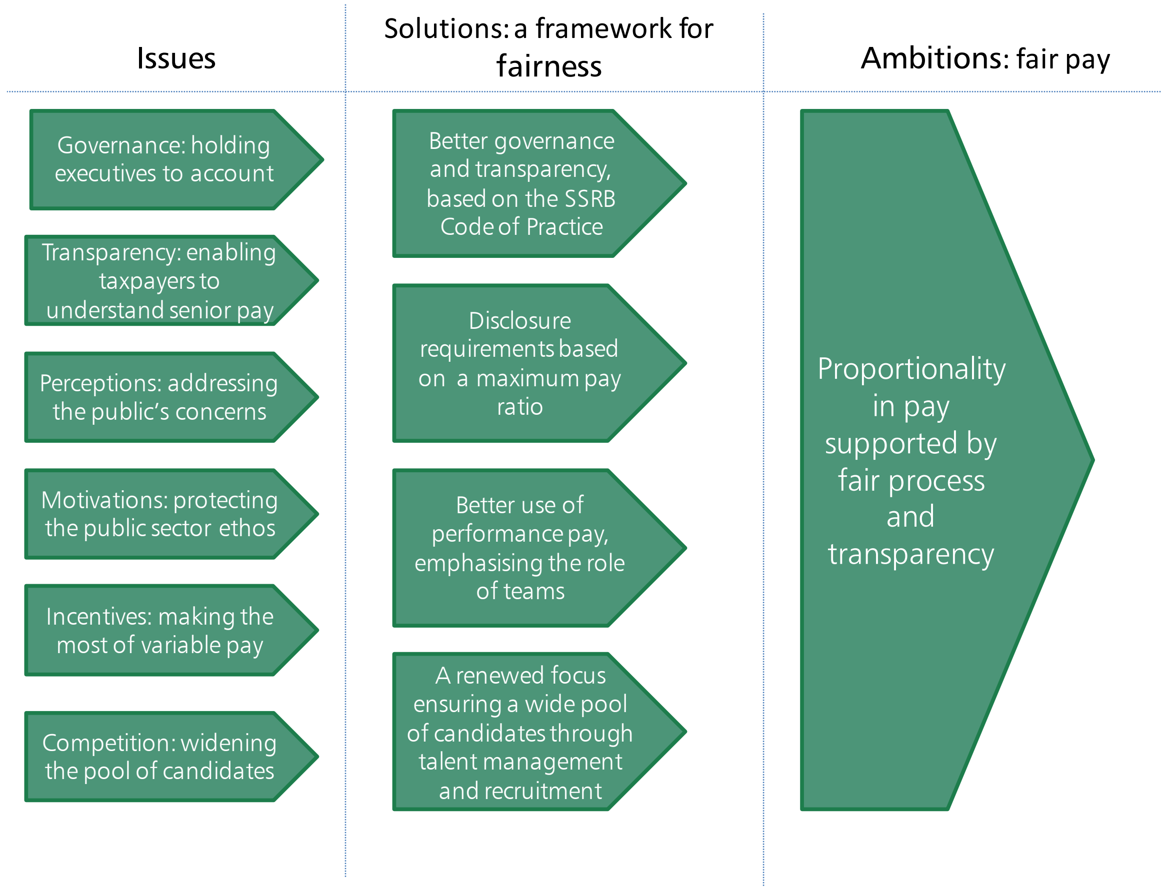
6.23 A way forward may be to develop **a framework for fairness in senior remuneration, including but going further than the Senior Salaries Review Body's draft Code of Practice.** To get around the increasing difficulty of defining public and private boundaries, it would ideally be applied in such a way that it covers all bodies delivering public services not already covered by the UK Corporate Governance Code requirements. Organisations would have to make certain information on remuneration policy publicly available in a format that is consistent, comparable and easy to use. This approach would enable greater local accountability, as it would allow citizens to see the data for themselves, and to judge individual organisations against reward principles based in the language of fairness understood by all.

6.24 The key principles that would underpin a framework for fairness in senior remuneration would be:

- **Real proportionality between pay and individual contribution** – individuals should be rewarded for their own performance, with top executives prevented from 'scooping the pool';
- **Fair process** – pay should be set according to consistent rules applied equally to all, independent decision-making and opportunities for staff to make their case;
- **Transparency** – pay outcomes should be openly disclosed and justified to staff and the public.

