Submission to Senate Inquiry into the Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009

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Executive pay and termination packages have become a focus of public attention, with widespread concern about the levels of executive remuneration and termination payments for executives. Across Europe and the US, four fifths of people believe that business leaders in their countries are paid too much (figures range from 75 per cent in France to 77 per cent in Spain, 79 per cent in the USA and Italy, 81 per cent in Britain and 88 per cent in Germany) (Harris Interactive 2009). Similarly, 78 per cent of British adults believed directors are overpaid (Blitz 2003). I have not seen comparable random surveys for Australia, though web surveys (St James Ethics Centre 2003) and public debate (Brisbane Times 2009) suggest similar concern here and a 2004 telephone survey of 400 Australians found only 36 per cent thought bonuses and fees for executives and board members were 'fair and reasonable' (Crosby Textor 2004).

The issue of termination payments for executives cannot be sensibly analysed separate from the broader issue of executive remuneration, as these termination payments are explicitly or implicitly part of executives' overall remuneration packages. This submission therefore locates termination payments within the broader data about trends and practices in executive remuneration and the causes thereof. This submission considers: the growth in executive remuneration since the 1970s; the alleged and actual causes of the growing divergence between CEO pay and pay of ordinary employees; termination packages; and recommendations in relation to this Bill and future policy development.

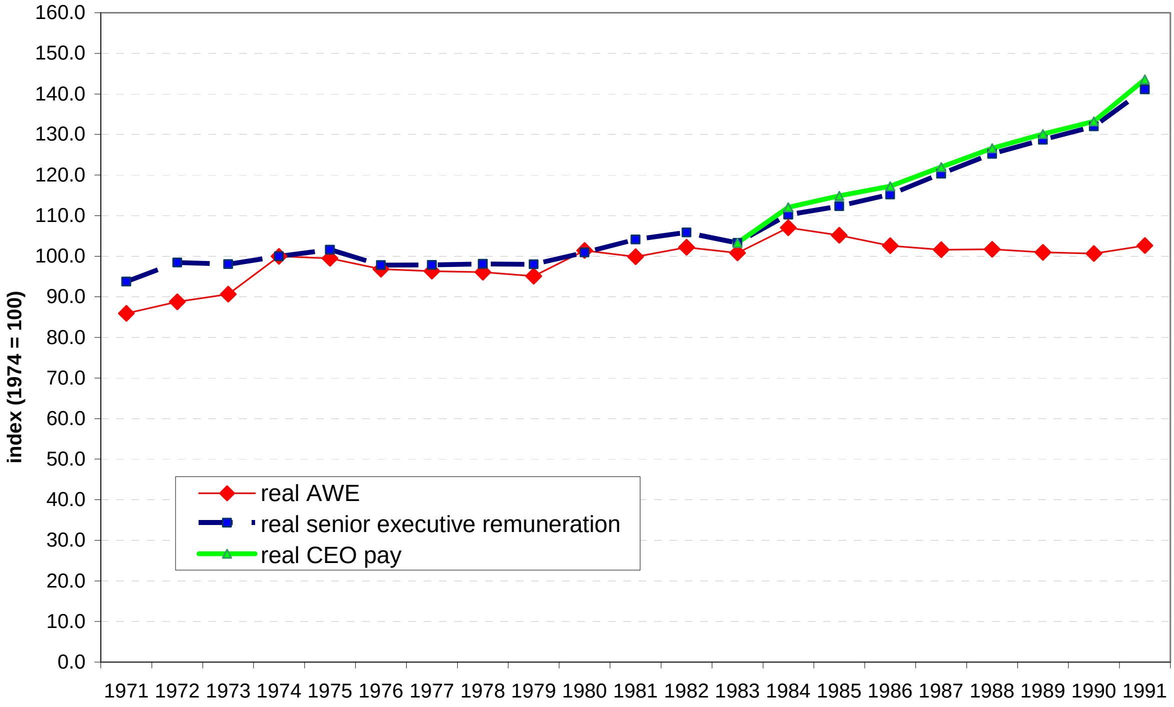
Relative growth in executive remuneration

Since the mid 1980s executive salaries have been growing faster than average wages. However, this difference in growth rates has not always existed.

Figure 1 shows real indexes of senior executive remuneration (as estimated from Cullen Egan Dell (CED) surveys in December each year from 1971 to 1991), and of average weekly earnings (deflated by the CPI) (1992, p11). It shows that through the 1970s and the first part of the 1980s, senior executive salaries maintained a fairly stable relativity with average weekly earnings. Figure 1 also includes, for later years, a CED series on CEO pay. The series on executive remuneration and average earnings tracked each other fairly closely (other than in 1974, when wage earners gained a significant increase in real earnings, and which established a new relativity that remained fairly stable until 1985). From 1985 the 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.

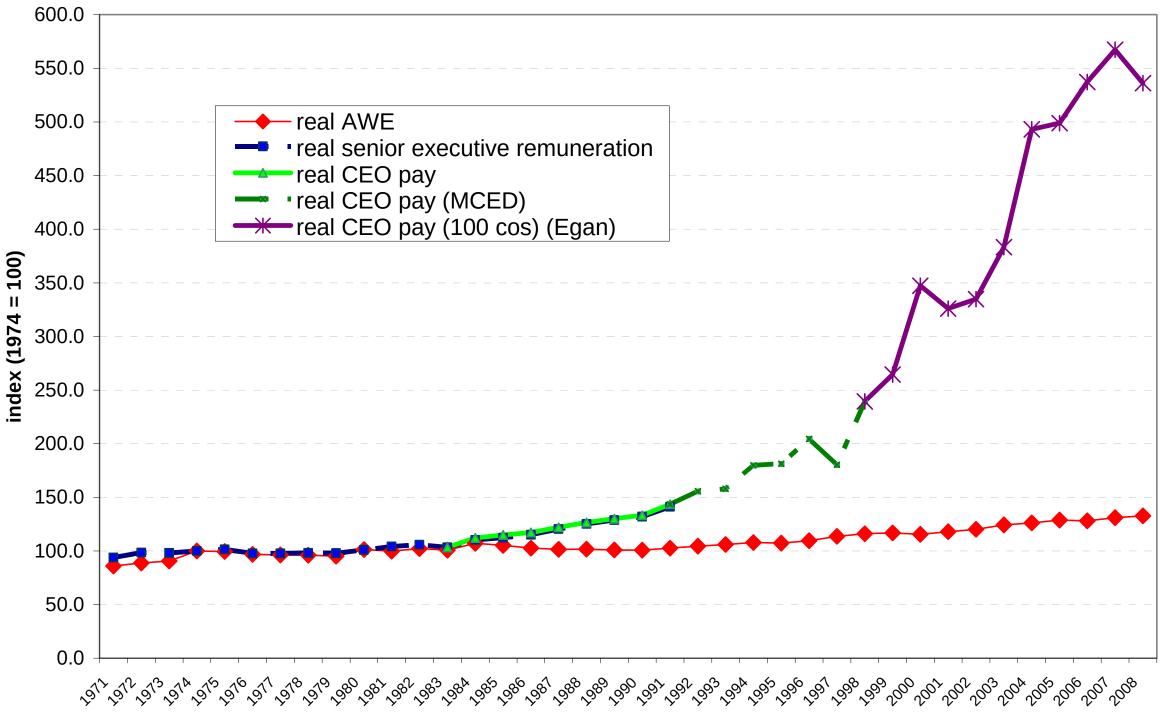
Figure 2 extends these data to 2008, by splicing CEO pay data from CED with other data. The first set, referring to average CEO cash remuneration (which includes base salary, benefits, allowances and incentive bonuses), come from Mercer Cullen Egan Dell data published by the Parliamentary Library (Kryger 1999). They cover the period from 1991 to 1998. The second set, from the John Egan Associates database, relate to *median* total remuneration of CEOs in the top 100 companies, and cover the period from June 1998 to June 2008. These latter data have been read from a chart in Egan (2009a). Note that median earnings can be well below average earnings (in 2005, mean earnings amongst the CEOs of the top 25 companies were 43 per cent higher than median CEO earnings (calculated from Nicholas 2006)). The AWE data are average weekly total earnings for full-time employees from 1983 onwards, and average male earnings before then.

