

ASYMMETRIC REFERENCE POINTS AND THE GROWTH OF EXECUTIVE REMUNERATION

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Various theories have been put forward for the recent divergence in growth rates of CEO pay and average earnings, but those which most clearly match the evidence concern power and the institutions of remuneration setting. Executive pay is characterised by 'dual asymmetric pattern bargaining', whereby firms seek to benchmark their CEO pay to higher-paying firms, and grant CEOs, with whom corporate decision makers share a social milieu, increasing benefits which also confer status benefits on the firm – in sharp contrast to the distributional pay negotiations which occur with workers. Executive remuneration rises disproportionately during boom periods, but fails to symmetrically fall during poor times. Thus 'everybody knows' that CEOs are overpaid, but firms are unwilling to do anything about it, because to do so would damage internal class relations and firm status. The different methods of pay setting for workers and CEOs reflect core differences in class power and changes in that balance of power during a period of neoliberalism.

Executive pay and termination packages have become a focus of public attention. Across Europe and the US, four fifths of people believe that business leaders in their countries are paid too much (Harris Interactive 2009; see also Blitz 2003). In Australia: nine in 10 adults believe that chief executive officers (CEOs) get paid too much; 79 per cent believe executive salaries should be capped; four in five believe high executive salaries do not increase company performance; and almost two-thirds of people believe high executive pay leads to higher risk taking (Colmar Brunton 2009; Ferguson 2009).

There are objective reasons for this disaffection. Since the mid 1980s executive salaries have been growing faster than average wages. However, this difference in growth rates has not always existed. Australian series on executive remuneration and average earnings tracked each other fairly closely through the 1970s and early 1980s (other than in 1974, when there was a significant increase in real earnings that established a new relativity that remained fairly stable until 1985). From 1985 the Australian series started to diverge, with major increases in real executive remuneration despite ongoing moderation in real average earnings in the context of the centralized phase of the prices and incomes Accord. The divergence continued through subsequent periods of decentralized bargaining for wage earners as well. Real CEO pay grew by nearly five times during the period 1971-2008, whereas real average weekly earnings grew just over 1½ times over the same period (calculated from Noble Lowndes Cullen Egan Dell 1994; Shields, O'Donnell and O'Brien 2003; Egan 2009). The increase in CEO pay is a significant factor explaining the rise in the share of national income going to top income earners over the past two decades (Atkinson and Leigh 2007). This increase in top income shares is a relatively recent phenomenon: from 1920 to the early 1980s, the share of top income earners generally declined (ibid).

This paper considers the growth in executive remuneration since the 1970s and the alleged and actual causes of the growing divergence between CEO pay and pay of ordinary employees. We commence by identifying and assessing various theories on the reasons for relatively high growth in executive remuneration. We then canvass an alternative theory, referred to as asymmetrical pattern bargaining theory. We assess it by revisiting a little utilised dataset from the 1990s and comparing its results with recent published data. We then seek further insights from other studies to help illuminate interpretation of the findings,

including understanding the breaking of the implicit nexus between CEO pay and average earnings. We explain the dual asymmetries and also undertake a simple simulation of the impacts of our hypothesised remuneration determination process to assess the magnitude of effects that can arise from asymmetric pattern bargaining.

Competing theories explaining relative growth in executive remuneration

Several theories have been put forward for the contemporary divergence between growth rates of CEO pay and the pay of ordinary workers. 'Productivity' theories explain this growth in terms of the economic performance of CEOs: it is simply the CEO's fair share of the corporate performance they deliver. There are several variants of this theory. A 'complex job' variant posits that the work of CEOs has become relatively more complex in recent years, requiring higher levels of skill than previously. Derived from this is a variant that that greater CEO skills and hence pay have been necessary to drive improvements in productivity and national prosperity. There is also a related body of thought based on 'tournament' models: that the market for CEOs is like a tournament, with high rewards for a small number of 'winners'. In this case, the argument is not that the high pay for CEOs induces better performance from CEOs; rather, it produces a strong incentive for all members of the organisation. 'A salary of, say, \$2 million may be "justified", not because of the CEO's contribution to profit but because of the contributions made by those competing to be the next CEO' (Norris, Kelly and Giles 2005:103).

Consistent with this broad framework, the Productivity Commission (Productivity Commission 2009:xxiii,73) argued that in aggregate 'executive remuneration has grown at similar rates to company performance' as evidenced by the fact that 'executive pay has tracked the (ASX) accumulation index' with a 'a strong correlation between pay and company performance'. The ASX200 is an index of the cumulative value an investor would have after year 1 if they invested in Australia's 200 largest listed firms and, after receiving dividends each year, took none of the dividends as income and instead reinvested the full amount of the dividends in the same companies. Yet in making this comparison the Productivity Commission was comparing chalk and cheese. Rather than just representing growth in income from one year to another, the ASX accumulation index signifies the

combined growth of accumulated, fully reinvested income plus the returns from that reinvestment of the full amount of income. The Productivity Commission confused income with an imaginary concept of accumulated wealth (imaginary in the sense that it is unrealistic to assume that no income is consumed and it is all, instead, invested). From a national welfare perspective, a more valid reference point is national productivity rather than the ASX accumulation index. Over the two decades from 1978, growth in real CEO pay mentioned earlier was approximately six times growth in productivity (Australian Bureau of Statistics 5204.0). Once again, the divergence commenced in the mid 1980s, with CEO pay and productivity moving fairly closely together over the period to 1984, but diverging thereafter.

