

Hutton Review of **Fair Pay**

Hutton Review of Fair Pay in the public sector: **Final Report**

March 2011



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Foreword

Civilisation needs government to prosper, and so does the economy and society. There are urgent and widespread concerns about the current size of government, the need for reform to produce more adaptability and creativity and in particular the scale of the current budget deficit. I share those concerns. But equally it is impossible to see how the physical, social and human capital necessary to support economic recovery and growth, along with the redistribution of income needed to alleviate poverty, and measures to promote more equal opportunity are possible without government. Government and the public sector are too easily regarded as an obstacle to growth and the good society. Properly organised, led and managed they are instead their handmaiden. Indeed most public servants are animated by precisely this aim.

This is a more complex and nuanced view of the public sector than the usual dialogue of the deaf between those who think it unambiguously good or bad – with a no less binary view of the private sector. Interestingly this nuanced view is one that most private sector CEOs share. In the most recent annual global survey of CEOs conducted by PwC, a majority (61 per cent) certainly expressed concern over the size of fiscal deficits but simultaneously even more (72 per cent) supported government policies aimed at promoting growth that is economically, socially and environmentally sustainable. Business acknowledges it looks to governments to develop infrastructure, ensure stable capital markets, protect intellectual property, build a skilled workforce, deal with climate change, address inequality and reduce poverty – and of course to do all this with as little taxation and regulation as possible. Business leaders recognise the reality that economic growth is co-produced by a collaborative relationship with government, both discharging their proper responsibilities.

But while business recognises the role of government, it also looks to the public sector to transform itself. The public sector will need to lower its cost base and manage risk better, invest in talent and develop new innovative organisational forms in which to deliver public services more adaptively and responsively to citizen needs – all while preserving the crucial public character of accountability and universality of access. New service delivery models will need to emerge – standardising, streamlining and sharing inputs where possible – along with seeking innovative means of financing. This is not just a British problem: it confronts public sectors across the industrialised west.

Nor is the issue solely economic. Public institutions at their best are means of expressing collective will and social solidarity: we want a strong police force or to witness “meals on wheels” delivered to the elderly. The public realm, whether a beautiful public park or an effective health service, is essential to our well-being.

This is a substantive challenge – and pulling it off is crucial to securing a more balanced, innovative and high growth British economy. Success would be a fundamental building block in supporting economic growth and social well-being, but it cannot be done without motivated, high calibre public servants, along with managers to lead them. But while the British public is very sympathetic to front line delivery staff, it is hostile to the public sector managers responsible and accountable for the effective deployment of resources – and even more hostile to their pay. In the eyes of some, they are the quintessential “burdens” on the rest of us.

Part of the reason for this is that public sector managers have been caught up in the backlash to the remarkable growth of the earnings of the top 1 per cent over the last thirty or forty years and in particular in the last ten. Bank bail-outs with scarcely checked bonuses have dramatised these concerns. What has made the impact so toxic is the growing scepticism about whether the rise of pay at the top is the due desert of those who receive it. The public is partly right. Some of the rise in executive pay in the private sector at the top has been accompanied by little tangible improved performance. The public sector has not been immune from the same suspicion even though, as

detailed in the Interim Report, only one pound of every hundred pounds earned by the top one per cent of earners is earned by public sector employees. The perception is that the public sector is no less awash with 'fat cats'; indeed in one poll a quarter of respondents thought that public sector executives earned more than their private sector counterparts.

Against this backdrop the response is that the pay and the reward package of public sector executives has necessarily got out of hand, an accusation made harder to rebut because of the lack of a robust framework to justify top public sector pay. On a gut level, the reaction is understandable – but dangerous. If the national conversation takes it as a given that the public sector is necessarily a burden and a problem, it can only demotivate public sector staff. Meanwhile, attacking pay and the overall reward package, especially given the growing and extraordinary differentials with parts of the private sector, will make it harder to recruit and retain good people just at the moment the UK is embarking on an ambitious programme of public service reform – and the painful rebalancing of its economy.

Of course, there are problems: some public sector executive pay has been rising for reasons no less opaque than in the private sector with little attendant rationale. There are anomalies and, before the current pay freeze, signs that in the more autonomous parts of the public sector the arms race effects in CEO private sector pay were being reproduced – albeit less markedly. And of course, at the taxpayer's expense. The public has the right to know that pay is deserved, fair, under control and designed to drive improving public sector performance – and that there are no rewards for failure.

Something has to change, hence the impulse behind commissioning this Review, with its explicit assumption that a better definition of fair pay is the precondition to cooling this increasingly febrile atmosphere. But if asked to lead a review into fair pay, the author must have an idea of fairness that can consistently guide his or her thinking. The golden thread that runs through this review is the notion of fairness as due desert – workers at every level in any organisation should be rewarded in proportion to the real value of their contributions, but not rewarded either for good luck which they have done nothing to deserve, nor for free riding on the efforts of others. Their pay should be their due desert – no more and no less.

