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High pay does not equal high quality

By Ruth Sullivan

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Learning from co-operatives such as Spain's Mondragon could help drive reform of excessive executive pay

The argument that higher pay leads to the selection of better senior executives is a familiar one, particularly for shareholders contesting dizzyingly high bonuses at this seasons's annual general board meetings.

However, two academics, Philippe Jacquart, assistant professor of leadership at French business school EMLyon, and Scott Armstrong, professor of marketing at Wharton at the University of Pennsylvania, argue in a paper to be published this autumn that high pay not only fails to promote better performance but can harm productivity.

“There is no evidence that massive financial incentives attract the best talent,” says Mr Jacquart, who believes the “job itself should be sufficient motivation”. Not only are financial incentives unnecessary but they can be counter productive. “Financial incentives fill up your entire thinking space, preventing you from focusing on other things or being open to ideas,” he argues.

“Excessive pay in the boardroom is bad for business, bad for our economy and bad for society. It imposes spiralling costs on business; perverse pay structures promote the wrong decision making, and pay inequality demotivates other employees,” according to Chuka Umunna, UK shadow business secretary.

Deborah Hargreaves, director at the High Pay Centre, an independent think-tank, agrees with Mr Jacquart. “When money is used as the only incentive to manage people, it is not good management.”

Financial incentives such as high salaries or bonuses can also be detrimental to the interests of shareholders if the benefits focus on short-term rather than long-term performance.

Top executives prefer to have cash-in-hand incentives rather than longer-term share awards, and this has pushed salaries and bonuses up, says Ms Hargreaves.

But paying top executives excessive salaries or high bonuses is often detrimental to the morale of employees further down the company chain.

Recent discussions on pay issues between private sector focus groups in the UK and the High Pay Centre revealed employees felt the success of a company was due to everyone's contribution and not just the performance of the chief executive. They felt they received neither recognition nor any bonus-sharing.

"The idea that there is only one person at the top is mad, as it is a team effort," points out Ms Hargreaves.

The pay gap between top executives and average workers, which is the thrust of shareholder protests at AGMs, is another concern among the focus groups.

As interest in pay ratios grows, shareholders are asking companies to publish their pay ratios online. Capita, the FTSE 100 support services company, recently agreed to publish the ratio between its highest and lowest earners on its website. Others, such as Barclays, the bank, are looking at it, according to Ms Hargreaves.

Although excessive pay may lure candidates to a particular job, there is no guarantee the most talented person will get it. Mr Jacquard believes the recruitment process itself is flawed, often undermining the incentives of high financial reward.

"Recruiters [the board of directors] are not good at hiring because they cannot work out who are the best candidates, as many biases come into play," he argues.

These include too much emphasis on past performance, personal recommendations and the use of unstructured interviewing techniques where candidates are asked different questions, making meaningful comparisons difficult.

Mr Jacquart suggests radical solutions are called for, such as abandoning current high incentive remuneration practices and reducing senior executive pay across industries, not just in the banking sector.

Closing the pay ratio gap between top executives and average employees would be a good starting place, he says. "The gap between the highest and lowest paid employees is ever widening," he adds.

If several companies agreed to lower remuneration packages, proving over a few years it was not harmful to business, then it would bring about change, he argues. But he believes it will take a large shareholder to drive such reform.

Learning from co-operatives such as Spain's Mondragon, where ownership of the company is in the hands of employees closely involved in issues, including appointments and pay, would also be valuable in driving reform, Mr Jacquard adds.

Some attempts to reform remuneration are already under way as the European parliament proposes to extend caps on bankers' pay to the asset management industry.

Swiss voters recently opted to clamp down on excessive remuneration by giving shareholders a binding say on pay, banning golden hellos and goodbyes, and threatening criminal sanctions for those who fail to comply. France and Spain are considering a similar route.

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