If the link between CEO pay and performance is weak at the aggregate level, other researchers have challenged the idea that it exists in a consistent way at the micro level. Shields, O'Donnell & O'Brien (2003; 2004) showed that, over the period 1999-2002, the 20 best-performing Australian companies paid their CEOs substantially less than did the 20 worst performing companies. It did not matter if corporate performance was measured by return on equity, share price change, or change in earnings per share, the same pattern held. The best performing companies as measured by return on equity increased the pay of their CEOs by only half the amount that the worst performing companies did. RiskMetrics, analysing CEO pay over four to twelve years in eight major companies, concluded that 'productivity improvements do not appear to explain executive pay increases, despite all CEOs in the case studies receiving performance based cash bonuses explicitly disclosed as being tied to performance' (RiskMetrics Australia 2009). The Productivity Commission (2009:76) found it 'difficult to draw conclusions' about the micro-level link between CEO pay and performance based on regression analysis over the 2003-04 to 2007-08 period, though the equations themselves are quite unambiguous. Consistent significant negative coefficients show that, after controlling for size, total executive remuneration is *negatively* related to total shareholder return; in addition, even after controlling for both these effects, total executive remuneration may also be weakly and *negatively* related to net profit after tax (Productivity Commission 2009:444).

Another, earlier Australian study found that CEO pay was only correlated with company performance during boom periods; during soft landing and flat recovery periods there was 'no relationship between corporate performance and executive remuneration', and during recession on one measure there was a negative relationship (Matolcsy 2000). An American study found that CEO pay was related to what was euphemistically called 'talent' (enterprise income, after an adjustment for incentives) but that this relationship did not hold for periods when enterprise returns were negative; rewards were substantial when enterprise income rises but there were no substantial penalties when enterprise income fell (Sung and Swan 2009, pp5-6).

It appears that there may be a ratcheting effect, whereby bonuses boost pay during good times, but base levels are then boosted (or bonuses restructured) to offset the loss of value of bonuses or options schemes in bad times (eg West 2008; Schwab 2009). The ratcheting effect is given support by a finding that asset volatility ('risk') is positively related to CEO pay (Sung and Swan 2009): a CEO benefiting from a rapid short term movement in share prices, and whose overall remuneration is then protected against share price decline by offsetting increases in other components of pay, will experience greater medium term remuneration gains than a similar CEO in a firm with stable share prices. Sung and Swan, it should be noted, find no upward trend over 1995-2007 in mean 'talent', but that volatility and real CEO pay both trend upwards, in the latter case by 4.4 per cent per year. The preceding studies also undermine the 'tournament' explanations, as this suggests the highest growth in rewards should be associated with the highest performing companies.

The 'complexity' variant has additional problems: CEOs are not the only people who make a corporation profitable. The majority of Australian workers have also faced increased work pressure (eg Morehead et al. 1997), and a majority of employees experience overload at work, leading to poor work-life interaction (Skinner and Pocock 2008). All a corporation's workers contribute to its profitability, and if it becomes more profitable it is not immediately obvious why the senior management would be the only ones to benefit. CEOs appear to be extracting gains far beyond those attributable to higher productivity.

A separate theory regarding the inflation of CEO remuneration is the ‘global labour market’ theory. This does not rely on there being any increase in value associated with the work of CEOs, rather it relies on changes in the labour market for CEOs: that, with globalisation, the market for senior executives has also globalised in recent decades, so that Australian firms now have to offer higher remuneration to attract or retain CEOs (Productivity Commission 2009:110-2). This can be tested by considering if there is a convergence in international pay levels of executives. If the market for CEOs was internationalizing, more so than that for other workers, then we would expect to see smaller differences in the pay of, say, American and Swedish CEOs, operating in the same labour market, than between the American and Swedish restaurant workers, operating in very different labour markets. The data suggest otherwise. In 2000-01 CEO pay was 367 per cent higher in the USA than in Sweden, but McDonalds workers' base pay was 8 per cent lower in the USA than in Sweden (Ashenfelter and Jurajda 2001). This is not principally because the USA is a larger country than Sweden or is home to a greater number of globally significant corporations. In 2006, the 20 highest paid US CEOs received an average of three times the remuneration of the 20 highest paid European CEOs – yet the companies controlled by the US CEOs had sales 29 per cent less than those controlled by the European CEOs (Anderson et al. 2007). If Australian CEO remuneration is rising to meet US standards, the US itself is accelerating further away from the pay of ordinary employees and productivity in the US, (Klinger and Cavanagh 2002), so the gap is never closed. The factors inflating US executive remuneration are likely to be also inflating Australian executive remuneration.