Figure 1: Real executive remuneration and average weekly earnings, indexes, Australia, 1971-1991



Sources: Noble Lowndes Cullen Egan Dell 1992, Australian Bureau of Statistics 6302.0, 6401.0.

Figure 2: CEO pay series and AWE, indexes, Australia, 1971-2008

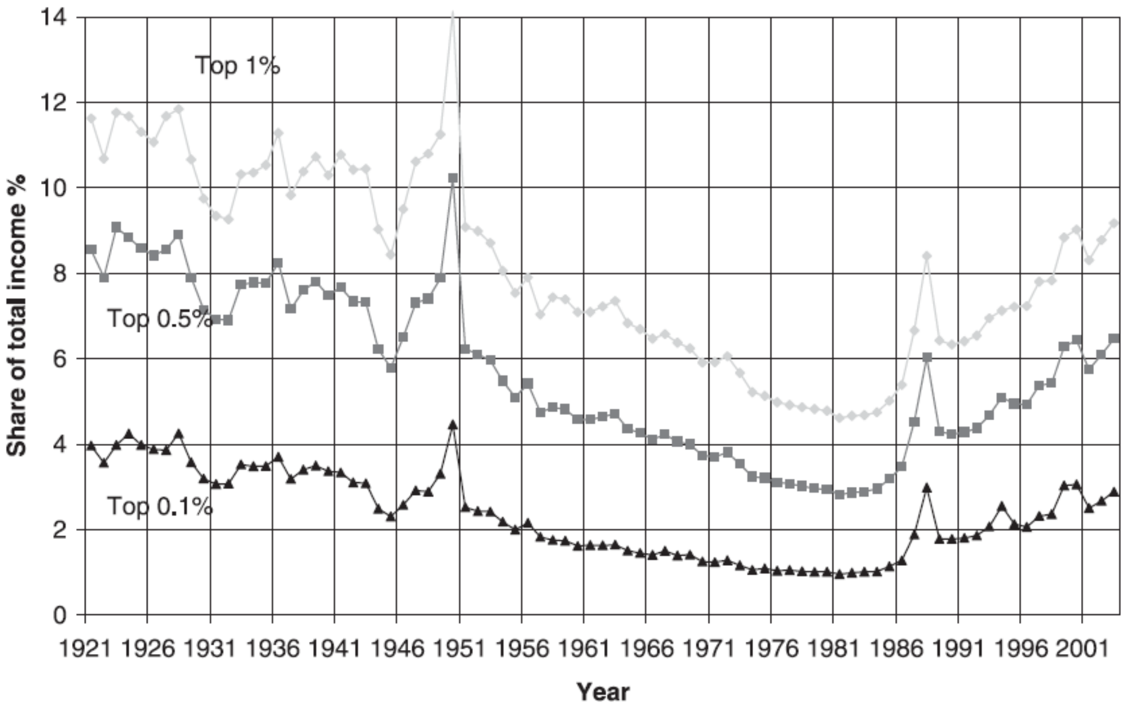


Sources: Egan 2009a, Kryger 1999, Noble Lowndes Cullen Egan Dell 1992, Australian Bureau of Statistics 6302.0, 6401.0.

Although the three CEO series relate to slightly different concepts, the picture is very clear and not dependent on how the series are spliced. As we saw in figure 1, while CEO pay maintained a stable relativity to average earnings during the 1970s and early 1980s, growth in CEO pay outstripped growth in real average earnings from the mid 1980s, but the divergence continued through the 1990s and the current decade. The divergence was not an artefact of the restraint exercised by average wage earners during the centralized Accord; it continued through subsequent periods of decentralized bargaining for wage earners as well. The growth in CEO pay, of something around 470 per cent over the period 1971-2008, was nearly nine times the 54 per cent growth in real average weekly earnings over the same period. It is possible this growth in CEO remuneration is understated, as the realised value of executive share options (a component of executive packages) was, in the middle of this decade, over three times the average 'fair value' attributed to options at grant date (Institutional Shareholder Services 2006).

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 & 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). The rising share of the top 0.1 per cent of income earners (along with the top 0.5 per cent and 1 per cent) since the mid 1980s – reversing the gradual trend in the post-war era of reducing inequality – is reproduced from Atkinson & Leigh (2007) in Figure 3.

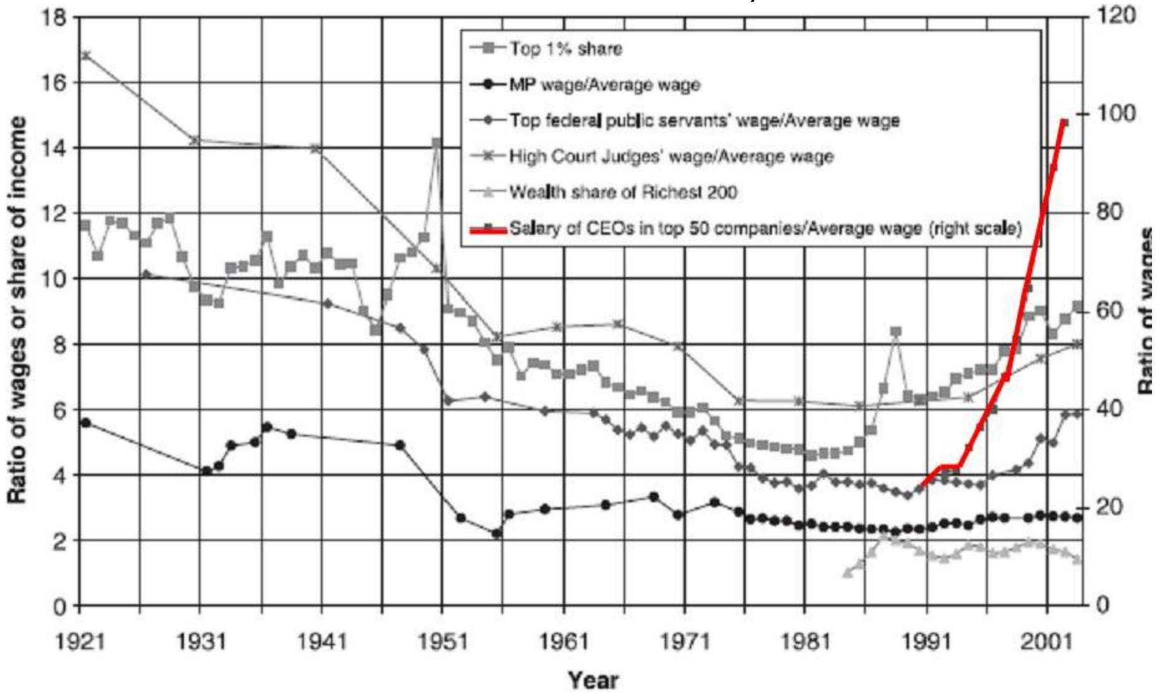
Figure 3: Shares of Top 0.1, 0.5 and 1 per cent in all personal incomes, Australia, 1921-2003



Source: Reproduced from Atkinson & Leigh 2007, Figure 1, p253.