6.25 Chart 6.A summarises the current issues, and points the way to a framework for fairness covering better governance and transparency, based on the Senior Salaries Review Body's code; disclosure requirements based on a pay ratio; better use of performance pay, emphasising the role of teams; and a renewed emphasis on the competitiveness of executive labour markets through ensuring a wide pool of candidates.

Chart 6.A: A framework for fairness in senior public sector pay



Source: Fair Pay Review

Next steps: towards the final report

6.26 In its final report, this Review will set out recommendations on a framework for fairness in senior public sector pay:

- **Governance and transparency.** The Review will take the Senior Salaries Review Body's proposed Code of Practice as its starting point for making recommendations on senior pay.
- **The multiple.** The Review will explore how as many elements of pay as possible can be included within a pay multiple. More work will be done on whether a multiple should be varied so as to be a meaningful comparator when applied to very different kinds of organisation in different regions. The final report will recommend which measure should form the base of the ratio, and whether 20:1 or another number should be the level at which the multiple is set. It will also suggest how ratio disclosures could be implemented in different sectors.
- **Performance pay.** The Review will set out how pay for performance can form part of fair pay, and suggest ways in which the public sector could make better use of alternative performance pay systems, including team based pay, where appropriate.

- **Market competitiveness.** The Review will continue to develop its understanding of labour market issues and the interplay between senior pay, recruitment and retention, talent management and related issues.

6.27 In formulating this framework, the Review will maintain a focus on shaping wider social norms. There is a strong case for private sector organisations to follow the public sector example and at the very least track and report on pay dispersion from year to year in a fully transparent manner. This would allow shareholders and wider stakeholders to monitor pay dispersion, and when it increases to hold management to account for achieving the promised performance.

6.28 In its Final Report, the Fair Pay Review will make detailed recommendations on the definition and implementation of a pay multiple, and will develop other elements of a wider fairness framework.

A The Review's terms of reference

The terms of reference for the Review were published in June 2010.

The Government has asked Will Hutton to make recommendations to the Chancellor and Prime Minister by March 2011 on promoting pay fairness in the public sector by tackling disparities between the lowest and the highest paid in public sector organisations. The review will produce an interim report by late autumn 2010.

This review, which will also help to shape broader social norms in relation to pay fairness, should comprise:

- Robust, evidence based analysis of the scale of the problem;
- Recommendations on how to introduce a public sector pay multiple that would mean that no public sector manager can earn over 20 times more than the lowest paid person in their organisation.

As part of this the review will need to consider:

- Over what timescale a cap could be applied;
- How a cap would operate in areas outside direct Ministerial control.

The review should have regard to:

- The Government's wider fiscal and public sector pay policies, in particular the need for senior staff to show leadership in pay restraint, and to deliver value for money from the public sector pay-bill. Recommendations from the Review should not increase the total pay bill;
- The level of remuneration necessary to attract, retain and motivate staff of the quality required – and the opportunity cost of working in the public sector for some staff;
- The fact that organisations may need flexibility to exceed multiples to match the market rate in exceptional cases where there is a clear justification to do so;
- The Government's stringent requirements for transparency and Ministerial approval in senior pay decisions.
- The benchmarking work currently being taken forward by the Senior Salaries Pay Review Body;
- The degree to which distortions and market failures in private sector pay create pressure for unfair pay multiples in the public sector.
- The importance of rewarding productive entrepreneurship by frontline public sector staff.

The review will examine all aspects of the public sector pay package, including base pay, variable pay, bonus and other elements, to the extent to which all can contribute to fairness across the pay range. The review will take into account any recommendations or findings from John Hutton's review of public sector pensions and will not make independent recommendations on areas covered by the scope of that review.

The scope of the review should include staff covered by the Senior Salaries Review Body (senior civil servants, very senior managers in NHS commissioning bodies, senior military), senior staff in non-departmental public bodies, managers in local government and the NHS, regulators which receive public funding, and senior staff in further and higher education.

B Disclosure requirements for senior public sector salaries

B.1 Current disclosure requirements are set out below. The government has committed to improving transparency of Government pay. In June 2010, the Government published the names, job titles and pay details of civil servants earning more than £150,000.[160] In September 2010 the Government also revealed the salaries of senior civil servants in Central Government and NDPB officials with salaries higher than the lowest permissible in Pay Band 1 of the senior civil service pay scale (around £60,000 per year).