I therefore propose a new settlement with public sector leaders based on the principle of pay as due desert. The package of recommendations must be taken as a whole, but if implemented together should reassure the public that it is not being taken for a ride, while creating a pay and performance framework that over time should drive more innovative and creative behaviour. This framework will offer flexibility and fairness both to senior executives and the tax-paying public. There should be the flexibility to respond to market conditions in particular parts of the public sector without having to refer to Ministers, but equally senior executives need the protection of a fair pay framework to give them a robust defence when and if they come unjustifiably under attack.

I was asked to consider whether a public sector pay multiple, in which no manager could earn more than twenty times the lowest paid person in the organisation, would be helpful as the core of a fair pay system in the public sector and tackle pay disparities. I have concluded that it is not. The evidence is that a hard cap would be inoperable across a diverse public sector workforce. People at the top of very large and complex organisations, but with low paid workers, could earn less than people running simpler bodies but whose bottom workers were better paid.

Hard caps go against the spirit of fairness as due desert. Rather the task is to create a context in which pay is consistently judged against individuals' proportional contribution. I thus propose that every public body should annually publish the multiple of top to median pay in a clear and presentable way, and that the results should be published every year by the Senior Salary Review Body in a Fair Pay Report. Median earnings are a more representative measure of the pay of the whole workforce. Public sector executives and their remuneration committees are highly conscious of public scrutiny, and they will increase pay when the case is close to indisputable. But in case this not

enough I propose a system of enforcement which escalates from public admonition to direct intervention if pay rises in an unjustified fashion.

My second proposition is that a proportion of executives' base pay should be earned back subject to meeting performance objectives; where they are not met, that money will be lost. However, where managers surpass objectives, they will be eligible for additional pay. This will create a pay framework that, unlike parts of the private sector where executives only have degrees of upside and no downside to their pay, guarantees that executives have skin in the game. Most public servants do good, day-to-day work, but if they do not, this system will send a powerful message to the public that there are meaningful consequences for underperformance.

All this demands much stronger governance of the pay-setting process and independent assessments of performance indicators – at present very patchy. Organisations are social in character, and among the best equipped people to judge what constitutes good performance are the workforce. I recommend that employees should be represented on remuneration committees to help assess performance metrics – not only a means to ensuring that committees are more effective but to show that everybody is in the same organisational boat.

The public sector needs to make itself as attractive as possible to new recruits – and to deepen its talent pool. I propose that executive development and career paths within the public sector are radically opened up. There should be a single online portal for advertising management roles, an induction and entry training should be organised, and a passport scheme for middle and senior managers to allow them to work across the public sector and potentially private sector – deepening their opportunities and experience.

These measures are all brought together in my proposed Fair Pay Code which should not only be observed in the public sector – but by its major suppliers. This may be a demanding requirement for some PLCs whose business is largely in the public services industry – but it will be an important reminder that what they are doing, while privately run, remains in the public domain. Publicness matters, as does fair pay. It will also allow the government to protect itself from charges that it is turning over large parts of the public sector to profiteering private companies.

These fairness principles should also apply in the wider private sector. I recommend that the Government uses the provision in the coalition agreement to improve corporate reporting so that Britain follows the US and makes it a requirement that all quoted companies publish, monitor and explain their pay multiples. But the private sector has a larger problem to which it should pay heed. In many listed companies, too much remuneration is given in too undemanding a way, and the principle of earn back – in which executives face some downside risk – is often absent. In terms of creating social norms I very much hope that institutional shareholders and their industry associations will take up some of the fair pay principles and introduce them in the private sector. Britain could yet become a fairer and more productive society.

I have led this Review, but it would have been impossible without the excellent Treasury team who supported me. I would like especially to thank Kumar Iyer, Matt Ray, Iain Rolfe, Philippe Schneider, Balraj Sura and Benedict Wagner-Rundell, and to all those who have contributed their time and insights to the Review (whose names are listed in Annex G). It has been a privilege to work with them – and to apply some of my ideas on fairness to the real world of public and private sector pay.



Will Hutton

Executive summary

High quality public services require high calibre leaders to deliver them, especially in difficult fiscal conditions. A key challenge for Government is to maintain and improve the standard of public service leadership as the structures of public service delivery are reformed. Vital to this will be to ensure that public service leaders are adequately and fairly rewarded for their contributions, and that the public service ethos – that sense of mission and public duty that motivates many to work delivering public services – is maintained. This requires that a delicate balance be struck. If senior public servants are inadequately rewarded, it will be ever more difficult to attract and retain individuals of the calibre required. At the same time taxpayers are right to demand value for money from public resources, and an assurance that their money is not being wasted on excessive executive salaries. Without that assurance, trust in public services cannot be maintained.

