in brief...
UK chief executives: paid for performance?

Is there any clear relationship between corporate performance and executive remuneration? To explore this question, **Brian Bell** and **John Van Reenen** have created a new database of pay for senior executives and employees in 400 UK firms.

Recent figures indicate a resurgence in the growth of executive pay in the UK at a time of austerity for most. Anger at these numbers is driven in part by a growing belief that such pay bears little relationship to how the companies managed by these chief executive officers (CEOs) actually perform. In other words, the argument goes, there is pay for no performance.

To shed more light on whether there is any link between the pay of top business people and the performance of their firms, we have created a database of pay for CEOs, senior executives and employees covering over 400 UK firms over the period since 2001. These firms account for about 90% of UK stock market capitalisation.

This is the first time that data covering everyone from the CEO to the cleaners in a large sample of firms has been collected and linked to stock market performance in this country. It makes it possible to explore how pay changes across a whole company as its performance improves or worsens.

As might be expected, we find that there are big differences in average pay. CEOs earn around 40 times more than the average employee, but this multiple rises to around 80 when we look only at the very top companies – the FTSE 100. The majority of pay for CEOs comes from bonuses and stock incentive plans, whereas 95% of employees' pay comes from basic salary.

Our evidence also shows that when corporate performance improves, so does pay. But pay goes up much more for CEOs than for ordinary employees. For example, if the firm's value as measured by shareholder returns increases by 10%, CEOs on average get an extra 3% in pay while employees get only 0.2% more.

This close pay-for-performance link among CEOs seems to be a fairly new development. Evidence from the 1980s and early 1990s found almost no link between pay and performance for top executives. Our research shows that today's correlation between pay and performance is driven by bonuses and other incentive packages, which have become more important in recent years.

We also find that poorly performing firms are much more likely to boot out their CEOs, and that when a firm does badly, CEO pay goes down. But it is worth noting that CEO pay cuts for failure are not as speedy as pay increases on the upside. So although it is true that CEOs are not just 'rewarded for failure', they get more pleasure when the company's performance goes up than pain when performance goes down.

Of course, these average effects of performance on pay cover both well-governed firms that use pay to provide incentives for their CEO and poorly performing firms that pay over the odds for questionable talent.

Finally, we demonstrate that there is a strong relationship between how tightly firms link CEO pay with performance and how significant institutional investors are among the firms' shareholders. For firms with low levels of institutional ownership, we find no link between pay and performance in general, although CEOs in such firms do benefit when performance is good.

In contrast, firms with high levels of institutional ownership are more successful at linking pay and performance, and ensuring that the link works in both good times and bad times. This all suggests that active and large shareholders can provide an important disciplining influence on the structure of CEO pay.

What are the implications for policy? We think that there are strong grounds for encouraging more transparent reporting of pay by companies. Many annual reports are unnecessarily complicated in their reporting of executive pay and, perhaps inadvertently, tend to obscure the size and nature of the pay awards.

We also think that there should be a requirement for each and every board to explain to shareholders and the public how the growth in pay of their CEO is linked to the performance of the company. Those that fail this test must be held to account by shareholders.

This article summarises 'Firm Performance and Wages: Evidence from across the Corporate Hierarchy' by Brian Bell and John Van Reenen, CEP Discussion Paper No. 1088 (http://cep.lse.ac.uk/pubs/download/dp1088.pdf).

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