Another theory can be described as ‘risk compensation theory’: senior executives' jobs are increasingly insecure, and their greater pay growth reflects the greater risk they will lose their job, and the greater losses they will face if this happens. On the risk side of this model, Isles (2006) tested whether labour turnover amongst US CEOs was higher than that of ordinary employees in 2005-06, finding labour turnover was 14 per cent amongst CEOs but 23 per cent across private sector employees generally. Overall turnover amongst Australian ASX200 CEOs over the 2000-2007 period (13.0 per cent) was marginally higher than the global average (12.8 per cent), but *forced* departures only affected 3.0 per cent of Australian CEOs a year, compared to 3.8 per cent globally (calculated from Manning and Sherwood 2008:3,7). Amongst ordinary Australian employees, turnover over this period ranged from 18 to 20 per cent (Australian Bureau of Statistics 6309.0).

As for the losses side of the risk compensation model, it is notable that unemployment duration is relatively short amongst former CEOs: a global electronic survey of 1000 unemployed executives in February 2009 found that 28 per cent had been unemployed for less than a month and just 18 percent had been unemployed for seven months or longer (Korn/Ferry Institute 2009). For reference, 24 per cent of Australian unemployed persons looking for full-time work had been unemployed for six months or more, and 15 per cent for 12 months or more (Australian Bureau of Statistics 6291.0.55.001). Yet the termination payments made to departing CEOs are substantially higher than for ordinary employees, as a proportion of their income (let alone in absolute terms), and often given for reasons (such as poor performance) that would render ordinary employees ineligible (Ferguson 2008), as evidenced by numerous instances of ‘golden parachutes’ worth, on average, two years’ salary (Ferguson 2008, Cassidy 2008; Mayne 2008; West 2008; Robinson 2009). The risk compensation model fails to explain CEO pay inflation.

One other approach that might be used to explain the growth of executive remuneration is agency theory, which implies that CEOs have different interests to those of shareholders and will act to maximise their own utility rather than that of shareholders, using the asymmetry of information between themselves and shareholders to their advantage. The policy response to this problem is to design incentive payment systems that align CEOs’ and shareholders’ interests. As Thornthwaite (2010) argues, agency theory makes dubious assumptions about the benefits of CEO incentive payment schemes, and she provides several reasons why incentive schemes might have adverse implications for firm performance. Negative significant relationships between long term incentives for CEOs and shareholder return shown in the previously mentioned Productivity Commission (2009:444) equations support the idea that incentives fail to deliver better performance, even though most of the growth in CEO pay over the 2004-07 period was due to growth in long-term incentives (Productivity Commission 2009:xvii).

Towards a better theoretical understanding

With existing theories inadequate, we turn to an explanation that is largely ignored: the asymmetry in pay procedures, in particular asymmetry in reference points for pay

determination. Some four decades ago Runciman (1972) drew our attention to how people compare themselves to others in a 'reference group' that occupies a similar position in the economic distribution, but the implications of this for executive pay markets, where power relations are very different to the working class people Runciman studied, have not been considered. The market for executive remuneration has strong elements of 'pattern bargaining'. However, it has two key asymmetries: a 'pattern' that is asymmetric, as it is based on asymmetric reference points that seek to achieve a position *above* the mean; and 'bargaining' that is asymmetric, as there is not an effective countervailing force at the bargaining table (in contrast to wage bargaining for ordinary employees). Hence the process can more accurately be described as *dual-asymmetric pattern bargaining*.

Our alternative explanation for growth in senior executive remuneration therefore focuses on institutions, in particular the existence of occupational power and the ability of that power to shape the reference points for setting executive remuneration. It focuses on the way in which CEOs hold positions of relative power, similar or related to the power that capital has in relation to labour, and that as power has shifted from labour to capital the capacity of CEOs to extract rents (Bebchuk and Fried 2004) has increased. It is based on the idea that CEOs are able to disturb relativities in CEO pay and then use their occupational power to attempt to reassert those relativities, imparting an upward bias to aggregate CEO pay unrelated to performance. For example, CEOs are able to persuade boards to attempt to pay them above the 'median' CEO salary for reasons of organizational status, and as it is mathematically impossible for most people to be paid above the median, relative CEO remuneration will rise regardless of performance.

Remuneration consultants play a significant role in the 'leapfrog' explanation. In the UK a leading fund manager recently opined:

I would say they are a thoroughly bad influence. They are seen by fund managers as having extreme conflicts of interest: they are effectively paid by the board and are only seen to be doing their jobs if remuneration rises. In theory, remuneration consultants bring a certain level of objectivity to the task, but their existence allows companies to say they have done due diligence on pay, therefore it's not their fault when benefits and performance do not match (quoted in Wachman 2009).