Yet public understanding of both senior public service roles, and senior public service pay, is often very poor. A quarter of the public believe that public sector executives are currently paid more than their counterparts in private businesses, while in fact executive pay in large listed companies far outstrips that in even the largest and most complex of public bodies. The public also often have limited knowledge of what senior public servants actually do, so are not in a position to judge what level of reward is fair for these roles. Meanwhile the absence of a consistent framework of senior pay principles denies citizens reassurance that rewards are fairly matched to responsibilities and performance, and leaves a gap in which mistrust of public servants can grow.

The UK therefore needs a framework for fairness in senior public service pay. This framework should be based on the principle of fairness as **due desert**: reward should be proportional to the weight of each role and each individual's performance; should be set according to a fair process; and should recognise that organisations' success derives from the collective efforts of the whole workforce. This fairness framework will ensure that senior pay in public services is fair and seen to be fair, and will preserve the ability of public services to recruit talented individuals while reassuring the public that their tax money is not being unfairly creamed off by 'fat cat' public sector executives. This report presents the Fair Pay Review's conclusions, and sets out twelve recommendations to the Government that together form the framework for fairness.

The framework for fairness in senior public service pay: summary of recommendations

1 Using pay multiples to track executive pay against that of all employees

The Government should not cap pay across public services, but should require that from 2011-12 all public service organisations publish their top to median pay multiples each year to allow the public to hold them to account.

2 Informing the public debate through annual Fair Pay Reports

To support citizen accountability, the Government should commission the Senior Salaries Review Body to publish annual Fair Pay Reports, starting from 2011-12. These reports should set out trends in pay multiples across public services, highlight year-on-year changes and identify organisations that fail to produce meaningful, specific and verifiable explanations for their pay multiples and for changes.

3 Re-calibrating the pay of Non-Departmental Public Body chief executives

To address particular concerns that the pay of Non-Departmental Public Body chief executives has become detached from the responsibilities of their roles, the Government should by December 2011 establish a series of pay benchmarks for NDPB chief executives, following advice from the Senior Salaries Review Body.

4 From disclosure to explanation: ensuring complete transparency over executive roles and remuneration

To enable citizens to understand executive remuneration and the nature of executive responsibilities, from 2011-12 the Government should require that all organisations delivering public services disclose in precise numbers the full remuneration of all executives, alongside an explanation of the responsibilities of each role and of how executives' pay reflects individual performance.

5 Enabling citizen analysis of executive pay

From 2011-12, the Government should require public organisations to submit executive pay data through an online template, and make this data available on data.gov.uk, to allow citizens to access and analyse this data and thus have the information required to hold public service organisations to account.

6 Abandoning arbitrary benchmarks for public service pay

Once this framework of recommendations is in place, the Government should refrain from using the pay of the Prime Minister or other politicians as a benchmark for the remuneration of senior public servants, whose pay should reflect their due desert and be proportional to the weight of their roles and their performance.

7 Preventing rewards for failure through earn-back pay for senior public servants

To allow pay to vary down as well as up with performance, all public service executives should have an element of their basic pay that needs to be earned back each year through meeting pre-agreed objectives.

The Government should by July 2011 bring forward proposals for Senior Civil Service pay to include an element of base pay at risk, and should encourage the application of earn-back pay to other organisations delivering public services. This earn-back should be conditional upon meeting pre-agreed objectives; excellent performers who go beyond their objectives should be eligible for additional pay.

8 Extending earn-back pay to high performing middle managers

To identify and reward high fliers, once earn-back pay has been implemented at the most senior levels, Government departments and other public service organisations should consider offering this pay structure to middle managers on an opt-in basis.

9 Sharing the rewards of greater productivity

To prevent executives monopolising the rewards of productivity increases, and allow all employees who have contributed to share the benefits, government departments should identify ways of offering gainsharing schemes linked to achievement of the efficiency aspects of their business plans. The Government should also explore options for gainsharing schemes across public services more widely.

10 Opening up opportunities for future generations of public service leaders

To increase the supply of candidates for top positions and reinforce public service management as a career, the Government should facilitate greater opportunities for managers to move across different public services. By the end of 2011 the Government should establish a single online portal for advertisements and applications for public service management roles, and work with major public service employers to establish a passport scheme for middle and senior managers across public services. It should also drive and prioritise ongoing collaboration between public sector graduate recruitment and development programmes.

11 A Fair Pay Code

To embed fairness principles and ensure fair process in executive remuneration, all public service organisations should adopt the Fair Pay Code proposed by this Review. Government departments should by July 2011 bring forward proposals for the application of this Code to all bodies and sectors in which they have an interest.

12 Tracking pay multiples across the economy

To make tracking pay multiples normal practice across the economy, as part of its commitment to improve corporate reporting, the Government should require listed companies to publish top to median pay multiples in their annual reporting from January 2012.

The full text of the Fair Pay Review's recommendations is set out at Annex A. The full text of the proposed Fair Pay Code is set out at Annex B.

