AUSTRALIAN COUNCIL OF TRADE UNIONS

Submission to the Productivity Commission's Inquiry into Executive Remuneration in Australia

The Australian Council of Trade Unions ('ACTU') represents 2 million Australian workers and their families through our 48 affiliate trade unions and regional trade union confederations.

We welcome the opportunity to make a short written submission to the Productivity Commission's Inquiry into Executive Remuneration in Australia. We plan to submit further material after the ACTU Congress in early June.

Trends in executive remuneration

Executive remuneration is out of control. Between 1990 and 2005, the average cash remuneration of CEOs in Top 50 listed Australian companies rose by 564 percent, from $514,000 to $3.4 million, or 10.7% per annum adjusted by inflation. During the same period, average full-time earnings only rose 85%, or 1.4% per annum adjusted for inflation. The result is that top CEO pay has ballooned from a multiple of 18 times average full-time earnings to a multiple of 63.[1]

The excesses are even worse overseas. Between 1992 and 2000, the average pay of CEOs of the top 500 US firms rose from US$3.5 million to $14.7 million. In 2003, the average CEO from these firms received approximately 500 times the pay of an average worker, up from a multiple of 140 in 1991.[2] Similarly, in the UK, between 1995 and 2002, the average remuneration of the highest-paid director in a top-350 listed company rose from about £500,000 to more than £800,000 – a rise of 60%.[3] On the other hand, it is important to note that in many developed countries that have resisted American corporate culture, executive remuneration has not been allowed to get out of control. In Germany, South Korea, Switzerland and Japan, executive pay remains at around ten times' average earnings.[4]

In Anglo-American countries, the enormous increases in executive remuneration have been out of all proportion to long-term company performance. The market value of the top 50 listed Australian companies has only risen by 28.5% since April 2000. This is not much better than the performance of Australian government bonds. In other words, there is not much to show for the $1.5 billion in top-50 CEO salaries paid since that date. The broken link between executive pay and corporate performance is even more obvious overseas. Since April 2000, the value of the top

[1] Shields, 'Setting the Double Standard: Chief Executive Pay the BCA Way' (2005) 56 *Journal of Australian Political Economy* 299.
[2] Bebchuk and Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge: Harvard University Press, 2004), 1.
[3] Paul Gregg, Sarah Jewell and Ian Tonks, 'Executive Pay and Performance in the UK 1994-2002' (2005) Centre for Market and Public Organisation, Working Paper 05/122.
[4] Eric Wahlgren, 'Spreading the Yankee Way of Pay' (18 April 2001) *BusinessWeek Online* <www.businessweek.com/careers/content/apr2001/ca20010419_812.htm>.

500 US American companies has *fallen* by 45% (about US$5.6 trillion). In that time, shareholders have spent *hundreds of billions* of dollars on executive pay.[5]

Consequences of excessive pay

The ballooning of executive remuneration is contributing to greater income inequality in Australia. In 1993, the top 10% of wage earners earned 5.6 times what the bottom 10% earned. However, by 2006, the top 10% of employees were earning 7.6 times more than the lowest paid workers.[6]

Rising income inequality takes us further and further away from the ideal of egalitarianism and a 'fair go', which are core Australian values. It risks dividing us into a country of haves and have-nots, in which the haves increasingly discriminate against the have-nots when making decisions about hiring and other opportunities.

Because most executives are men, the explosion in executive salaries is worsening the gender pay gap. Only 11% of executives in ASX200 companies are women, and only 2% of CEOs or Chairs of the Board are women.[7] The blowout in executive pay is threatening to make the women in business even worse off, in relative terms, to men.

Also, in many cases, rising executive pay puts downward pressure on the pay of ordinary workers, and creates unemployment pressures. This is most obvious in a recession, when a firm can only maintain high executive salaries at a cost of suppressing the wages of ordinary workers, or by making other workers redundant. The most notorious recent example is Pacific Brands. Between 2007 and 2008, the company doubled the benefits paid to its top 13 executives, to $15.5 million. Then, when difficult business conditions hit, the company preserved executive salaries but made 1,850 workers redundant. Given that the money spent on executive salaries represents more than 400 jobs for ordinary workers,[8] it is obvious that there has been an invidious trade-off between jobs and executive salaries.

Massive increases in executive pay are also likely to increase job dissatisfaction, and so reduce job commitment and performance by other workers. According to one study, having a large pay gap within a workplace reduces job satisfaction by 28% (irrespective of the worker's satisfaction with their own levels of pay).[9] Executive pay is argued by its apologists to increase performance on the part of executives, but it seems to reduce performance by everybody else.

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[5] Ibid 1.

[6] ABS, Employee Earnings and Hours (1993) cat 6306.0, 4; ABS, Employee Earnings and Hours (2006) cat 6306.0, 171734. See also ABS, Australian Social Trends (2000) cat 4102.0, Income Distribution: Trends in earnings distribution.

[7] Equal Opportunity for Women in the Workplace Agency, *Australian Census of Women in Leadership* (2008).