The House of Commons Treasury Committee investigating the financial crisis received ‘a body of evidence linking remuneration consultants to the upward ratchet of pay of senior executives in the banking sector’. (House of Commons Treasury Committee 2009:32,33).

Attitudinal evidence, from the class inhabited by senior executives, points to an inflationary bias in executive remuneration. A 2005 survey co-sponsored by the Australian Institute of Company Directors showed that even a majority of directors believe that CEOs are overpaid – notwithstanding the fact that, technically, it is the job of the board of directors to set CEO pay. Indeed, over two thirds of directors considered that CEOs were overpaid by between 20 per cent and 50 per cent (Buffini and Pheasant 2005). A separate study found similar results. O'Neill (2007), undertaking in-depth, semi-structured interviews with non-executive directors of Australian public companies, found that 'when the issue of "how much is too much?" arises, almost all express a level of concern', evoking comments from directors such as that CEO pay 'needs to be capped so that it doesn't become obscene' and 'I don't think any individual is worth that much' (O'Neill 2007). Even Paul Anderson, then retiring CEO of BHP Billiton, remarked:

CEO compensation is out of control, totally out of control. It's reached a point now that there's no way to justify the incredible compensation...there is just no value that can be created by a CEO that you can say that makes a lot of sense (Correy 2003).

There is a high element of status in executive pay which shapes remuneration decisions. According to the director of the Australian Institute of Company Directors:

it's quite possible that a bank CEO would do a terrific job on quite a lot less pay, but no bank board is going to want to pay its CEO substantially less than the market norm. (Ralph Evans quoted in Buffini and Pheasant 2005).

Australian data

Useful cross-sectional data on the role of institutions, including remuneration consultants, are rare. So our starting point is a survey of executive pay methods undertaken by Noble Lowndes Cullen Egan Dell (Noble Lowndes Cullen Egan Dell 1994), which showed that the

most important factor influencing executive pay was 'remuneration market forces' (that is, what other corporations were paying).

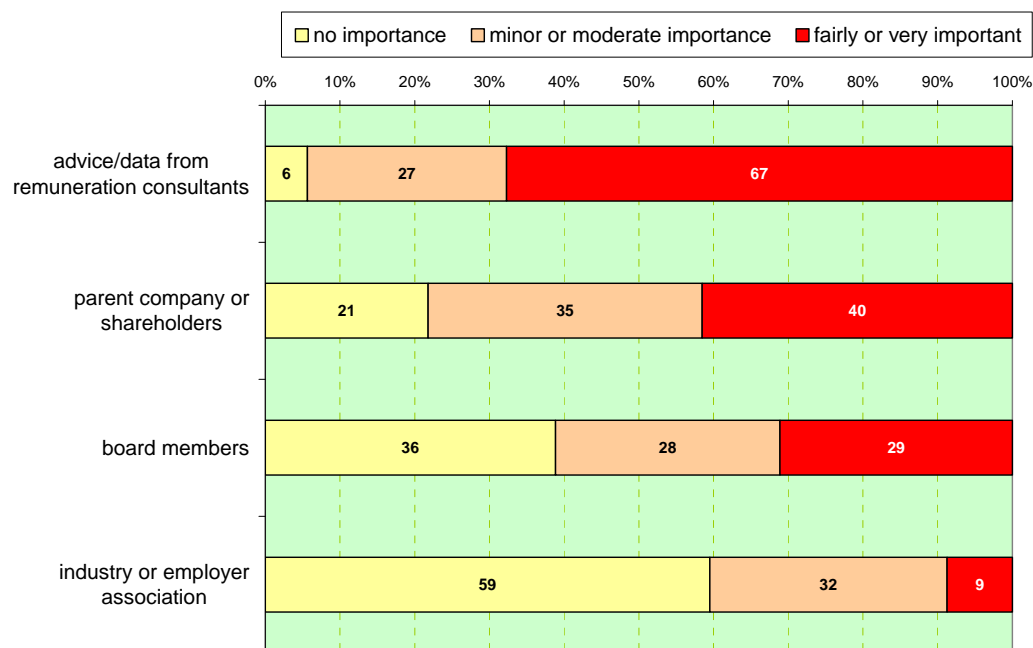


Figure (1) How important is each of the following as a source of information, advice or direction on pay levels for senior executives, Australia, 1991.

Source: Noble Lowndes Cullen Egan Dell 1994

Although the survey, commissioned by the then Department of Industrial Relations and supervised by this author, is over a decade old, it is a crucial source of data as it provides a rare, frank insight into executive pay determination, an area that is normally shrouded in self-justification and a shortage of transparent publicly available data. Figure 1 shows the main sources of information, advice or direction on executive pay levels in that survey. It indicates that advice and data from remuneration consultants was far more important than the views of shareholders, board members or industry associations in determining executive pay. In a separate question, only 2.5 per cent admitted 'pay levels overseas' were a 'fairly' or 'very important' source of direction on executive salaries.