Disclosure requirements for salaries of senior public servants

Sector	Senior staff salary disclosure requirements
Central Government	Central Government is subject to the requirements of the Government Reporting Manual (FReM)[161]. This requires salaries of board members to be disclosed in bands of £5,000[162] (and actual amounts for Ministers). Information on remuneration of officials below board level may be made available following specific freedom of information requests, but is not regularly published.
Local Government	Currently the only requirement for remuneration reporting is to provide a note of the number of employees receiving remuneration above £50,000, in brackets of £10,000[163]. However, there are proposals to require these bodies to publish detailed information about the remuneration of their senior officers from 2010–11 onwards.
NHS Foundation Trusts and Primary care trusts	Gross Salary and allowances (in bands of £5,000) must be shown for all Directors and senior managers[164].
Higher and Further Education colleges	HE and FE colleges are required to disclose the following information in their financial statement, which are publically available[165]: • The salary and allowances of the principal (and the highest paid senior post, if it is not the principal) • The aggregate salaries of the College's senior post holders[166]. • The number of senior post holders in salary bands of £10,000.
NDPBs	Non-charitable NDPBs are subject to the requirements of the Government Reporting Manual (FReM) Charitable NDPBs are required to disclose the salaries of trustees[167].
Public Corporations	Public corporations which are not trading funds generally follow private sector practice in disclosing remuneration, providing detailed information about Directors' salaries[168] Trading funds are subject to the requirements of the Government Reporting Manual (FReM)

Source: Fair Pay Review

[160] Cicil Service High Earners list, June 2010 http://www.direct.gov.uk/en/Nl1/Newsroom/DG_188114

[161] Government Financial Reporting Manual, 2010-11, HMT.

[162] The rationale for disclosing in bands is that the disclosure of exact salaries would amount to an unwarranted intrusion into individuals' privacy and personal affairs. This has been upheld by the Information Commissioner as striking a proportionate balance between the public's right to information and the individual's right to see their personal data protected.

[163] The Accounts and Audit Regulations 2003 (no. 533)

[164] NHS Foundation Trust Annual Reporting Manual 2009-10 and Draft Primary Care Trusts- Manual for Accounts 2010-11, October 2010, DH. Senior managers are defined as 'those persons in senior positions having authority or responsibility for directing or controlling the major activities of the Trust'. This will include the chair, the executive and non-executive directors

[165] Accounts Direction Handbook, June 2010, Skills Funding Agency, Chapter 5, Note 7. This statement of recommended accounting practice (SORP) applies to FE and HE institutions throughout the UK.

[166] This is defined as "the Principal and holders of other such senior posts as the governing body may determine for the purposes of the articles of government of the College relating to the appointment and promotion of staff"

[167] Accounting and reporting by charities: Statement of Recommended Practice, 2005.

[168] The large and medium sized companies and groups (accounts and reports) regulations, 2008. This is called a Directors Remuneration report

C Additional notes on the data

C.1 This Review has not sought to be a definitive pay survey. It has sought to highlight indicative trends. With that in mind the following provides more detailed information on the background and definitions of the data that we have used to describe the overall economy, public and private sectors. The information aims to allow a more detailed understanding our data sources than was feasible to include in the main text whilst still allowing ease of reading. However what follows includes important caveats on conclusions that can be drawn from charts within the review.

A note on chronology

C.2 Due to the different sources of our data and our need to make comparisons between them compromises have needed to be made when describing the year in which the data is from. As a general rule if data was given for financial years we have converted this calendar years so 08/09 has become 2008. In additional certain data points were given for specific times of year. In these examples we have taken the year in which the data is provided.

Data used to describe the economy as a whole

- The definition of 'gross income' used in our analysis of ASHE data includes pay before deductions for PAYE, National Insurance, pension schemes and voluntary deductions. It also include basic, overtime, shift premium, bonus or incentive pay and any other pay The data only includes employees on adult rates who have been in the same job for more than a year.
- We have been explicit where the data refers to full time or all employees.
- In order to accommodate methodological changes in ASHE we have used the 2004 data set (e.g. not excluding the additional information) and 2006 that is consistent with 2007 methodology.
- Our calculations using Gross Domestic Product were taken directly from the HM Treasury website and do not reflect HM Treasury analysis.
- GDP per worker was calculated using money GDP figures divided by an annual average of the seasonally adjusted monthly data based on three month rolling averages for all people in employment taken from the Office of National Statistics.

