Probing Executive Remuneration.

Has Capitalism Failed Us?

No. 1

Setting the Scene

A PEST analysis is often used in strategic management when considering the macro-environmental factors that may influence the organisations future. Although the model has undergone changes and factors have been added and others sub-divided in an attempt to make it more comprehensive, a PEST analysis requires one to consider of a few core factors from a local, national and international perspective. The basic principle of the model is to discuss and identify influences in the following areas:

Politico / Legal: Anything related to the political stability and direction of the country or context, usually linked to laws compiled by the political sector.

Economic: All factors related to the financial status of an area – micro and macro - where the business operates, be it in terms of sales, location or suppliers.

Socio / Cultural: Any human factors – individual and communal - that might have a direct or indirect influence on the operating environment and operations in general.

Technological: New developments that can be utilised for improvement or that could become threats. It also includes consideration of environmental readiness for such technology.

More recently, and based on aspects such as global warming (or global weirding), **Environmental** considerations are included. A second aspect which is slowly becoming part of the core, is **Governance** in its broadest sense. These two factors are so over-arching and internationally driven, that it is no longer possible not to consider them.

The key to interpreting a PEST analysis is that factors should be considered systemically and not linearly or in isolation. Very few – if any - societal or world events are attributable to a single factor. The PEST analysis also requires a macro approach and should not only be viewed from the perspective of the organisation, as is often the case.

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is a husband and wife team that supports Individuals, organisations and communities in their development.

Jan and Lyn bring together more than 70 years of experience. They share a passion for helping people, teams and organisations optimise their potential.

Although they work together at times, they each have their own unique strengths and consult individually under their own names.

Lyn supports organisations and individuals to bring social wellbeing and change through advocacy, mentoring, training and communication, while Jan works primarily to enhance understanding and support improvement through development/training and systems thinking.

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Sometimes a number of factors interact, resulting in a perfect opportunity or even a so-called “perfect storm”. Such storms usually bring radically new outcomes. These outcomes could have serious influence – either positively or negatively - on an organisation.

One well-known example of such a “storm” is the French Revolution (1789 – 1794). In the revolution, the bourgeoisie (or middle class), joined by clergy and provincial nobles, overthrew the holders of power.

Today we hear of many similar protests against not only the decision makers - politicians – but also against the so-called rich, the one percent and captains of industry. Although the French Revolution and current protests had political, socio/cultural and even technological causes and effects, this article will focus on an economic perspective and particularly the role of economic inequality.

Capitalism and Equality

Economic inequality is not a new, or even relatively new, problem. **Plato** (born 427 BCE) observed that most states seem to be divided into two; one composed of the very rich and the other of the poor. He suggested that these two states are forever "at war with each other."[i] In an attempt to attain a truce between the groups, he argued for proportionality: that profit should be ethical to the extent in which it is proportionate to effort, and not due to good luck, or to the use of brute power[ii].

Adam Smith - often referred to as the father of capitalism – wrote in *The Wealth of Nations* that individuals work to better themselves, with no regard for the common good[iii]. In *“A Theory of Moral Sentiments”,* he however noted that people have a natural affinity for justice, because it promotes the preservation of and propagation of society[iv]. He assured readers that his model for economic success would result in “universal opulence which extends itself to the lowest ranks of the people.”[v]

To clarify the contradiction between these views, Smith referred to an ‘invisible hand’, which he described as follows;

> *As wealthy individuals pursue their own interests, employing others to labour for them, they “are led by an invisible hand” to distribute the necessities that all would have received had there been an equal division of the earth… self-interested actions are so coordinated that they advance the public interest[vi].*

The ‘invisible hand’ becomes more understandable if one considers supply and demand in practice. In a free economy, an over-supply of a product or service – including labour - will result in lower prices and vice versa. On a larger scale, an over-supply will reduce overall company profits – prices will drop and profits reduce. If a product is undersupplied, it will result in increased competition, resulting in more businesses entering the market and an eventual balancing of supply. From a labour perspective, an over-supply, with a drop in wages, resulting in fewer people that can afford the product/service, thus an effective drop in organisation profits.