Indications that the factors driving the relative size of executive pay have not significantly changed since then came from a recent 'web poll' by Egan Associates, using quite different questions. This indicated that the three factors 'with the most significant influence on executive pay' were 'company remuneration policies/ competitive positioning', 'market rates'

and 'remuneration consultant data'. Although the results should be treated cautiously because of web-based sampling, it was clear that 'remuneration consultant data' was over twice as likely as 'shareholder views' to be rated significant, while 'shareholder views' were at least three times more likely than 'remuneration consultant data' to be rated the 'least significant influence' on executive pay (Egan 2009).

The NLCED survey also asked about the 'comparative remuneration market' for their senior executives. Some seven tenths of companies benchmarked their senior executives pay by reference to the industry in which they operated. Smaller proportions referred to occupational labour markets, firms of similar size or the Australian private sector in general.

Most relevant, however, was the question on how companies sought to pitch or 'position' their senior executives' pay. Results are shown in Figure 2. Nearly two thirds of companies had a policy of 'positioning' their executives' pay above the median and 92 per cent claimed to set them around or above the median. The 65 per cent who pitch their executive pay above the median comprised 35 per cent who pitched between the median and the 75th percentile and 31 per cent who pitched at or above the 75th percentile. Only 2 per cent aimed to position their pay below the median. Of course, it is mathematically impossible for all companies to achieve the position they are seeking. By definition, 50 per cent of firms will be paying below the median, not 2 per cent. As virtually all firms attempt to position themselves at or above the median, senior executive remuneration will increase even in an environment of zero inflation and zero productivity gains. A similar pattern was seen in the USA at that time (Crystal 1991). NLCED Respondents were also asked the time frame they used when estimating pay comparators for senior executives. Some 31 per cent did not just rely on the current rates but attempted to anticipate where the median would be any time up to twelve months into the future.

In June 2009, Hewitt CSi, a management consulting firm, asked 53 medium-large respondent corporations to indicate where they positioned their CEO and Senior Executives in the market for three different components of executive remuneration. The sample was around a quarter of that in the NLCED survey, but it provides a useful comparison and confirmation of asymmetry in executive pay-setting. For fixed term remuneration, only 6

per cent pitched CEO pay below the median, while 54 per cent pitched at the median and 40 per cent pitched above the median (comprising 20 per cent in the upper quartile, 14 per cent in the third quartile and 6 per cent who pitched at the 'average', which is somewhat above the median). For short-term CEO incentives, the skew was higher, with *none* pitching below the median, only 47 per cent at the median and 53 per cent above the median (comprising 33 per cent in the upper quartile, 11 per cent in the third quartile [the '62.5th percentile'] and 9 per cent who pitched at the 'average', again above the median). The distribution of long-term CEO incentives was also skewed, in a pattern in between these two distributions (Hewitt CSi 2009). Results are summarised in Figure 3. The greater likelihood of pitching incentives, particularly short-term incentives, compared to fixed remuneration at the upper part of the distribution may help explain why short-term incentives became a larger component of CEO remuneration over the last decade. While asymmetry in the distribution of pitches is evident in both the Hewitt 2009 survey and the NLCED 1992 survey, the extent of the asymmetry differs. We return to this later.

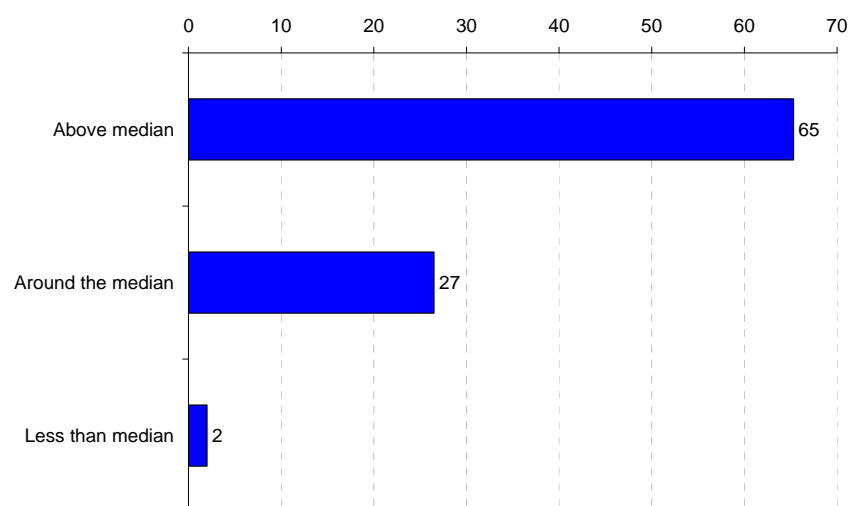


Figure (2) In relation to this comparative market, where do you generally aim to position your senior executives' pay?