[8] Based on the wage rate set out in the applicable workplace agreement (Pacific Brands Holdings Pty Ltd - Holeproof (Underwear Division) and TCFUA Collective Agreement 2008) plus 25% on-costs.

[9] Petrescu & Simmons, 'Human Resource Management Practices and Workers' Job Satisfaction' (2008) 29 *International Journal of Manpower* 651.

Regulatory failure

The numbers speak for themselves. Clearly, existing regulations have failed in preventing the rent-seeking behaviour of company executives and directors.

The major flaw has been the voluntary nature of 'regulation' to date. As expected, non-binding pay guidelines and non-binding shareholder votes on executive pay have had little or no effect on corporate behaviour. Regulation requiring transparency has helped publicise excesses, but boards continue to award these benefits without shame, and large institutional shareholders continue to vote in favour of them. They do this because of an institutional bias in favour of pursuing short-term returns but also because of self-interest (in that directors and fund managers wish to ensure a high 'market wage' for the types of jobs they possess themselves).

It is clear that strong measures need to be taken to closely align executive remuneration with long-term, sustainable, and responsible corporate performance. To this end, the law should regulate the base pay of executives, and other payments, as follows.

Base pay

- The base salaries of directors and company executives should be subject to an overall reasonableness requirement. Reasonableness should be determined according to the skills and experience of the executive, the nature of their role, and the size and complexity of the enterprise. An appropriate public oversight mechanism should be established to allow a corporation to determine in advance if a package meets the reasonableness test.
- There should be an absolute cap on the base earnings of executives and directors, of a multiple of ten times the average weekly full time earnings paid to employees of the enterprise.
- A shareholder, or ASIC, should be given standing to sue for the return of any unreasonable portion of base salary to the company.

Additional pay

- Any additional payments made to directors or executives, or for their benefit, should be prohibited, except for:
  a) mandatory payments under legislation (including the Fair Work Act and superannuation legislation) or salary sacrifice arrangements;
  b) reimbursement of legitimate expenses;
  c) termination payments of up to one year's base salary, paid in accordance with a pre-existing agreement, and not payable in the event of dismissal due to misconduct or poor performance;
  d) genuine performance-based payments (see below).
- A shareholder, or ASIC, should be given standing to sue for the return of any unlawful additional payment to the company.

Performance-based payments

- Genuine performance-based payments should be strongly linked to the long-term and socially sustainable performance of the company. Such payments should only be paid in cases where:
  a) the company has performed better than its peers, over a period of at least five years;
  b) the executive or director personally contributed significantly to the superior performance (rather than chance or the work of others); and
  c) the executive or director's contribution provides the foundation for sustainable business growth over the long term. For example, if executives are selling assets or using borrowings to fund dividend payments, they should not be rewarded for any temporary increases in the share price. Similarly, if executives are increasing the company's share price by running down assets, winding back maintenance, reducing workers' wages or making redundancies (thereby damaging morale), or engaging in dangerous business practices (such as banks making sub-prime loans), they should not receive additional payments. In contrast, executives should be rewarded where they develop existing assets (including 'human capital'), responsibly invest in new assets, and build a strong base for growth in the long term.
- Additional payments should be required to be approved by shareholders before they can be paid.
- That portion of salaries beyond a certain maximum amount (say, $1 million) should not be tax deductible by the company as an expense incurred in the course of earning income.
- There should be strong anti-avoidance measures. Arrangements made to circumvent these restrictions should be prohibited. Benefits provided to executives (such as non-recourse loans) should be treated as if they were part of salary. Attempts to manipulate performance-based payment schemes, for example by seeking to alter the share price immediately before they receive or exercise options, should be clearly prohibited.

These principles should be enshrined in legislation. Voluntary standards simply will not work. We see no constitutional impediment to using the corporations power to achieve these outcomes.

In addition to these measures, the government should consider imposing other rules to discourage excessive risk-taking by executives where those actions are not in the best interests of stakeholders in the company. These include:

- Extending directors' existing duties (of care, good faith and proper purposes) to executives. Executives should face civil and criminal sanctions for breach of their obligations. This measure was recommended by the government's Corporations and Markets Advisory Committee.
- Requiring the company's Annual Report to contain a comprehensive report concerning payments to directors or executives, justifying the payments and certifying that they are consistent with the legislative requirements in respect

of both base salaries and additional remuneration. This report should also be given to the Annual Meeting of the company.

- Increasing executive liability for the consequences of reckless behaviour (for example, by ensuring that victims of executive excess have legal remedies against executives, and ensuring that executives cannot hide behind the corporate veil, or behind corporate insurance policies);
- Increasing progressive taxation on extreme incomes;
- Promoting diversity of executive recruitment (to redress gender and social discrimination); and
- Promoting the enagagement of executives in the lives of the people and communities who are affected by their decisions (on the basis that executives are more likely to respect the interests of these stakeholders if they have regular, personal, contacts with them).

Conclusion

The time is right to do something about soaring executive pay. The present economic difficulties may take executive pay out of the headlines, but when the economy turns around, executives will be the first to put their hands up for a pay rise, claiming personal credit for the performance of the company. This perverse cycle has got to stop.