Atkinson & Leigh compared income growth among several high income groups – High Court judges, Members of Parliament, top federal public servants – and found that CEO remuneration growth in recent years far exceeded that in those other groups. The relevant chart is reproduced in Figure 4 (Atkinson & Leigh 2007).

Figure 4: Income Trends for Top Public Servants, Judges, Top Chief Executive Officers and Wealth Share of Richest 200, 1921-2003



Source: Reproduced from Atkinson & Leigh 2007, Figure 2, p254. (Red highlight added.)

Sources of relative growth

Several explanations have been offered for the contemporary divergence between growth rates of CEO pay and the pay of ordinary workers.

The 'global labour market' explanation is 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.

The 'risk' explanation is that executives' jobs are increasingly insecure, and their greater pay reflects the greater risk they will lose their job, and the greater losses they will face if this happens.

The 'tournament theory' explanation is that the market for CEOs is like a tournament, with high rewards for a small number of 'winners'.

The 'complex job' explanation is that the work of CEOs has become relatively more complex in recent years, requiring higher levels of skill than previously. The 'productivity' explanation, related to this, is that greater CEO skills and hence pay have been necessary to drive improvements in productivity and national prosperity.

The 'profitability' explanation is that shareholder returns and company profits have increased in recent years and the higher remuneration of CEOs simply reflects these greater profits and their contributions to them.

The 'power' explanation is that CEOs hold positions of relative power, similar or related to the power that capital has in elation to labour, and that as power has shifted from labour to capital the capacity of CEOs to extract rents (Bebchuk & Fried 2004) has increased.

The 'leapfrog' explanation is 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 crucial role in the 'leapfrog' explanation.

What does evidence suggest?

First, there evidence does not conclusively support any link between rising executive pay and productivity, in support of the 'productivity' explanation. Indeed, there is good evidence for the reverse. Shields, O'Donnell & O'Brien (2004, 2003) 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. What is more, the best performing companies increased the pay of their CEOs by only half the amount that the worst performing companies did. The researchers examined the link between CEO pay and performance in different pay bands and concluded that:

> the current average pay gap between top 100 CEOs and ordinary employees is at least three times higher than that required to maximise organisational performance. (Shields, et al. 2003)

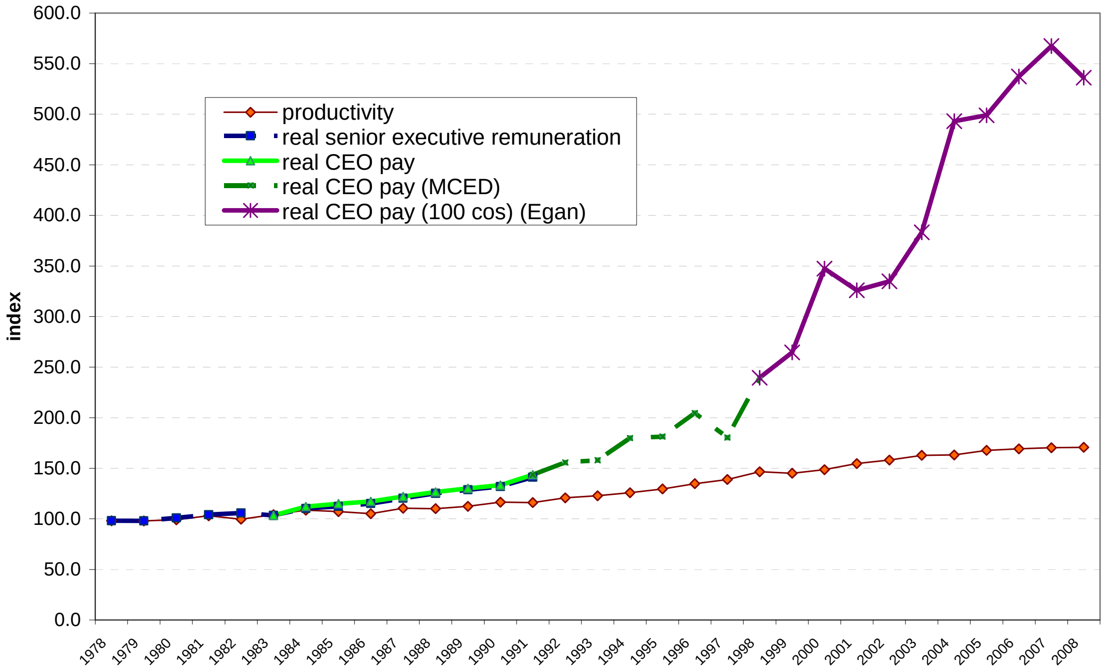
Less systematic analysis in later years also indicated highly paid CEOs underperformed lower paid CEOs (Trounson 2007) alongside numerous examples of CEO pay rising while their firm's performance deteriorated (eg Steffens 2008, West 2009, Williams 2009). At the aggregate level, while the shareholder value in the ASX 200 fell by 17 per cent in 2008, CEO pay among the top 300 companies rose by 1 per cent (West 2008). 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 2009a). 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). It is possible that there is 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 Schwab 2009a, West 2008)

That said, even if there were a positive (rather than negative) relationship at the micro level between company performance and executive remuneration, this would not in itself indicate that the growth in executive remuneration was due to improving performance. It would be possible for executive remuneration to reflect both micro-level performance differentials and an underlying inflation, redistributing income from elsewhere to CEO remuneration. The relationship between CEO pay and national market sector productivity over the past decade is shown in Figure 5. This compares the movements in the spliced series of real CEO pay (used in Figure 2) with movements in national market sector productivity over the period from 1978. As can be seen, growth in executive remuneration has far outstripped growth in productivity. Over the two decades from 1978, growth in real CEO pay was approximately six times growth in productivity. 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.

We see that the rise in CEO remuneration far exceeds the improvement in national economic performance, suggesting that there is an underlying inflationary factor in executive pay that goes well beyond any productivity effects. Even if CEOs are rewarded for a contribution to higher productivity, the rewards dwarf any contributions they have made to it.

The preceding data also undermine the 'profitability' and 'tournament' explanations, as these suggest the highest growth in rewards should be associated with the highest performing companies. The 'complexity' argument also has some 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 & 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 should be the only ones to benefit. Indeed, as mentioned, CEOs appear to be extracting gains far beyond those attributable to higher productivity.

Figure 5: CEO pay series and GDP per hour worked in the market sector, indexes, Australia, 1978-2008



Sources: Egan 2009a, Kryger 1999, Noble Lowndes Cullen Egan Dell 1992, Australian Bureau of Statistics 5206.0.

The excessive growth of CEO pay is not a uniquely Australian phenomenon. American executives remuneration grew from 42 times average production workers' wages in 1982, to 411 times in 2001 (Klinger & Cavanagh 2002). But does this mean that executive remuneration growth results from the internationalisation of the labour market for executives – a 'global market'? Or does it simply mean that similar forces are at work in largely separate national markets?

The 'global market' explanation 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 & 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).

Further refutation of the 'global markets' theory comes from a 1990s survey in which only 2.5 per cent of large corporations admitted 'pay levels overseas' were a 'fairly' or 'very important' source of direction on executive salaries (Noble Lowndes Cullen Egan Dell 1992). More recent data reinforce this view. A web-based survey by remuneration consultants Egan Associates indicated that 'scarcity of executive talent' was rarely seen as the most significant influence on executive pay – they were twice as likely to say it was the 'least significant' influence on executive pay (Egan 2009b). The data should be treated cautiously because of the web-based sampling technique. More systematically, though, an examination of executive appointments and departures at the 50 largest ASX companies over the 2003-2007 period showed that only 4 per cent of confirmed departures 'were as a result of an executive being recruited by an offshore employer' . Indeed, only 17 per cent of departures were due to executives being recruited by another employer in Australia or overseas – most were terminations or retirements. Amongst CEOs, departures were even less common – only 7 per cent of CEO departures were to join another employer, including less than 4 per cent (one CEO) going overseas (RiskMetrics Australia 2009b).