The case for fair pay in a reformed public sector

Fair pay should be understood as pay that reflects due desert: **fair pay must be both proportional to each individual's contribution and set according to a fair process.** Fairness is more than simple equality, individuals should face the consequences of their choices and efforts, but not be rewarded or punished for brute luck or circumstances beyond their control.

Fair pay is essential to high quality, well managed public services. Public services are vital co-creators of wealth and well-being, and have direct and important consequences for the lives of citizens. Public trust in public services requires that public service pay is fair and seen to be fair, and that public services stand up to high standards of scrutiny.

There are genuine concerns about executive pay in public services, as discussed in the Fair Pay Review Interim Report. These include top pay pulling away from bottom pay in many areas; a patchwork

quilt of governance arrangements; inadequate transparency; insufficient competition in executive labour markets; and the risk of senior pay inflation where institutions are granted autonomy over pay. **Taxpayers are right to demand value for money from public resources, and assurance that their money is not being wasted on excessive executive salaries.**

Yet the public overestimates how much public sector executives are paid. The sharp increase in executive pay over the last decade, and the wider trend of growing income inequality, has been largely a private sector phenomenon.

The UK must take care to avoid making the public sector a fundamentally unattractive place for those with talent and drive. Management roles in public services are becoming more complex and risky, making the need for talent greater than ever. Meanwhile elements of the wider public sector reward package are being cut back. If the wider value of public service is diminished, the talented and motivated will only be willing to work in public services to the extent that they are paid what they can make elsewhere.

A delicate balance must be struck between defending the attractiveness of public service careers while ensuring taxpayers can be confident that public money is being wisely used. **A framework for senior pay is required that is understood by both citizens and public servants to be fair, and to guarantee that public servants' pay is duly deserved for contributions that citizens value.**

Pay multiples, transparency and public accountability

The Fair Pay Review was asked to consider the case for a fixed limit on pay dispersion in the public sector, and a ban on managers earning more than 20 times the pay of the lowest paid person in their organisation. **A single limit on pay dispersion would however be unfair, hitting some organisations more than others,** and could create perverse incentives and even become a target for executives earning less. At present, a 20 to 1 maximum multiple would impact as few as 70 senior managers.

Rather than complying with a cap, organisations delivering public services should track, publish and explain their pay multiples over time. The most appropriate metric for pay dispersion is the multiple of chief executive to median earnings. This will ensure public service organisations are accountable for the relationship between the pay of their executives and the wider workforce.

To aid citizen scrutiny of organisations' pay multiples, **the Government should commission the Senior Salaries Review Body to publish annual Fair Pay Reports,** setting out pay multiples across public services, highlighting year-on-year changes and identifying organisations that fail to produce specific and verifiable explanations for their multiples and for any changes. If in the light of these reports the Government judges that pay multiples have increased without adequate justification, it should consider intervening directly to restrict executive pay.

Given the inconsistencies in their executive pay, **the Government should establish a system of benchmarks for executive pay in Non-Departmental Public Bodies on the advice of the Senior Salaries Review Body** in parallel with requiring them to public pay multiples year on year.

To ensure complete transparency over executive pay, and to aid greater public understanding of senior roles and their remuneration, **all organisations delivering public services should disclose full details of executive remuneration, together with an explanation of how executive pay relates to the weight of roles and individuals' performance.** The Government should establish an online system for comprehensive disclosure of pay data in a consistent, re-usable format to allow citizens and third-party organisations to collate and analyse these data.

Greater transparency, disclosure and explanation will allow a more rational and informed debate on senior public service pay, and enable citizens to hold public service organisations to account. **This will remove the need for simplistic benchmarks, such as the pay of the Prime Minister.**

Ensuring pay reflects performance

Understanding fairness in terms of due desert inevitably implies that pay should vary according to individuals' performance. Despite well-rehearsed objections to performance pay in the public sector, **there are compelling reasons why performance pay for senior staff should not be abandoned in the face of public criticism of bonuses, or because of difficulties of implementation.** An outright rejection of performance pay implies that there should be no financial reward to differentiate the good from the poor performer.

The public demands consequences for failure as well as rewards for success, and behavioural studies suggest that individuals are more powerfully influenced by the prospect of losses than of gains. **There therefore needs to be a better balance between rewards and penalties in performance pay schemes. The Government should give serious consideration to reconfiguring performance pay systems for senior managers to include an element of 'earn-back' pay.** This system would see executives required to meet pre-agreed performance objectives in order to **earn back** an element of their basic pay that had been placed at risk. Only if objectives were met would executives receive their full basic pay, and only if objectives are clearly exceeded can additional awards be made.