Source: Noble Lowndes Cullen Egan Dell 1994

Data were also collected in the pitching of senior executives' remuneration. This followed a similar pattern to that for CEO pitching, though there was a slightly lesser tendency to pitch for the upper quartile for senior executive pay and incentives than in CEO pay and

incentives. For example, 28 per cent of senior executives' short term incentives were pitched at the upper quartile, compared to 33 per cent for CEOs (Figure 4).

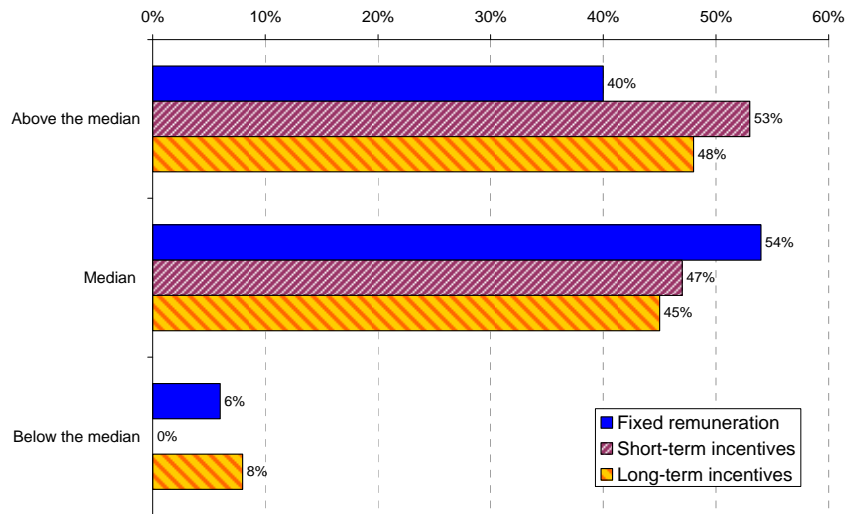


Figure (3) Positioning of components of CEO pay

Source: Hewitt CSi 2009

Social capital in executive remuneration

There is also strong evidence from US studies that this process continues. In the US, Faulkender and Yang (2007:i) found that, when selecting comparators for determining CEO pay, 'firms forego lower paid potential peers in their same industry in favor of higher paid peers outside of their industry when constructing the peer groups.'

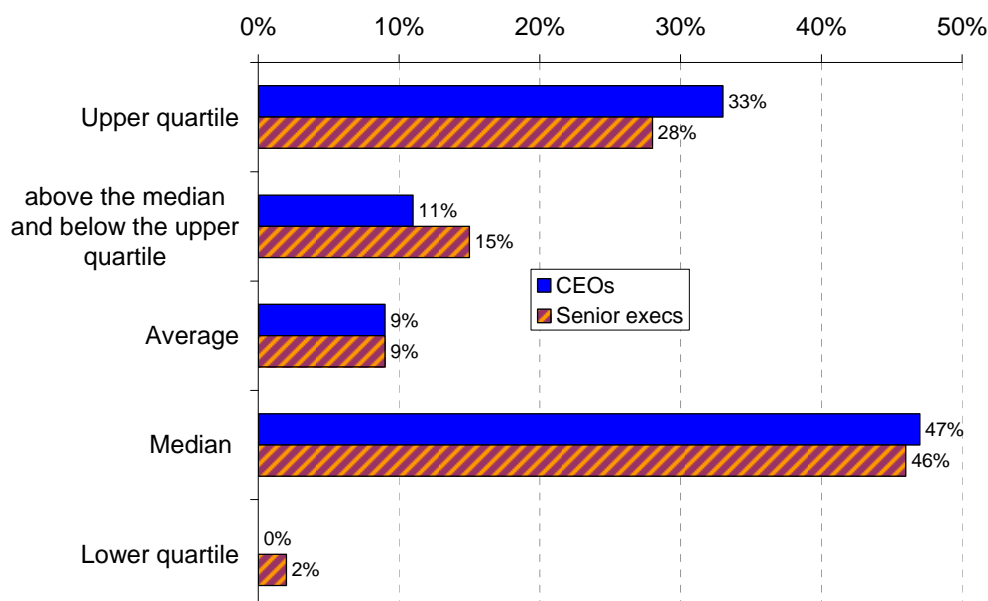


Figure 4 Positioning of short-term incentives for CEOs and senior executives

Source: Hewitt CSi 2009

This effect persisted when controlling for industry and size. Indeed comparative pay of peers was far more important in determining CEO pay than industry or size. They concluded that the selection of relatively highly paid (above median) peers to justify CEO compensation was more common where the CEO was chairman of the board, when the firm had greater market share, poorer governance and where a particular remuneration consultant was used by the firm (Faulkender and Yang 2007).