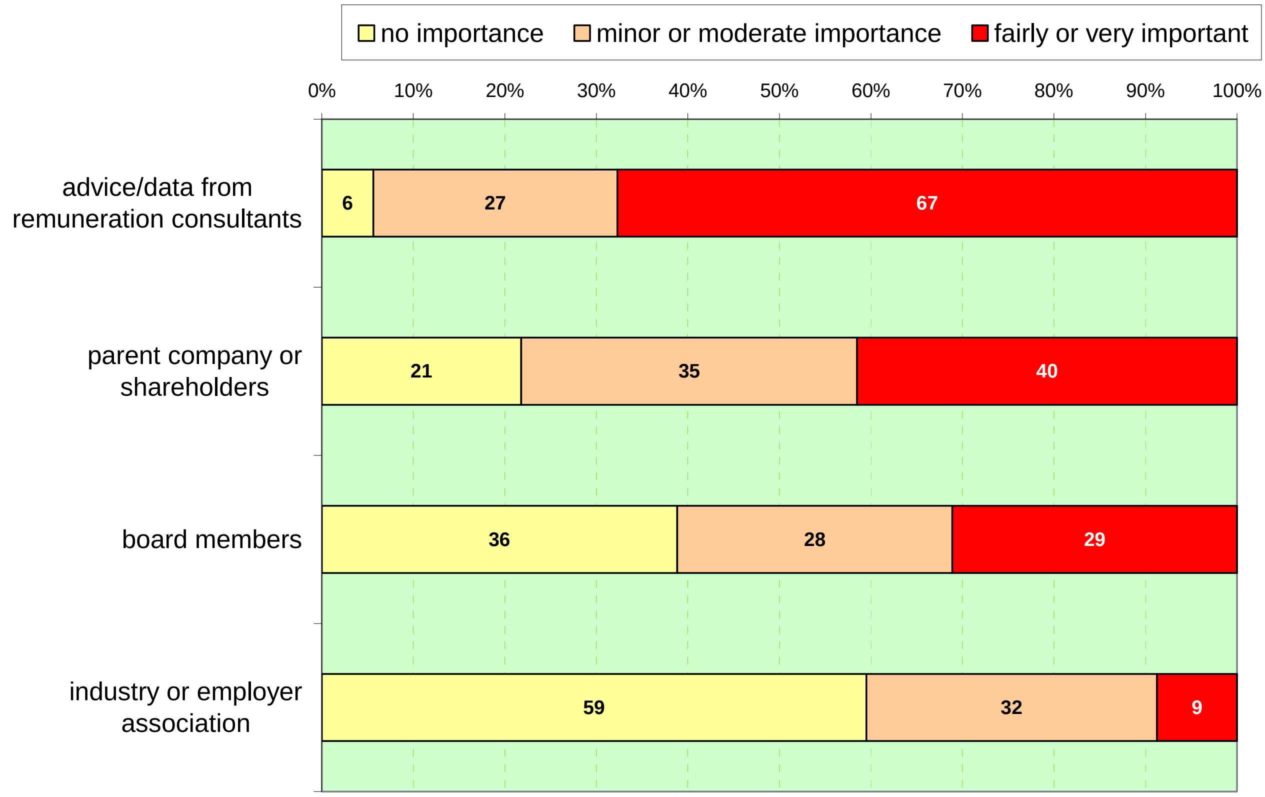
The large differences in CEO pay levels between countries do not reflect differences in national economic performance. They appear more likely to reflect differences in corporate cultures or 'varieties of capitalism' (Hall & Soskice 2001). Swedish CEOs and boards appear to feel a greater sense of responsibility and need for restraint than do American ones.

There is evidence for the 'leapfrog' explanation in a survey of executive pay methods undertaken by Noble Lowndes Cullen Egan Dell (1992), which showed that the most important factor influencing executive pay was 'remuneration market forces' (that is, what other corporations were paying). Although the survey, commissioned by the then Department of Industrial Relations, 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 6 shows the main sources of information, advice or direction on executive pay levels in that survey.

It showed 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.

There is little reason to believe that the factors driving the relative size of executive pay have significantly changed since then. A recent 'web poll' by Egan Associates, using quite different questions, 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 were presented graphically rather than numerically, and, again, 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 2009b).

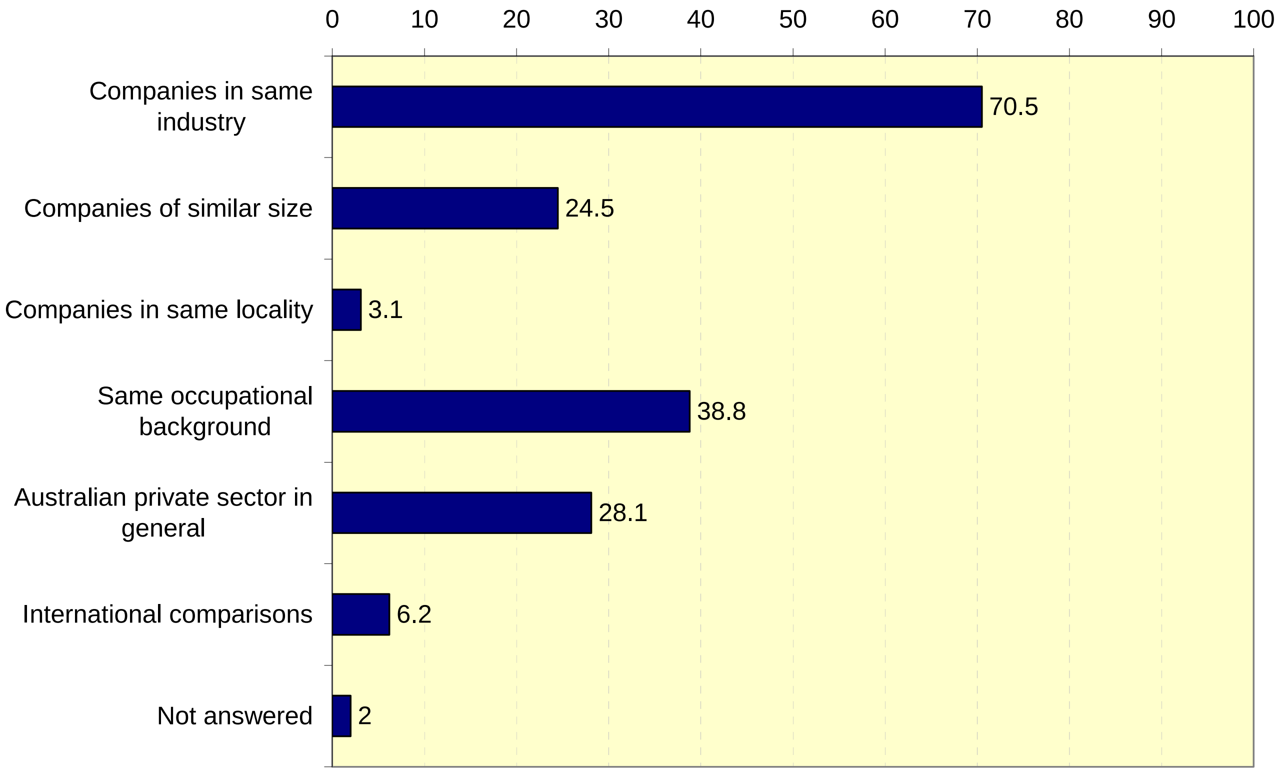
Figure 6: How important is each of the following as a source of information, advice or direction on pay levels for senior executives, Australia, 1991.