Smith often stated that the true measure of a nation’s wealth is not the size of its king’s treasury or the holdings of an affluent few, but rather the wages of “the labouring poor.” He also had more to say in opposition to inequality than in its defence.[vii]

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More recently the term "**trickle-down economics**" became common. According to this model "taxes on businesses and the wealthy in society should be reduced as a means to stimulate business investment in the short term and benefit society at large in the long term." [viii]

Despite the promises of Smith and the concept of the 'invisible hand', **Will Hutton -** a British political economist, academic administrator, and journalist.- is of the opinion that capitalism can become corrupted when wealth and power combine to undermine the role of merit. Such corruption can lead to exploitation and great social harm. He notes that capitalism without fairness becomes toxic.[ix]

This is mirrored in wide-spread criticism of the trickle-down-economy. A 2015 International Monetary Fund paper even argues that rather than benefiting the economy, these policies cause harm:

"[I]f the income share of the top 20 per cent (the rich) increases, then GDP growth actually declines over the medium term, suggesting that the benefits do not trickle down. In contrast, an increase in the income share of the bottom 20 per cent (the poor) is associated with higher GDP growth."[x]

Capitalism and Business Management

How does this influences business and business management? When considering capitalism from the perspective of managing organisations, four distinct, yet overlapping, perspectives are identifiable:

Most organisations start as an entrepreneurial concern. An individual identifies a gap in or brings a new product or service they developed to, the market. They often take big risks investing their time and money. At times, they might employ people to work with or for them, but the businesses is owned and managed by the founder or inventor of a product. The entrepreneurial model most clearly explains the capitalist concept that a person is entitled to rewards for their risks and efforts. The founder must balance their risk and return within a market of supply and demand. It is a personal gain in exchange for personal effort and risk. The perspective here is that of **Personal Capitalism**. This is still seen in many owner-run businesses.

There are many reasons why an entrepreneur might not continue managing their own business and decide to appoint "career" managers to oversee their interests. This approach became more prominent with the growth of technology and of the number of businesses during the late nineteenth and early twentieth centuries. Developers/entrepreneurs started relying on teams of appointed and salaried managers who had little or no ownership in the enterprises they operated.[xi] In essence, the entrepreneur appoints a CEO that they can hire of fire, depending on the terms of the agreed contract.

From a governance perspective, the organisation may appoint a board to oversee the CEO but a majority owner can control the board, and thus the choice of CEO[xii]. This model of appointed "caretakers" is called **Managerial Capitalism**. Here we still find the fundamental concept of the developer or entrepreneur taking the risks – including managing and paying the appointed manager(s) fairly – while obtaining the returns linked to their levels of risk. An example of this is an entrepreneur that starts a second or third shop and appoints a store manager to run it on their behalf.

In managerial capitalism it became acceptable for the original owner to share the responsibility and the rewards with the appointed managers. Owners started rewarding the managers with some degree of "ownership" in the organisation. The result of this "sharing of success" is referred to as **stakeholder capitalism**. Here the "success" of the organisation is shared more freely between employees, managers and

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shareholders. This led to a flourishing middle class, as workers and communities benefited from the success of the corporations of which they were part[xiii]. A form of stakeholder capitalism is seen when organisations pay performance bonuses or where salespeople work on commission.

As a result of a variety of institutional, legal, political, and ideological changes, a greater shift from stakeholder capitalism was seen from the 1970s.[xiv] This led to simplified processes where independent companies can obtain funding from investors by pooling capital from shares, traded freely through a stock market[xv]. The stakeholder concept of "shared" ownership expanded to shareholding options for executive management, resulting in a shift from managerial and stakeholder capitalism to **Shareholder Capitalism.** This caused a shift in ownership from stakeholders to shareholders with limited liability, primarily in organisations listed on the stock exchange. An inherent contradiction in this model is that the paid manager of managerial capitalism is now a "part owner" while the entrepreneur that took the risks in starting a business has become just another shareholder. In essence, the business itself became a "sellable product".

The Effect

The increase in the remuneration of management, as well as the increase in the gap between these highest-paid employees and "ordinary" workers, are raising red flags.