The public sector may be missing out on high calibre individuals because it does not offer sufficient opportunities and incentives to perform. Public sector organisations may not do a satisfactory job of spotting and developing future senior managers at the mid-career stage. **If employees were not eligible for additional performance pay unless they also signed up to earn-back, this could prove a useful way of helping to attract and identify strong performers.**

It should be possible to design team-based incentives that reconcile the importance of due desert with the reality that outcomes are collectively produced by the whole of an organisation's workforce. In this context, **gainsharing – the sharing of the rewards from productivity gains and resultant savings among all the staff that contributed to them – is an option that should feature more often.**

Strengthening the talent pipeline

The ability to attract, retain and develop high calibre employees is a vital prerequisite of strong and innovative public services. Action is needed to support and expand the 'pipeline' of talent that supplies public service organisations.

There are four key priorities in this area. **The talent pool from which executives are recruited should be broadened,** to minimise the risk of constrained supply putting upward pressure on senior pay. **Managers should be supported at all stages of their development,** to maximise the opportunities for managers to progress and build varied careers within public service. **Broader career paths should be encouraged** to produce the cross-sectoral skills vital for public service reform to succeed. And **the profile of public service leadership should be raised to reinforce the value and ethos of public service** and help the public sector to compete for the best.

A cultural shift is needed among recruiters, who should be encouraged to be more open to talent across public services, and given the infrastructure to allow them to look more widely when filling top positions. **An online recruitment portal for the advertisement of management roles across public services would help achieve this. There would also be benefit in a 'passport' scheme that helped open up movement across different areas of public services, as well as to and from the private sector.** This would not just help ensure adequate competition for top jobs to restrain unnecessary pay inflation, but would also help to match public servants' desire for greater opportunity and progression with the need to develop people capable of leading public services in a time of institutional reform and disaggregation.

Attention also needs to be given to the leaders of the future. Given the influence of factors such as career prospects and job security on attracting graduate recruits, there are risks to the quality of the

public service workforce if these factors are diminished, especially in a time of spending restraint. **Greater collaboration between graduate schemes can help ensure graduates see a career in public services as having varied career prospects. It should also help graduate recruits to develop the cross-sectoral experience and genuine generalist skills that leaders of the future will need.**

A Fair Pay Code

Independent pay-determination is vital for fairness, particularly where pay can vary with performance. Employees must perceive that pay-setting processes are fair, and be assured this they are free from arbitrary influences such as political interference. Taxpayers must also be confident that decisions about pay and performance are robust and protected against undue managerial influence.

Pay governance practices currently vary significantly across public services. Such variation is not necessarily a problem, but to reassure the public **a consistent framework of pay principles should be established.**

The Senior Salaries Review Body has produced a draft Code of Practice on senior pay. This has much to recommend it, but does not include fairness among its principles. Building upon this work, **this Review has therefore produced a Fair Pay Code, to be adopted by all organisations delivering public services on a 'comply or explain' basis.**

This new Code includes provisions on proportionality in executive pay, the use of variable pay and enhanced disclosure of executive pay in line with the recommendations of this Report. It also requires improved independent pay-determination processes.

To ensure that decisions on executive pay take account of the whole workforce context, and that executive pay decisions are justifiable to all employees, **organisations delivering public services should include an employee representative in the membership of their remuneration committees.**

There are risks in a 'comply or explain' approach; hence the importance of supporting good governance with the potential for tougher regulatory intervention, through a 'pyramid' of gradually escalating sanctions.

Fair Pay as a Social Norm

The principle set out in this Review, that pay should reflect due desert, set within a fair process, applies more widely than just to the issue of differentials between top pay and the pay of the rest. It is unfair that anyone should be rewarded or penalised for the brute luck of having been born male or female, or into any given ethnic or socio-economic background.

The revolution in executive remuneration is part of a wider trend of increasing pay dispersion. Some of this will have been fair and deserved, but some attributable to brute luck and economic rent.

There is growing concern that increasing executive pay is not justified, and that it has detrimental results for organisations and for society at large.

The pay norms that are accepted where public meets private will affect the ability of public sector organisations to recruit and retain. Hence **it is important that the Fair Pay Code and as far as possible the other recommendations of this Review are extended into the public services industry.**

The framework of tracking multiples, of transparency and explanation, of earn-back, of escalating intervention, and of widening the talent pool, should be applied in the private sector.

1

The case for fair pay in a reformed public sector

Chapter summary

Fairness should be defined as due desert – that individuals should face the consequences of their choices and efforts, but not be rewarded or punished for brute luck or circumstances beyond their control. Fair pay must be both proportional to each individual's contribution, and set according to a fair process.

Fair pay is essential to high quality, well managed, public services. Public services are important contributors to wealth and well-being, have direct and important consequences for the lives of citizens, and must stand up to high standards of scrutiny.

There are genuine concerns with executive pay in the public sector, as highlighted by the Interim Report: the fact that in many areas top pay has outstripped low pay; a patchwork quilt of governance arrangements; inadequate transparency; insufficient competition when top roles are recruited; and the risk of pay escalation where autonomy over pay is being granted. **Taxpayers are right to demand value for money from public resources, and an assurance that their money is not being wasted on excessive executive salaries.** Without that assurance trust in public services cannot be maintained.