Notably, Ang, Nagle and Yang (2007) showed the role of social capital, demonstrating that CEO compensation includes a 'social circle premium', in excess of what could be justified by firm performance. They found that channels of social interactions that shaped these social circle premiums included 'golfing in the same exclusive club, sharing directors who understand the local pay norm and displaying luxury mansions' (Ang et al. 2007). Rather than having opposing interests to executives, the board members or others who set their pay are from the same social milieu with broadly comparable interests, and often they see status or reputation costs and benefits associated with executive remuneration. In other words, the market is distorted by the absence of genuine opposition of interests that exists elsewhere in the labour market and the high degree of power possessed by CEOs, arising from the resources and information that they have access to within the corporation, their connections or networks with other CEOs and directors, the norms or attitudes that permeate the

executive 'market' and their collective social identity as a class, things that all set aside 'arms length bargaining' in executive remuneration (Bebchuk and Fried 2004; Yablon 2008).

For ordinary workers, leapfrogging is prevented by the existence of countervailing forces at the bargaining table. Management has a clear interest in resisting employee attempts to raise wages through leapfrogging. In the past, tribunals also effectively placed a break on asymmetric pattern bargaining in the public sector once its disutility became apparent in an environment of generalized wage restraint. More recently, the Workplace Relations Act and Fair Work Act have prohibited something referred to as pattern bargaining by employees. No analogous restraints or symmetries operate in the executive remuneration market.

The breakdown in labour/CEO relativities

Why then the breakdown of CEO/AWE relativities in the 1980s? First, 'today's universal practice of setting CEO pay relative to peers was not common in the 1970s... the 1970s were marked by relatively little compensation consultant activity and scarce objective pay information' (Nagel 2007).

Second, in part as a result of changing economic policies associated with the move towards neoliberalism, the 1980s marked a shift in power between labour and capital. The share of national income going to profits relative to that going to wages increased, and continued to rise through the 1990s and 2000s (Australian Bureau of Statistics 5204.0). Income inequality – particularly between very high income earners and the rest of the population – also began to increase at this time (Atkinson and Leigh 2007). Rents that previously were shared between labour and capital have increasingly been appropriated by capital. Although at law CEOs are employees, and their income counts towards labour's share of national product (thereby understating the shift in income from labour to capital), in substance their income, like their social context, has much more in common with that of capital than of labour. As their relative power has grown, so has their relative income.

Cycles of asymmetries

The most recent Australian data suggest that the nature of positioning might vary according to the stage of the business cycle. While the Australian data from both the 1992 NLCED survey and the 2009 Hewitt survey show evidence for dual asymmetric pattern bargaining, the upward bias appears to be stronger in the 1992 data than in the 2009 data. It appears that the ‘aggressiveness’ of asymmetric pay pitching strategies (Ryan 2009) may be related to economic and social conditions facing the corporation. Losses or sometimes major falls in profits may lead to firms temporarily freezing, but less commonly cutting executive remuneration, often offsetting losses through incentive payments with increases in other components of remuneration. Conversely, boom times for corporations appear to facilitate more ‘aggressive’ pitching under the guise of linking pay to performance. This is broadly consistent with the evidence from two Australian and US studies indicating that CEO pay growth may be positively correlated with company performance during boom periods but negatively correlated or uncorrelated in downturns or flat periods (Matolcsy 2000; Sung and Swan 2009, pp5-6). The ‘aggressiveness’ of pay positioning is also influenced by the social and ideological climate. When public ‘outrage’ is aroused by executive pay rises, and especially if it leads to the threat of policy intervention, pay positioning is likely to be temporarily tempered. Thus in 2010, following substantial controversy and a Productivity Commission report recommending mild changes to corporate obligations, one analysis of ASX200 companies showed ‘boards are bending - if not entirely buckling - by overhauling their incentive schemes, including cutting base pay for some chairmen and chief executives’ as ‘corporate Australia’ engaged in ‘a race against time to persuade politicians not to intervene’ (McIlwraith 2010). Similar considerations apply across national boundaries. Differences between Europe (particularly Scandinavia) and the US in the tolerance of inequality and high CEO pay (including amongst the ideologies of those in economic elites) (Osberg and Smeeding 2006; Svallfors 1993; Austen 2002) likely play a role in helping explain the substantial difference in CEO pay between Scandinavia and the US mentioned earlier.