Data describing public sector workforces

Higher Education

Lead Executives:

- Provided by the Universities and Colleges Employers Association (UCEA).
- The data refers to emolument figures based on the total remuneration package (excluding pension contributions and excluding payments made to compensate for a pension cap) as declared in institutions' published annual accounts. This data is compiled yearly as part of UCEA's Remuneration Survey, which collects data from

institutions on the pay of heads of institution, senior and middle staff in UK HE Institutions.

- Please note that the time series data has been constructed using the same methodology for previous years and are not a constant sample. This means that the composition of individuals and institutions for each year are potentially different. However, the number of institutions for which data is available is high as a proportion of total institutions and the figure provided is the median so this should deflate some of the possible problems of using a non-constant sample.

Lowest Earners:

- Provided by the Universities and Colleges Employers Association (UCEA).
- The data refers to the lowest point of the UCEA pay spine. The pay spine data is from the national HE pay spine which is reviewed by the Joint Negotiating Committee for Higher Education Staff. Please note that the pay spine is used by the vast majority of institutions, although institutions map the spine points to their own grading structures. Please note that the lowest point on the pay spine therefore may be lower than the lowest paid post at a given institution.

Further Education

Lead Executives:

- Provided by the Association of Colleges (AoC)
- The data refers to the average principals salary taken from the management pay scale data provided to AoC by the Skills Funding Agency. This data is for England only.

Lowest Earners:

- Provided by the Association of Colleges (AoC)
- The data refers to the lowest point of the AoC national recommend pay spine. Please note that as this is a voluntary pay spine actual lowest pay may vary between colleges. A consistent data series is only available for 2003-2009. The data is for England, Wales and Northern Ireland.

The NHS

Lead Executives:

- Provided by IDS.
- The data refers to Chief Executives of NHS Hospital Trusts in England. The data was originally harvested from annual accounts. Please note that the Chief Executive is not always the highest paid executive.

Lowest Earners:

- Source material provided by NHS Employers
- For 2000 – 2004 the data refers to the lowest point of administrative and clerical pay band taken from Administrative and Clerical Staffs Whitley Council Advance Letters. For 2005 onwards the data refers to the lowest pay on Agenda for Change. Please note that prior to Agenda for Change the pay spine for ancillary workers was lower than for ancillary workers. Administrative and clerical staff have been used to

as a more consistent time series and to avoid issues of contracting out. The pay spines cover the UK.

The Civil Service

Lead Executives:

- 2003 onwards provide by Cabinet Office.
- The data refers to an estimated median of Permanent Secretaries salaries created by taking the midpoint of the pay band for the median group of permanent secretaries from SSRB reports. For 2003 onwards we use the median base pay of Permanent Secretaries provide by Cabinet Office.

Lowest Earners:

- IDS Pay in the Public Services (2000-2010)
- For the year 2000 the data refers to the minimum earnings of an administrative assistant in the Department of Social Security (DSS) in Inner London. For 2001 onwards the data refers to the minimum earnings of an administrative assistant in the Department for Work and Pensions (DWP) in inner London. Please note that neither DSS or DWP are necessarily the lowest paid departments for administrative assistants. The data was used as it was the most consistent series.

The Military

Lead Executives:

- Taken from Senior Salaries Review Body report.
- The data refers to the top of the pay band for 4 star generals – between 2000 and 2002 this was the maxima of range 7 and for 2003 onwards it is Scale Point 6. Please note that although the term '4 star generals' has been used for ease of understanding the pay ranges also apply across the services and so also to Admirals and Air Chief Marshals.

Lowest Earners:

- Taken from Armed Forces Review Body reports
- For the year 2000 the data refers to Private III band 1 and for 2001 onwards it refers to the lowest point of range 1. Please note this these figures are for the lowest pay upon completion of basic training. Additionally please note that pay ranges apply across the services and so also to Able Rates, Marines, Aircraftman/Leading Aircraftman.