Source: Noble Lowndes Cullen Egan Dell 1992

The NLCED survey also asked respondents about the 'comparative remuneration market' for their senior executives. Results are shown in Figure 7. They indicate that 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.

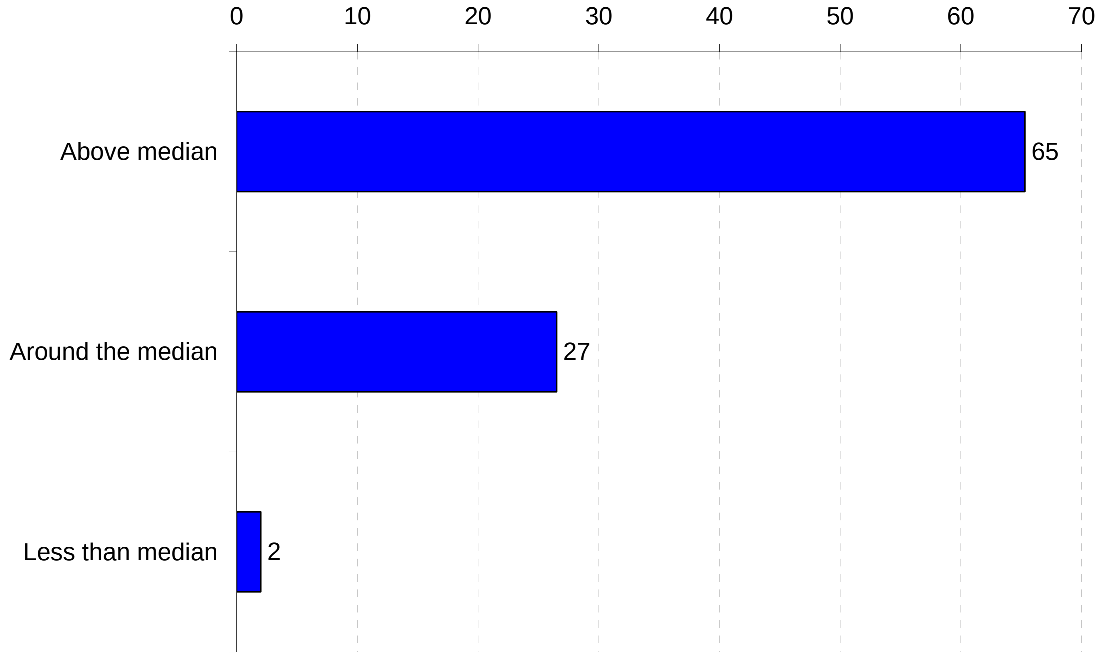
Figure 7: Taking into account where you typically attract senior executives from, and where they go to when any leave the company, how best would you describe their comparative remuneration market?



Source: Noble Lowndes Cullen Egan Dell 1992

Most relevant, however, was the question on how companies sought to pitch or 'position' their senior executives' pay. Results are shown in Figure 8. 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).

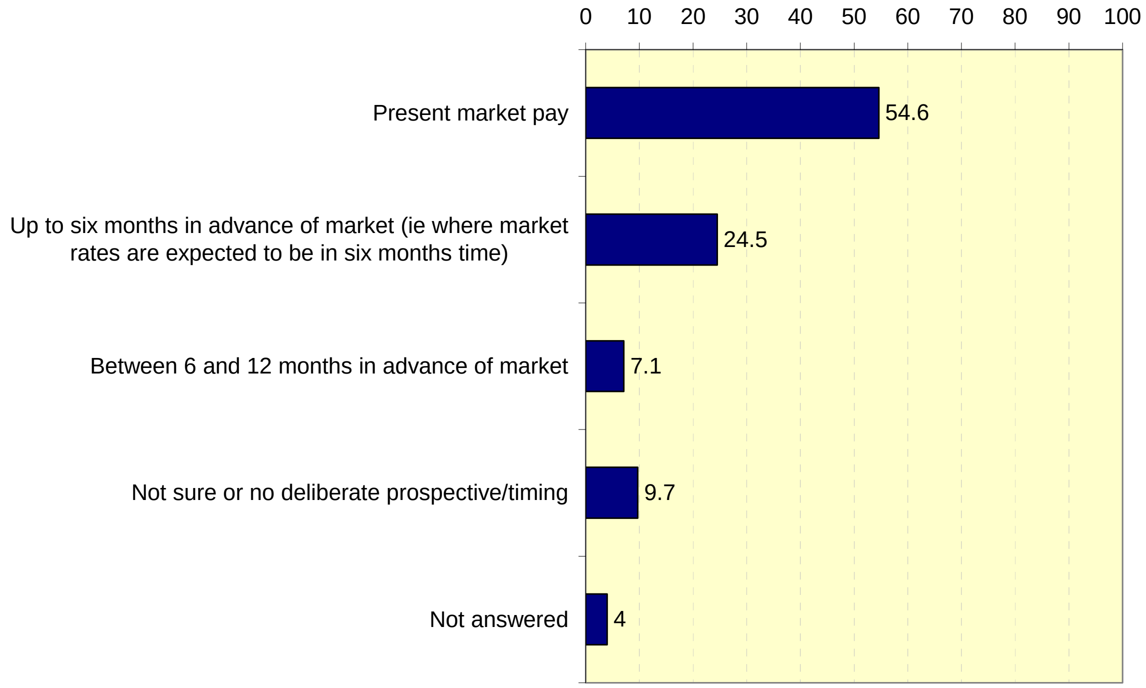
Figure 8: In relation to this comparative market, where do you generally aim to position your senior executives' pay?



Source: Noble Lowndes Cullen Egan Dell 1992

Respondents were also asked the time frame they used when estimating pay comparators for senior executives. Figure 9 indicates that 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.

Figure 9: At this policy position, what is the timing of the market?



Source: Noble Lowndes Cullen Egan Dell 1992

As a consequence of this inflationary bias in executive pay determination, 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 those considered that CEOs were overpaid by between 20 per cent and 50 per cent (Buffini & 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).

Such cynicism is not restricted to Australians. Two thirds of human resources, ethics and legal executives participating in the US corporate Conference Board's 2003 Ethics Conference said that compensation for senior executives was 'out of control' in their companies (Conference Board 2003). The problem in Australia was recognised at the top, when Paul Anderson, retiring CEO of BHP Billiton, remarked:

> I think that 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).

Exemplifying the status element of the 'leapfrog' explanation, 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 & Pheasant 2005).

These findings suggest that public opinion, cited at the beginning of this paper, is well founded. They reinforce that the outcome of the leap frog syndrome is overpayment in executive pay determination.

To express it crudely, the process is something like this. Private sector executive salaries are typically set by a body like a board remuneration committee. These may include outsiders (that is, senior executives and directors from other corporations) but in Australia they are rarely fully independent of executive influence (Schwab 2009b, Shields, et al. 2003). Particularly in large corporations, this committee typically looks at the results of executive salary surveys undertaken by remuneration consultants, and takes advice from such consultants. The committee members, who identify and network with the senior executives under scrutiny, are easily persuaded that the company needs to pay above the average in order to retain such high calibre executives. Otherwise the company may under-perform and be under threat of takeover. So a large number of firms raise their salaries so that they are paying above the median (the middle of the market), and others paying below the median raise theirs to match the median. Another survey is then published. Companies see that the market rate has risen, and they have to readjust their executives' pay so that they are paying above (or at) the market median again.

While the Australian and US survey data are from the 1990s, there is strong evidence from several recent US studies in support of the view that this process continues. In particular, Faulkender & Yang (2007) 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.

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 & Yang 2007).