Yet the public overestimates how much public sector executives are paid. Significant increases in executive pay over the last decade, part of a wider trend of growing income inequality, is largely a private sector phenomenon.

The UK has to guard against making the public sector a fundamentally unattractive place for those with talent and drive. Management roles in the public sector are becoming more complex and risky whilst elements of the reward package are being cut back. The talented and motivated will only want to enter a devalued public service to the extent they are paid what they can make elsewhere.

A framework for senior pay is required that is understood by both citizens and public servants to be fair – that pay reflects contributions that citizens want and value.

Fairness and fair pay

1.1 The evidence from moral philosophy and behavioural science is that **fairness should be defined as due desert – that individuals should face the consequences of their choices and efforts, but not be rewarded or punished for brute luck or circumstances beyond their control.**

1.2 Fairness should not be understood as simply about equality of outcomes. Individuals' due desert will vary according to their differing contributions and choices. Human beings strongly distinguish between deserved and undeserved gains – crucial to any conception of what is fair.¹ For example, a

¹ Interim report, chapter 1

properly competitive labour market works to ensure that employers get what they pay for, and employees get what they work for and thus deserve. However, where there are market failures, for example that enable executives to extract more than their economic contribution (what economists call 'economic rent') remuneration departs from due desert – it is undeserved.

1.3 Fairness requires fair processes as well as fair outcomes. People care passionately about the fair or due process by which decisions are reached, often showing considerable willingness to make sacrifices on outcomes in return for satisfying themselves that processes were fair.² Fair process has two crucial characteristics – impartiality and transparency of the decision-making process on the one hand; and secondly the ability to participate in shaping decisions. One focuses simply on whether there is a level playing field, whether procedures are even-handed and decisions rely on facts rather than personal opinions. The other builds on this by giving people the opportunity to express their views to decision-makers.

1.4 From this definition of fairness as due desert realised by due process it follows that **fair pay must be both:**

- **proportional to each individual's contribution, and**
- **set according to a fair process.**

1.5 Pay that is proportional to the value of an individual's contribution should reflect both:

- **The nature of the post** – senior executives managing large organisations will manage greater complexity, have greater influence, and greater responsibility for their organisations' outcomes than a new graduate entrant or junior employee; and
- **The performance of the post holder** – some individuals will make greater efforts than others to put their talents and abilities to productive use.

1.6 Fair pay does not mean equality of outcomes, but it does imply that with few exceptions, pay levels will remain within bounds. The emphasis on proportionality implies that there is a limit to how much of wider staff performance can fairly be ascribed to an organisation's leadership (productive work does not all cease the instant a leader leaves); so there should be a limit on how far rewards for collective success can accrue to a single individual or small group. It cannot be fair for a small elite to 'scoop the pool' entirely.

Conclusions of the Interim Report

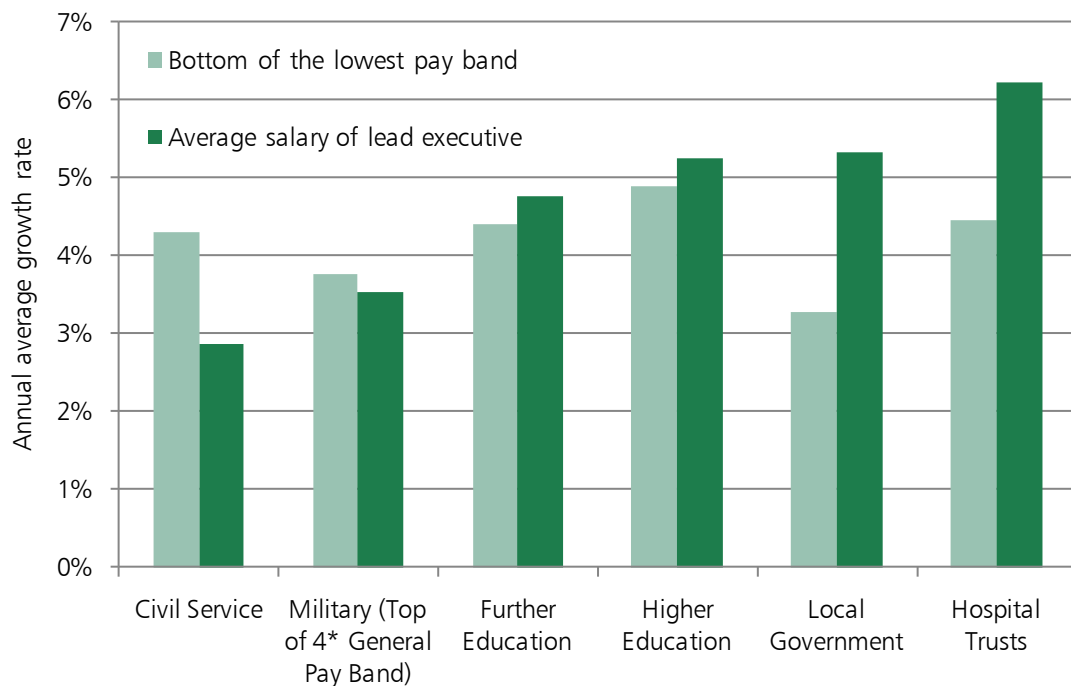
1.7 At the interim stage, the Review's key conclusions regarding executive pay in the public sector were as follows:

- **Although rises in pay for public sector executives is not matching the rise in private sector pay, it has been increasing faster than pay for public sector low earners – begging the question of whether this has been proportional.** Pay ratios in the public sector have also increased over the last decade, with pay for top earners in most public sector workforces increasing faster than for bottom earners since 2001 (chart 1A).

² In a seminal study of responses to arbitration processes, Lind et al (1993) found that individuals rated the fairness of the dispute resolution process so highly that they were willing to forgo as much as \$800,000 in return for the chance to participate in an arbitration process that they trusted to be impartial, that treated them respectfully and offered them an opportunity to make their case. 'In the eye of the beholder: Tort litigants' evaluations of their experiences in the civil justice system', Allan Lind, Robert MacCoun, Patricia Ebener, William Feslimer, Deborah Hensler, Judith Resnik and Tom Tyler (1990) *Law and Society Review* 24(4): 953-996. See also 'Procedural Justice and Compliance with the Law' Tom Tyler (1997) *Swiss Journal of Economics and Statistics*, 133(2): 219-20.

Chart 1.A: Average annual salary growth for top management positions and bottom of pay spine for selected workforces between 2001 and 2008

In the NHS, local government and further and higher education, median top salaries have been growing at faster rates than entry level salaries



Source: Fair Pay Review analysis
See Annex E for full details of the sources

- **Yet it is difficult for the public to be assured that senior pay in the public sector matches performance.** There is a patchwork quilt of pay arrangements, inconsistent governance and insufficient transparency, which may not be controlling senior pay sufficiently nor supporting public scrutiny adequately. And given the deep seated performance issues, the public sector should look again at the opportunities presented by greater use of performance pay, particularly schemes that emphasise group or organisational performance.
- **Restricted labour markets for senior positions are unnecessarily fuelling pay inflation.** In a number of sectors the Review heard concerns about the adequacy of internal talent coming through to senior roles; it is also questionable whether there is enough focus on recruiting from a sufficiently wide pool of candidates. These create avoidable pressures on pay.
- **The risks of unfair rises in executive pay may increase as the public sector is reformed.** It is notable that those areas that have seen the lowest growth in senior pay (and levels of growth most close to bottom pay) are those where Ministers, supported by the Senior Salaries Review Body, have greatest influence over all aspects of the pay package. The more boundaries of the public sector are broken down, the more it risks being exposed to private sector competition for scarce managerial talent. Greater flow of managerial experience, expertise and mutual understanding between sectors may well bring great benefits to the country. But there are serious risks of further pay inflation, unless senior pay is carefully monitored.

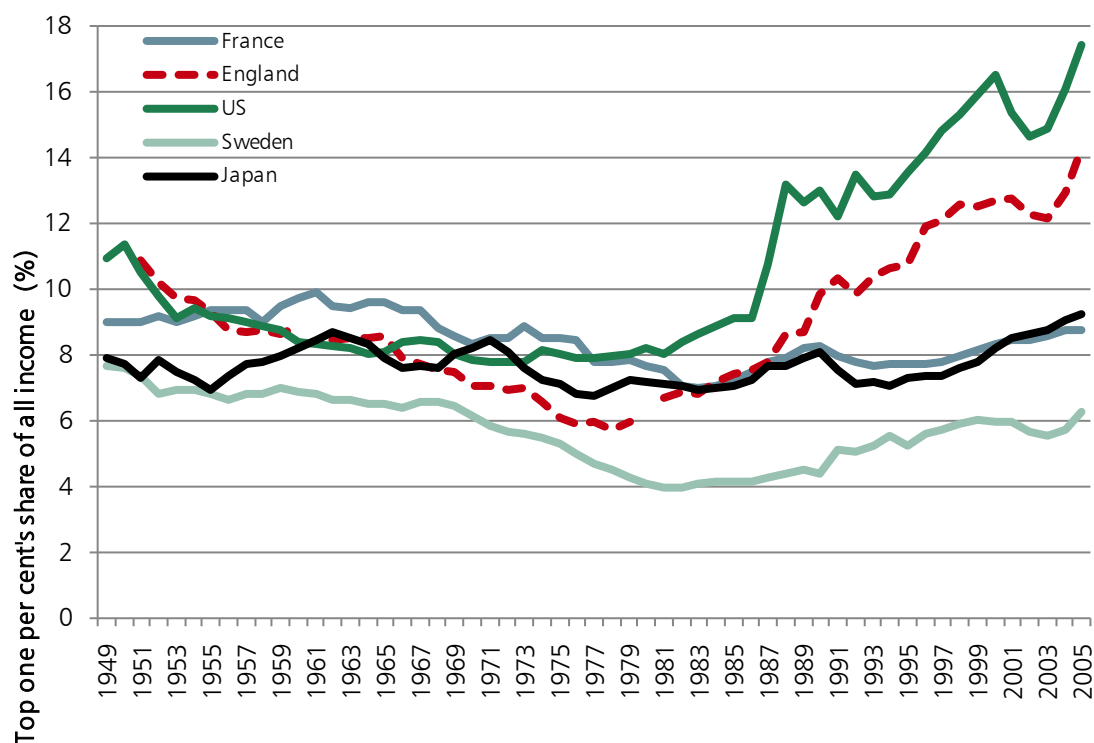
- **Misconceptions about senior public sector pay risk undermining the relationship between public servants and citizens.** Though there are issues to be addressed, the public overestimate how much public sector executives are paid and doubt that they are worth it. If top professionals no longer feel valued, the public sector is likely to have to pay more, rather than less, to encourage talented people into senior roles.