Local Government

Lead Executives:

- Data provided by the Local Government Association.
- The data refers to the average salary of Chief Executives of Local Authorities across England and Wales. Please also note that the 2007 figures did not include national pay awards as these were agreed after the survey and that the 2008 figures include the 2007 national pay award but not 2008 as this was agreed after the survey was taken.

- Also please note that the exact relationship in individual councils is likely to be different than the overall ratio suggested in the charts. This is because the councils with the highest chief executive salaries will be in areas that are less likely to use the lowest pay point we have listed.

Lowest Earners :

- The data refers to the bottom of the LGE Spinal Point as given here: http://www.lga.gov.uk/lga/core/page.do?pageId=5822050 as also refers to England and Wales. Please note the caveat above however and that not all councils will pay the minimum indicated.

A note on the Panorama data set

C.3 We have used the data obtained by the Panorama investigation into top pay in the public as it is the best source of data on individual remuneration that we are aware of and we did not feel it appropriate at this stage to replicate their work. Rather, we have conducted a number of checks back to original sources (primarily annual accounts).

C.4 A full description of their methodology is available at http://www.bbc.co.uk/news/uk-11369278

C.5 We have made additional attempts to 'clean' the data for our purposes for specific workforces:

- Military: The of Chief of the Defence Staff is counted as central Government
- Higher Education: Excludes those listed as "academic, clinical, non-clinical, staff, employee, professor, research or left blank
- NHS: Excludes those listed as consultant, GP, with specific medical, technical or scientific roles, other, unknown or blank
- Central Government and QUANGOs: Bodies listed as Central Government but that could also be described as arms length bodies have been merged with those classed as QUANGOs and the whole group reclassified as Arms Length Bodies.
- Attempts have been made to delete duplicate entries but we cannot guarantee some of not contained due to the absence of names for some entries.
- Finally, please note that no attempt was made to differentiate between 2008/09 data and 2009/10 data.

A note on the data describing the private sector

C.6 Calculating the exact total of CEO remuneration is a contentious issue as shown by the recent debate in the Financial Times http://www.ft.com/cms/s/0/1490a046-e6e8-11df-8894-00144feab49a.html#axzz16OSipxjO. The main question is around whether to count the value of options as they are awarded or when they are become redeemable or 'vested'. We have sought to differentiate this clearly when we have used each. In order to further clarify the data we have used we will set out below in more detail what is included within the two main data sets from IDS and Manifest/MM&K.

C.7 Our charts using IDS data represent 'actual total earnings'. This represents the total amount earned by a director during the year, excluding company pension contributions. It includes:

1 Total cash representing contractual annual remuneration for management services plus bonus payments received by a director during the company's financial year. More specifically it includes:

- basic salary: this is not necessarily the figure set at a director's salary review, but the amount received during the year. It may also include any fees paid to directors and, where it is not possible to separate, a salary supplement relating to pensions;
- benefits-in-kind. These are the estimated money value of any benefits, excluding company pension contributions, received by the director. Where a cash alternative to a company car is paid, it is included under benefits. Also includes, in some cases, a cash payment pension supplement where this is not given separately;
- annual bonus: this is often a cash payment but may include the cash value of any (deferred) shares awarded as part or all of the award. It may also include profit sharing and profit-related pay.

2 The cash value of any long-term incentive plan (LTIP) and/or matching share scheme shares vesting, but not the value of any conditional share awards that may vest at some time in the future;

3 The notional/actual gains on the exercise of SAYE and executive share options: The profit or notional gain on share options has been calculated by multiplying the number of shares exercised by the difference between the exercise price at grant and the market price for a share on the day the options were exercised. It should be remembered that unless the director has sold the shares, none of this 'profit' will necessarily have been realised in cash. Further, if shares have been sold subsequent to exercise, they may not have been sold at the same market price as was in effect at exercise.

4 Ant miscellaneous payments. These include special payments for pensions, housing assistance, one-off bonuses for particular projects and profit share.

5 Additionally Pension provision is not included in any of the data (aside from occasional special payments for pensions outlined above and included in misc payments in total earnings.)