Notably, Ang, Nagle and Yang (2007) showed that CEO compensation includes a 'social circle premium', in excess of what could be justified by firm performance, and 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).

The role of remuneration consultants in the UK was recently described disparagingly by a leading fund manager:

> Generally, 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, reporting earlier this month on the financial crisis, noted that

> We have received a body of evidence linking remuneration consultants to the upward ratchet of pay of senior executives in the banking sector. We have also received evidence about potential conflicts of interest where the same consultancy is advising both the company management and the remuneration committee. We have received a body of evidence linking remuneration consultants to the upward ratchet of pay of senior executives in the banking sector. We have also received evidence about potential conflicts of interest where the same consultancy is advising both the company management and the remuneration committee. Both these charges are serious enough to warrant a closer and more detailed examination of the role of remuneration consultants in the remuneration process. (House of Commons Treasury Committee 2009:33).

The Committee referred to evidence of

> remuneration consultants of having "contributed to the general ratchet in executive remuneration because they seem to have business models which require them to earn fees which require them, therefore, to modify packages every year which, therefore, requires the packages to go up" (House of Commons Treasury Committee 2009:32).

Another witness

> spoke of the 'ratchet' effect telling us that it was remarkable how many remuneration consultants "are given remits which refer to a benchmark of the

> upper quartile. If endlessly, year after year after year, you are referred to the upper quartile, then that is an endless ratcheting and an ever-increasing gap with the rest of the workforce”. (House of Commons Treasury Committee 2009:32).

'Leapfrogging' – which can be better described as asymmetric pattern bargaining – was a significant problem for public sector pay amongst ordinary employees up until the early 1980s. Surveys would identify average 'market rates' which would lead to wage increases, followed by further rounds of surveys and wage increases. Industrial tribunals abandoned market surveys as the basis for setting public sector pay rates over two decades ago. In the modern era of enterprise bargaining, employees are warned against notions of 'comparative wage justice'. Yet an inflationary form of 'comparative wage justice' has emerged in the market for executive remuneration. Forced disclosure of executive pay, while assisting transparency, does nothing to little the pressure, though it probably does not worsen it much either, because it is the remuneration surveys that really set the pace.

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 once its disutility became apparent in an environment of generalized wage restraint. More recently, the Workplace Relations Act and Fair Work Act have prohibited employee pattern bargaining.

In the case of executive remuneration, there is no effective countervailing force at the bargaining table. 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 promote asymmetric pay pegging in executive pay. It is not 'arms length bargaining' (Bebchuk & Fried 2004, Yablon 2008).

The mechanism is also described in a recent study by DiPrete, Eirich & Pittinsky (2008), who modelled executive remuneration based on Standard and Poor’s ExecuComp data on executive compensation and concluded that

> a small and shifting fraction of CEOs have regularly been able to “leapfrog” their compensation benchmarks by moving to the right tail of the benchmark

> distribution and get larger than normative compensation increases, even after taking job mobility and executive performance into account. These events produce subsequent “legitimate” pay increases for others, and potentially explain an important fraction of the overall upward movement of executive compensation over the past 15 years.

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, the 1980s marked a shift in power between labour and capital. The share of national income going to profits relative to that going to labour 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 & 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, they have increasingly captured rents through asymmetric pay pegging. The high rate of CEO remuneration in the US mentioned earlier reflects not the greater size of US companies, but the greater power in the US of capital in general, and CEOs in particular, by comparison with labour. The US has one of the lowest rates of union density in the OECD; Sweden has one of the highest (Visser 2006).

There are two key asymmetries in the market in which executive remuneration is determined. First, the 'pattern' is asymmetric – it is not based on bringing the typical participant up to a common mean (as in traditional pattern bargaining), but to a position *above* the mean in a leapfrog pattern. Second, the 'bargaining' is asymmetric, as there is not an effective countervailing force at the bargaining table, as there is with wage bargaining for ordinary employees. Hence the process can more accurately be described as *dual-asymmetric pattern bargaining*.

Risk and golden parachutes

The 'risk' argument that CEOs face higher risks that ordinary workers, which therefore justifies the above-productivity growth in CEO pay, is difficult to sustain. There is little reason to believe that CEOs face substantially longer periods of unemployment when dismissed than do ordinary workers. 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). By comparison, Australian labour force data indicate that at that time 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).

If there is increasing risk facing CEOs, it is no greater than the increased risk facing ordinary employees compared to two decades ago, as they work in what is sometimes referred to as the 'risk society' (Beck 1992). The increased casualisation of employment has transferred many of the risks of employment from capital onto labour (Watson, et al. 2003). In the US, a comparison has been made between labour turnover amongst CEOs and ordinary employees in 2005-06, to test whether turnover was substantially higher amongst CEOs: labour turnover was 14 per cent amongst CEOs but 23 per cent across private sector employees generally (Isles 2006). CEOs also have far greater assets than ordinary employees, meaning they have a much more comfortable 'cushion', and lower risk of poverty or homelessness, than ordinary employees who lose their jobs.

The argument about greater risk faced by CEOs is especially difficult to sustain when we compare the termination packages to which that CEOs typically have access with those available to ordinary workers (Cassidy 2008, Mayne 2008, Robinson 2009, West 2008). The substantial safety nets in event of dismissal provided by the 'golden parachutes' of CEOs are much more generous than those available to ordinary workers. For ordinary employees, termination packages are normally payable upon redundancy, and CEOs would normally have access to such payments in similar situations (eg when their position is made redundant due to a corporate restructure or merger). But they are also often payable in circumstances when ordinary employees would have no entitlement to a termination package. In particular, they are typically paid when CEOs are removed due to underperformance, an entitlement which ordinary employees do not have. Some large payments are paid to executives who simply retire – for example, the head of Rio Tinto's aluminium division, received a $16 million payout on retiring before the end of his fixed term contract – to then stay on as an adviser (Robinson 2009).

In many instances they represent over a year's salary, and in some instances up to seven years' salary. In October 2008 the *Mayne Report* published a list of the 37 most 'excessive' payouts over the past two decades. That list is reproduced verbatim in Box 1 below:

Box 1

Biggest golden parachutes in corporate Australia

Mayne Report, October 20, 2008

Rodney Adler: collected a $4.3 million termination when HIH took over his worm-infested business in 1998 but then stayed on the board as a non-executive director with a $480,000 a year consultancy that was not disclosed to shareholders.

Paul Anderson: the BHP CEO engineered his only early departure by gifting $5 billion of value to Billiton in the "$58 billion merger". Despite all his public statements about executive excess, Anderson came out on top of the Aussie-based list with a grand pay packet of $18 million in his final year at the top. Lo and behold, he is allowed to go a year early, receive his contract in full as if terminated and also stay on a non-executive director. Not bad if you can get it.

Paul Anthony: measuring the specific termination element wasn't easy but this Welshman pocketed $17 million for 17 months work at AGL which was outrageously excessive given the performance he delivered.

Don Argus: Walked away from the NAB with $9.259 million in cash in 1999 including $7.47 million in "retirement allowances". The Don was also allowed to keep all his options which have made him more than $20 million in profits.

Peter Bartels: New Foster's chairman Nobby Clarke did himself no credit by agreeing to an $8 million payout to Peter Bartels when he refused to sign the accounts in 1992. Outrageously, this was staggered over 5 years so it never showed up as a big lump sum and the market was never told.

Len Bleasel: After starting out as a humble plumber, the retired AGL CEO collected a very handy $11 million in 2001 and that's before considering superannuation.

Chase Carey: became a director of Fox Entertainment in 1992 and was News Corp's co-chief operating officer from 1996 until 2002 when he departed after the Sky Global float fell over and Lachlan Murdoch was promoted over him. The total pay of $US10.7 million included $US5 million for termination, a base of $US1.6 million and a $US3 million bonus.