Magnitudes

How inflationary can dual-asymmetric pattern bargaining be? A simple simulation can give us an indication of the orders of magnitude involved. The NLCED (1992) survey mentioned earlier contained a distribution of executive remuneration with a 92 per cent response rate.¹

We can undertake a simulation based on the following assumptions: (1) the distribution of executive remuneration by income band reflects that in the NLCED report, such that within income bands, remuneration is evenly distributed, while in the highest and lowest income bands the income gap between percentiles matches that in the adjoining bands; (2) the lowest 8 per cent of firms pitch their pay between the 1st and 45th percentiles,² with pitches evenly distributed within those ranges; (3) the next 27 per cent pitch between the 45th and 55th percentiles, with pitches evenly distributed within those ranges; (4) the next 15 per cent³ pitch between the 55th and 75th percentiles, with pitches evenly distributed within those ranges; (5) above-median firms aim to maintain their prior percentage differential with the median. On these assumptions, the simulation suggests that within one remuneration cycle (one year), average executive remuneration would rise by 16.4 per cent. In some respects, the assumptions of this model are quite cautious. The model makes no allowance for the disturbance to relativities caused by firms successfully changing their rank (it assumes they attempt to change their ranking, but fail to do so), perhaps due to above-average growth in productivity or profits or just above-average generosity by the board, and downplays leapfrogging by firms already above the median. Nor does it allow for second round effects whereby higher ranked firms aim to offset any compression of relativities that has occurred.

However, its assumptions may be unduly harsh in one major respect, because the reference groups for executive pay are more commonly industry than national, and so would occupy a smaller income range than the national range. We can adjust for this in our model by dividing this simulated economy into three industries, one occupying the highest third of the income range, one the middle, and one the lowest. (While there are obviously more than three industries in a real economy, the idea that the range of executive pay in each industry would encompass no less than a third of the total income range is probably conservative.) Under these assumptions, our simulation produces a more realistic increase in average remuneration of 5.1 per cent in a year. This is in an environment with zero growth in productivity and zero inflation in prices or wages. It is, in other words, an indication, albeit simple, of the order of magnitude of the pure inflationary impact of the institutions of setting executive remuneration. Interestingly, over the quarter century since 1983, growth in our index of real CEO pay has exceeded growth in national productivity by an average just under 5 per cent per annum. Thus while it is not possible to precisely estimate the inflationary

impact of the dual-asymmetric pattern bargaining effect, it is certainly plausible for it to explain the inflation in executive remuneration over the past quarter century.

Conclusions

Although growth in executive remuneration maintained parity with average earnings until the mid 1980s, thereafter it has grown at a rate far exceeding that of average earnings or national productivity. The inflation of executive remuneration is fundamentally a phenomenon of class. It reflects the asymmetries of power between labour and the agents of capital. While labour negotiates with capital over the determination of wages, capital actively resisting labour's efforts to raise real wages, there is no such 'arms length' symmetry in the determination of executive remuneration. Agents of capital negotiate with agents of capital, perhaps members of the same golf club or occupants of neighbouring mansions, over what percentile in the executive pay distribution they should occupy. Executive pay is characterised by 'asymmetric pattern bargaining', whereby firms use asymmetric reference points for CEO pay, seek to benchmark it to that in higher-paying firms, and grant CEOs, with whom corporate decision makers share a social milieu, increasing benefits which also confer status benefits on the firm – in sharp contrast to the distributional pay negotiations which occur with workers. Thus 'asymmetric' refers not just to the targeting of percentile bands in the executive pay process, but the lack of similarity between the pay setting procedures for CEOs and for workers. The asymmetry also occurs over time: executive remuneration ratchets up disproportionately when corporate profits rise, but fails to fall by an equivalent amount when profits fall, cushioned by changes in the structure of executive remuneration. The nature of positioning might vary according to the stage of the business cycle, with more 'aggressive' positioning occurring in boom times and in times when public opinion is less antagonistic to executive pay increases. That is, pay pitching strategies are probably related to the economic and social conditions facing the corporation within a country and at a specific time. Remuneration consultants facilitate asymmetric pattern bargaining. While disclosure laws on executive pay are sometimes blamed for executive inflation, the existence of remuneration consultants and their surveys mean that it would take place regardless of disclosure laws. Indeed disclosure is likely to increase the likelihood of public 'outrage' that can temper leap-frogging.

As a result of dual-asymmetrical pattern bargaining, CEOs obtain gains in remuneration well above any growth in productivity they engender, absorbing an ever increasing share of the 'rents' that are available for distribution, at the expense of workers. As a consequence, that CEOs are overpaid is something, as Leonard Cohen would say, 'everybody knows', including the directors who decide what they should be paid. Yet firms are unwilling to do anything about it, because to do so would damage internal class relations and firm status. The different methods of pay setting for workers and CEOs reflect core differences in power and changes in that balance of power through a period characterised by the growth of 'neoliberal' policies and practices.

Notes

¹ In this survey 22 per cent of firms had remuneration below \$100,000 per year (in 1991 terms), 45 per cent between \$100,000 and \$149,999, 20 per cent between \$150,000 and \$199,999, and 9 per cent at \$200,000 or above, while 5 per cent did not respond (NLCED 1992).

² This comprises the 2 per cent of companies in Figure 2 who pitched below the median, and 6 per cent who did not answer.

³ This comprises the remaining firms who are below the median at the start of the period (50 per cent minus 8 per cent minus 27 per cent).

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