C.8 Our charts using the Manifest/MM&K data show both realised and total earnings. Below are extracts from the The Manifest/MM&K Executive Director Total Remuneration Survey 2010 definitions of its collection process:

- Salary: The amount paid in the year as shown in the annual accounts, not the current salary.
- Benefits: The taxable value of benefits as reported in the table of emoluments in the annual report. It excludes the value of pension, but includes compensation for loss of office.
- Cash Bonus: This is the figure shown in the emoluments table for annual bonus, less any bonus which is deferred. This produces a lower bonus figure than some other surveys. However, we take the view that only bonus that has actually been received should be counted. The amount that was deferred in respect of the previous year's bonus will be included in the long term incentive awards, plus the value of any potential matching awards. It should be noted that the amount of bonus deferred for the latest year will (usually) not show in our survey until the next year, if it made as a share plan award, or until vesting if it is a deferred cash award. When the deferred bonus vests (e.g. in three years' time), the amount plus any bonus matching shares is recorded in the long term incentive " realised" and Total Remuneration " realised" part of the survey.

- Long Term Incentives: We survey both the amount of long term incentive awarded in the latest year and the amounts “ realised” in the year, from previous years’ wards.
- Awards In The Year: “Fair Value” , i.e. expected value of awards, is rarely disclosed in the annual report. We adopted the simple approach of using the Fair Value of options as 30% of the face value of grant in the latest year. For LTIPs and bonus matching, when performance linked, 60% of the face value is used. This may be over simplistic for some companies with complex plans but, if we have overestimated some and underestimated others, it balances out to give a fair estimate of the market place. We do not apply a discount for the possibility of forfeiture on leaving as the executive, if successful and recruited elsewhere, will be able to negotiate an equivalent or better incentive.
- Amounts “Realised”: This is the value of shares that vest under LTIPs, deferred bonus plans and any other share plans plus the gains from options exercised in the year plus any cash payments received from any cash long term incentive plans.
- Total Remuneration Awarded: The sum of salary, pension, benefits, cash bonus and the fair value of share options and other long term incentives awarded.
- Total Remuneration “Realised”: The sum of salary, benefits, cash bonuses and the amount of long term incentives “paid out” , i.e. notional gains from options exercised in the year calculated at the date of exercise of each option, plus the value of other share schemes that vested in the year, at the date of vesting.

D Organisations that have contributed to the Review

On 19 July the Review issued a call for evidence, inviting views from all interested parties on issues around fairness in pay. A summary of the responses can be found at:

http://www.hm-treasury.gov.uk/indreview_willhutton_fairpay.htm

The Review team would like to thank all those individuals and organisations who submitted responses. We received submissions from a range of academics, human resources specialists and members of the public, as well as the following organisations:

Association of Colleges

Association of Local Authority Chief Executives

Association of Managers in Education

Association of Teachers and Lecturers

British Association of Journalists

Citizens UK

Committee of University Chairs

Confederation of British Industry

Educational Institute of Scotland

Equality and Human Rights Commission

First Division Association

Gatenby Sanderson Ltd

Gateshead Council

GLA Economics

Hay Group

The Higher Education Funding Council for England

The Institute for Employment Studies

John Lewis Partnership

Kent County Council

Local Government Employers

Managers in Partnership

NASUWT

National Union of Teachers

New Economics Foundation

Nottingham City Homes

One Society

Other TaxPayers' Alliance

Prospect

Public and Commercial Services Union

Royal College of Midwives

Royal College of Nursing

Senior Salaries Review Body

Shepway District Council

Society of London Treasurers

South East Employers

Towers Watson

Trades Union Congress

Trust for London

Unison

Unite the Union

The University and College Union

West Sussex County Council

Zacchaeus 2000 Trust

We are also grateful to the representatives of the following bodies who have met with us to help develop our understanding of particular sectors and workforces:

Association of Colleges

Association of Local Authority Chief Executives

Association of Teachers and Lecturers

Cabinet Office

Chartered Society of Physiotherapy

Committee of University Chairs

Department for Business and Skills

Department for Communities and Local Government

Department of Education

Department of Health

FDA union

Fire Brigades Union

GMB union

Higher Education Funding Council for England

Managers in Partnership

NASUWT The Teacher’s Union

National Union of Teachers

NHS Employers

Local Government Association

Local Government Employers

Home Office

Managers in Partnership

Ministry of Defence

Ministry of Justice

Odgers Berndtson

Office of Manpower Economics

National Offender Management Service

NHS Employers

Prospect

Public and Commercial Services Union

Society of Radiographers

Towers Watson

Trades Union Congress

Unite the Union

Universities UK

University and Colleges Employers Association

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