Rod Chadwick: After 37 years with Pacific Dunlop, the ousted CEO collected a total payout of $3.49 million in 2001.

Sir CK Chow: given a huge package by Brambles chairman Don Argus after the dual listed company merger with GKN in 2001 and then performed terribly but departed with a $7.7 million payout three years later.

Frank Cicutto: hand-picked by Don Argus to succeed him as NAB CEO and then presided over the Homside and foreign exchange debacles before departing in early 2004 with a package reported to be worth $14 million but which did specifically include $6.5 million in termination benefits.

Ian Clack: when punted from Burns Philp years back, the former CEO received a total payout of $7 million.

Chris Cuffe: the former managing director of Colonial First State shocked everyone when his farewell package from Commonwealth Bank in 2003 weighed in at a staggering $32 million.

Tony D'Aloisio: flicked by the ASX in 2006 after SFE Corp shareholders insisted that their man Rob Ellstone run the combined operation. The $7.8 million payout was just under the level that would have required shareholder approval. And this man is now running ASIC.

Doug Ebert: the long-serving CEO of NAB's Michigan National bank collected a whopping $20.8 million payout and pension when NAB sold it for a $2 billion profit to ABN Amro in 2001. The structure was put in place back in 1995 and at least he created loads of shareholder value.

Dennis Eck: The Coles Myer CEO walked away with $8.65 million in his final year at the retailing giant in 2000-01 and remains on a consultancy deal for several years. This included specific termination benefits worth $4.7 million.

John Ellice-Flint: ousted from Santos in 2008 with an enormous payout of more than $15 million which assumed all his long-term incentive hurdles had been satisfied. They hadn't.

Duncan Fischer: the former audit signing partner of collapsed property group Estate Mortgage resurrected himself to become CEO of Tattersall's and then departed with a $4.4 million termination payout in 2006 after the Unitab merger.

John Fletcher: Talk about ironic. Fletch was terminated by Brambles when Don "Don't Argue" Argus took over as chairman and he got precisely the same payout that Dennis Eck enjoyed from Coles Myer. But after a few weeks of golf, Fletch decided he'd like to replace Eck even though he'd not been into a supermarket for 20 years. So far, it has been a disaster but with all that Brambles cash in the bank, who cares.

Greg Gailey: departed as Zinifex CEO in 2007 at the very top of the resources bubble and collected a $13 million payout based on a share price assumption of almost $20 when it is now back below the equivalent of $5 after the Oxiana merger.

Brian Gilbertson: punted as BHP-Billiton CEO in early 2003 after initiating merger discussions with Rio Tinto without board approval, the package was estimated at $10 million with the most outrageous element being the $1.5 million indexed pension for life.

Owen Hegarty: did a great job building Oxiana Resources during the commodities bubble but then disgraced himself by pocketing an $8.4 million ex gratia termination payout after the Oz Minerals merger, even though shareholders had specifically rejected an earlier $10.7 million payout proposal which was assuming the share price would top $6 by 2012. The stock plunged to below $1 in October 2008.

David Higgins: the former Lease CEO is now chief executive of the body delivering the London Olympics but gets by nicely with that $6.7 million termination payout when he left the Australian property giant in 2002.

Richard Jenkins: this chap was never even a main board director of Macquarie Bank but after serving as one of the many internal executive directors for 15 years, his final payout was a handsome $7.4 million, almost of which of was accrued but deferred bonuses. One hates to think what some of the really big boys such as Allan Moss and David Clarke will get when they retire or get fired from the millionaire factory.

Hugh Harris: NAB's former Homeside chief financial officer copped a $4.53 million "performance based" lump sum when terminated for losing $4 billion in 2001 which brought his total pay to a thoroughly undeserved $5.6 million.

Nick Falloon: It is not so bad getting sacked by the Packers when you walk out with $5.27 million which is exactly what happened to the former PBL CEO. A nice round $3m of this was for "termination".

Ted Kunkel: after an entire career at Foster's, we all thought Ted Kunkel was retiring after an excessive 12 years as CEO but instead he walked out with a termination payment worth

Keith Lambert: hired to run the business because was the son-in-law of largest shareholder Bob Oatley, the former Foster's strategy chief made a right hash of things and was fired with termination benefits worth $4.4 million in 2003.

Peter Macdonald: might yet go to jail for James Hardie's asbestos dodge and by any measure his $8.2 million termination package after tarnishing a once great Australian corporate brand was outrageous.

Joe Pickett: NAB's former Homeside CEO was fired when he lost $4 billion but still walked out with a handsome $5.8 million in 2001 which included "performance based remuneration" of $4.53 million.

Sheryl Pressler: the ousted head of Lend Lease's US real estate business managed to get her contract paid out in full so she walked away with $15 million in 2001 which was 10 per cent of the company's overall profit in 2000-01.

John Prescott: After almost 40 years with BHP, John Prescott walked away after an 8 years stint as CEO with $11.17 million in his final year back in 1998. The company wrote off about $10 billion thanks to his mistakes so he should have been sacked at least three years earlier.

Tom Park: the former Southcorp CEO only spent 5 months of his 5 year contract with the company but after buying Rosemout for $1.5 billion and bringing the management team in he was redundant but still collected $7.8 million in 2001 before taking the reigns at Goodman Fielder where he lined up for another huge whack of options. Add another $2.3 million that he got the following year and Park's 5 month effort paid him an incredible $10.1 million.

Andrew Scott: after building Centro into a debt-fuelled house of cards, the long-serving CEO was finally flicked in January 2008 with a golden goodbye worth $3 million.

Mike Tilley: the former investment banker hardly set the world on fire at Challenger Financial Group but pocketed another fortune after his recently renewed five year contract was terminated at short notice in 2008, sparking a $1.75 termination benefit on top of the $8.1 million paid in 2007-08.

George Trumbull: After 3 years causing a lot of damage at AMP, George Trumbull was finally sacked in August 1999 and walked away with a tidy $12.12 million in his final year. He got $4.94 million the year before and didn't need to work again but after more than 12 months off he's back in the game as a CEO in America.

Lloyd Williams: after PBL bought Crown casino, Lloyd bowed out of PBL with a $375,000 base salary and a $6.92 million "termination payment" bringing the total figure in 1999-2000 to $7.295m. James Packer told Crikey after an AGM question that an independent arbitrator came up with the figure despite the fact that Lloyd and Kerry are best mates.

Peter Yates: Kerry Packer never really liked the man promoted by his son James to run PBL, but the former Macquarie Banker negotiated himself a water-tight contract and walked out with a $6.5 million payout.

(Mayne 2008)

Without commenting on individual cases identified by Mayne, it is clear that a number of large payouts were made to CEOs who underperformed, or whose poor performance was the reason for their departure. Indeed, a study by RiskMetrics reportedly found that 'one-third of the nation's top 100 companies in the past three years paid their chief executives a combined $112 million to go away' (Ferguson 2008). The study also reportedly showed that the average CEO of a top 100 company received a termination payment of $3.4 million, equivalent to twice their annual salary. Reviewing the RiskMatrics survey, financial journalist Michael West made a number of observations in Box 2.

Box 2

extract from: 'Golden Chutes Back in Vogue', Michael West, *Sydney Morning Herald*, 27 November 2008.

The RiskMetrics Big Five are John Ellice-Flint with his $16.8 million golden handshake care of Santos shareholders, John Alexander ($15 million ConsMedia), Owen Hegarty ($8.35 million Oz Minerals), Tony D'Aloisio ($7.8 million from ASX, now chairman of ASIC) and Challenger's Mike Tilley (a cool $6 million).