In addition to the decrease of power and profit for the entrepreneur and increase for the paid manager already mentioned, the business focus seems to shift from collective entrepreneur/management/employee growth to one of investor returns. This leads to a focus on investing only where best possible returns can be obtained. The investment focus is not universally seen as positive and some feel that investors hijacked capitalism, leading to movements such as Occupy Wall Street. Some concerns are that;

- *Corporate governance has become dominated by the need to maximise short-term shareholder returns.*[xvi]
- *Demands for greater profits continue, as companies are pressured by share portfolio managers and activist investors to increase their profitability and share price*[xvii]*.*
- *With executives incentivised to maximise profits, meet quarterly share price targets and ensure profits are returned to shareholders, they have been able to game the system to ensure they receive excessive remuneration, while at the same time cutting costs and squeezing wage growth in search of higher profits*[xviii]

The dangers of executive management becoming shareholders was already noted in the early 1970s, when Milton Friedman said: "corporate shareholders should be understood to own the company and its executives should be seen as their hired help".[xix] A more recent comment is from Jack Welch. Although he was dubbed "***Neutron Jack***" during the early 1980s for his drive to eliminate employees while leaving buildings intact[xx], more recently he said; "Shareholder value is the dumbest idea in the world. Shareholder value is a result, not a strategy … your main constituencies are your employees, your customers and your products."[xxi]

Remuneration Gap

From an Organisation Development perspective, the key problem is not the growth in remuneration, but rather the growth in the "gap" between management and rest of staff and the broader effect it has on equity and related expectations. The gap in remuneration between employees and CEOs in shareholder

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economies not only damages productivity and morale,[xxii] it also breaks down employee engagement and builds perceptions of inequality.

There are many views and theories about the level of executive remuneration. Some state that high remuneration is a reflection of the value of executive skills and the shortage thereof, others refer to requiring market prices for extensive experience. Some also the have the view that executives have too much power in setting their own pay. For a broader perspective, let us consider some facts around executive remuneration:

- A review of CEO remuneration in South Africa showed that "the average CEO salary of listed companies is almost 95 times more than the average employee salary".[xxiii]
- In 1965 in the UK, the chief executive-to-worker compensation ratio was 20:1. Today it is 312:1, more than five times greater than in 1989 when the ratio was 58:1.[xxiv]
- A fascinating quote is that "Chief executives are even leaving the 0.1% in the dust. The bosses of large firms now earn 5.5 times as much as the average earner in the top 0.1%."[xxv]
- The average CEO makes as much money in one day as the typical worker earns in a full year.[xxvi]
- In some companies, executive pay has become disconnected from the performance of the company itself.[xxvii]

Changes to and Governance of Remuneration

Calls have been made that "the time has come for business to understand the societal consequences of our business culture and change to a more fair, just and effective sharing of value to benefit all stakeholders and society."[xxviii] This is supported by the comment that "companies should be explicitly accountable to a mission and a set of interests beyond shareholder returns." [xxix]

A practical result of these calls for change and perceived lack of fairness is discussed in a 2017 UK White Paper. Four key comments from this White Paper are that;

- *Companies need to review the work of their remuneration committees. Remuneration committees [must] take on a new responsibility for oversight of company remuneration and wider workforce policies.*
- *It is suggested that other committees such as corporate responsibility, sustainability or people committees may be used to meet this expanded remit.*
- *Specifically, there is an additional reporting requirement for companies to explain what workforce engagement has taken place to demonstrate how executive remuneration aligns with wider company pay policy.*
- *The Chair of the remuneration committee also needs to have at least 12 month's experience on a remuneration committee before taking on this role.*[xxx]

A further proposal is that UK-listed companies "with more than 250 employees will have to report annually on the difference in pay between their chief executive officer ("CEO") and their average UK worker."[xxxi] Deloitte indicates that this will be in the form of a ratio of CEO's 'single figure' total remuneration to the median, 25th and 75th percentile total remuneration of their full-time equivalent UK employees [xxxii]. They clarify the comparisons in that; "employee remuneration will be calculated on the same basis as the CEO".

From the USA the call for change is similar. Recently there has been the introduction of the "Accountable Capitalism Act". This act requires company directors to consider the interests of all major corporate

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stakeholders and that workers are given a stronger voice in decision-making at large companies[xxxiii] The purpose of the act is described as;

> *"shifting American business culture out of its current shareholders-first framework and back toward something more like the broad ethic of social responsibility that took hold during WWII and continued for several decades."*[xxxiv]

Where to from here?

These changes are an attempt to return to some degree of managerial / stakeholder capitalism and should be supported and encouraged. But can business wait for legalisation to solve the problem?

Does the context and the situation not call for more? Is it not time for boards, owners, and management itself to reflect on these imbalances and the ever-widening gap with-in and outside organisations.

The multiple and complex effects of inequality are well known. Addressing income inequality between staff and management could contribute to addressing this. The questions are:

- *Are organisations brave enough to take this step?*
- *Will executive management be willing to step away from their often extravagant lifestyles in order to make this possible?*
- *Is society willing to move towards greater equality?*

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