In their customary best-of-both-worlds style CEOs have been able to leave, unsacked, with a warm statement from the chairman in appreciation of their good service...then pick up a lush payment for being terminated to boot.

The only executive who springs to mind as having actually been terminated with cause in recent years is Amcor's Russell Jones, amid the price-fixing fracas with Dick Pratt's Visy group. In Jones' case, chairman Chris Roberts and the Amcor board saw that he left with nothing. They even cancelled his vested options.

Other chairmen have been far more charitable. In the case of James Hardie and AWB for example, their CEOs Peter Macdonald and Andrew Lindberg both retired peacefully. What would have happened, one wonders, if an ordinary employee had presided over the underfunding of asbestos victims and the Iraq wheat-for-weapons scandal, respectively?

…Brambles' David Turner, AXA's Les Owen and BHP's Chip Goodyear did not pick up termination payments. Neither did Allan Moss at Macquarie for that matter.

Yet the abuses are newsworthy. Looking at the Big Bad Five then, Owen Hegarty and John Alexander picked up $23.3 million between them in termination and still stayed around.

Santos's disclosure on the Ellis-Flint extravagance was a debacle, conveniently announced one day after the AGM to avoid scrutiny and waved away by directors as "at the board's discretion".

Discretion? Shareholders would have employed another ``D'' word: despicable.

Sympathetic smootch

In the case of Tony D'Aloisio, the $7.8 million golden handshake (671% of annual base pay) appears to have been a sympathic smootch goodbye as institutional shareholders had put the heat on the board to select SFE boss Robert Elstone over incumbent ASX chief D'Aloisio to run the merged company.

Keeping ASIC sweet surely would not have been a factor.

RiskMetrics argues that the Corporations Act ought to be amended to require shareholder approval of termination payments above $1 million - including the vesting of unvested options (which is how they often get away with it).

Let's not forget the executives get superannuation as well. Isn't the point of super to cater for tram tickets and so forth in retirement?

(West 2008)

Conclusions and recommendations

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 pay pegging', 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. 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.

As a result of dual-asymmetrical pay pegging, 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 'neoliberal' policies and practices.

Policy proposals to curb excessive CEO and senior executive pay have largely centred around giving shareholders greater say over it. Such proposals are to be welcomed, both in relation to pay packages and to termination payments as set out in this Bill. Accordingly, I **recommend passage of the Bill.** The interests of shareholders presently feature well behind the urgings of remuneration consultants in shaping excessive executive pay. Generous termination packages transfer risk from CEOs to shareholders, and shareholders should have a say in containing those risks.

A danger, perhaps not large, is that the new ceiling on termination payments, of one year's salary before shareholders' approval must be sought, may also become a floor. Consideration should be given to a lower limit. The legal minimum for termination payments set out in the *Fair Work Act 2009* is a useful benchmark. It is unclear why CEOs should receive extraordinarily generous payouts on terms vastly superior to those available to ordinary employees dismissed for similar reasons.

It is even less clear why CEOs whose early termination is often brought about by poor performance in the job should receive generous termination payouts at all, particularly in light of the inflation of executive remuneration in recent years.

The European Commission recommends that termination payments should:

> not be paid if the termination is due to inadequate performance or if a director leaves on his own account. This does not preclude termination payments in situations of early termination of the contract, due to changes in the strategy of the company or in merger and/or takeover situations. (Commission of the European Communities 2009)

Consideration should be given to following this recommendation in Australia.

Issues for further consideration

The issue of termination payments can only properly be considered in the context of broader issues of the size of executive remuneration packages. They are, after all, a part of the overall package.

However, policies giving shareholders greater say will have only a very limited effect. This is partly because CEOs retain a strong position of power even when shareholder approval is required. Moreover, as DiPrete, et al. (2008) note, the finding of a leap frog effect:

> implies that the concept of firm-level governance of corporate compensation is inherently flawed; the linkages among firms produced by the benchmarking process guarantee that firm-level governance failure becomes a factor in the environment of other firms. In other words, rent extraction takes place even when CEOs are paid their “market wage” as established by competitive benchmarks. This argument supports the recent attention in the stratification literature to rent extraction as a manifestation of occupational power rather than an outcome of the bargaining power of individual workers.

Policies aimed at improving corporate governance will not address the core problem with senior executive pay: it is not just an issue of a misallocation of resources within an organisation, between CEOs and shareholders. It is also, and indeed more significantly, an issue of misallocation of resources within society as a whole. The very substantial relative growth in CEO remuneration has not been matched by equally substantial growth in national welfare as indicated by productivity growth. The distortion in CEO pay determination – creating an imbalance in pay setting procedures between, on the one hand, ordinary wage and salary earners and, on the other hand, CEOs – means that the former are in effect cross-subsidising the latter. In the end, the widening gap between CEOs and ordinary wage and salary earners is both a cause of, and symptomatic of, widening inequality between the wealthy and the rest.

Consideration needs to be given to the role of remuneration consultants. The recommendation of the UK House of Commons Treasury Committee (2009:33) for a code of conduct for the use of remuneration consultants is worthy of consideration, particularly with a view to removing discernible conflicts of interest. But short of banning their use altogether – an option which has been proposed (eg Peston 2002) – it is difficult to see how the upward bias imparted through remuneration surveys can be avoided altogether.

The tax-transfer system is a mechanism that is conventionally used to deal with adverse distributional outcomes. One option that lends itself to consideration is an increase in the top marginal tax rate – or perhaps more accurately, the creation of a new, higher marginal tax rate that cuts in at a substantially higher income range than at present (say, above $400,000 per annum) but into which CEOs would typically fall. This measure would appear warranted by the increasing inequality in personal income, particularly between very high income earners and the rest, that has been witnessed in recent years (even before allowance is made for the reductions in top marginal tax rates that have occurred over that period). Another option is to introduce wealth taxation (or estate taxation) on very high income individuals (for example, those with over $20 million in accumulated wealth, including through trusts). Australia is one of a minority of OECD countries that does not have at least one of wealth or estate/inheritance/gift taxes (Warburton & Hendy 2006).

That said, policy makers may prefer options that exclusively relate to senior executives. Another approach (not mutually exclusive with those above) would be to abolish tax deductibility against company income for senior executive remuneration packages above a certain value (indexed against growth in AWE) (eg Gittins 2009). This would act as a partial disincentive to firms to agree to excessive executive remuneration packages, and also return to the community a fraction of the losses associated with excessive growth in executive remuneration. A Bill introduced into the US Congress by Rep. Barbara Lee (the Income Equity Act, HR 1594) would deny tax deductibility for any executive pay above $500,000 or 25 times the pay of a company's lowest-wage worker.

A more active measure would be to impose tax penalties (surcharges) for firms that exceed certain benchmarks in executive remuneration. Similarly, tax penalties could be applied to termination payouts above a certain amount. In the Netherlands a 30 per cent tax penalty is to be applied on payouts above around $850,000 (Horin 2008).

The choice of benchmarks would be highly subjective, but attention could be given to the estimate by Shields, et al. (2003) of the 'performance-optimal range for executive remuneration of between 17 and 24 times average wage and salary earnings, beyond which the performance of a company begins to deteriorate'. It is also a range broadly consistent with the opinion of the late management academic Peter Drucker, that CEO pay should be no more than 20 times that of the rank and file worker in the company (interviewed in Schlender 2003), with the Lee Bill mentioned above, and with the recommendation of the Institute of Policy Studies that bail-outs should be only available to firms with CEO pay restricted to no more than 25 times that of the lowest paid employee (Anderson, et al. 2008). It is, however, considerably higher than Plato's recommendation that no one should accumulate more than five times the income of the lowest paid (Morrow 1993:131).

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