Pay dispersion and desert

1.8 After decades of decline, income inequality in the UK has seen a reverse and significant rise since the 1980s. This is consistent with the experience of the United States, less so other nations (Chart 1.B).

Chart 1.B: The share of total pre-tax incomes received by individuals within the top one per cent income bracket, in selected developed nations

In the US and England, individuals with the highest incomes have been taking a greater share of total incomes since the 1970s – reversing the trend of the previous 30 years

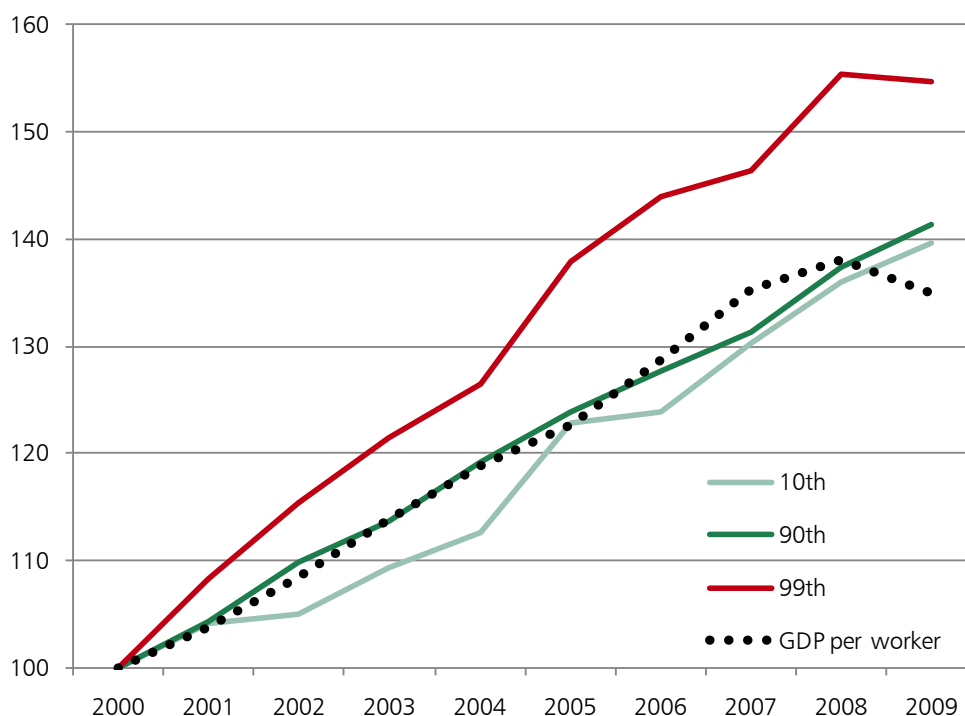


Source: 'Top Incomes in the Long Run of History', A. B. Atkinson, T. Piketty and E. Saez (2010)

1.9 The distribution of wages or salaries is a vital factor in shaping income inequality, though there are others (e.g. pensions, income from capital). Pay is in the UK is unevenly distributed, and the gap between the top one per cent and the rest of the population has been widening steadily over the last decade (Chart 1C) – in other words, 'pay dispersion', the way pay is distributed across the population, is rising.

Chart 1.C: The Top pulling away: Gross annual earnings of 99th, 90th and 10th percentiles against GDP (indexed, 2000=100)

The top one per cent of earners have seen their earnings grow much faster than others, even relatively high earners



Source: Fair Pay Review Analysis of ASHE. GDP figures from HM Treasury

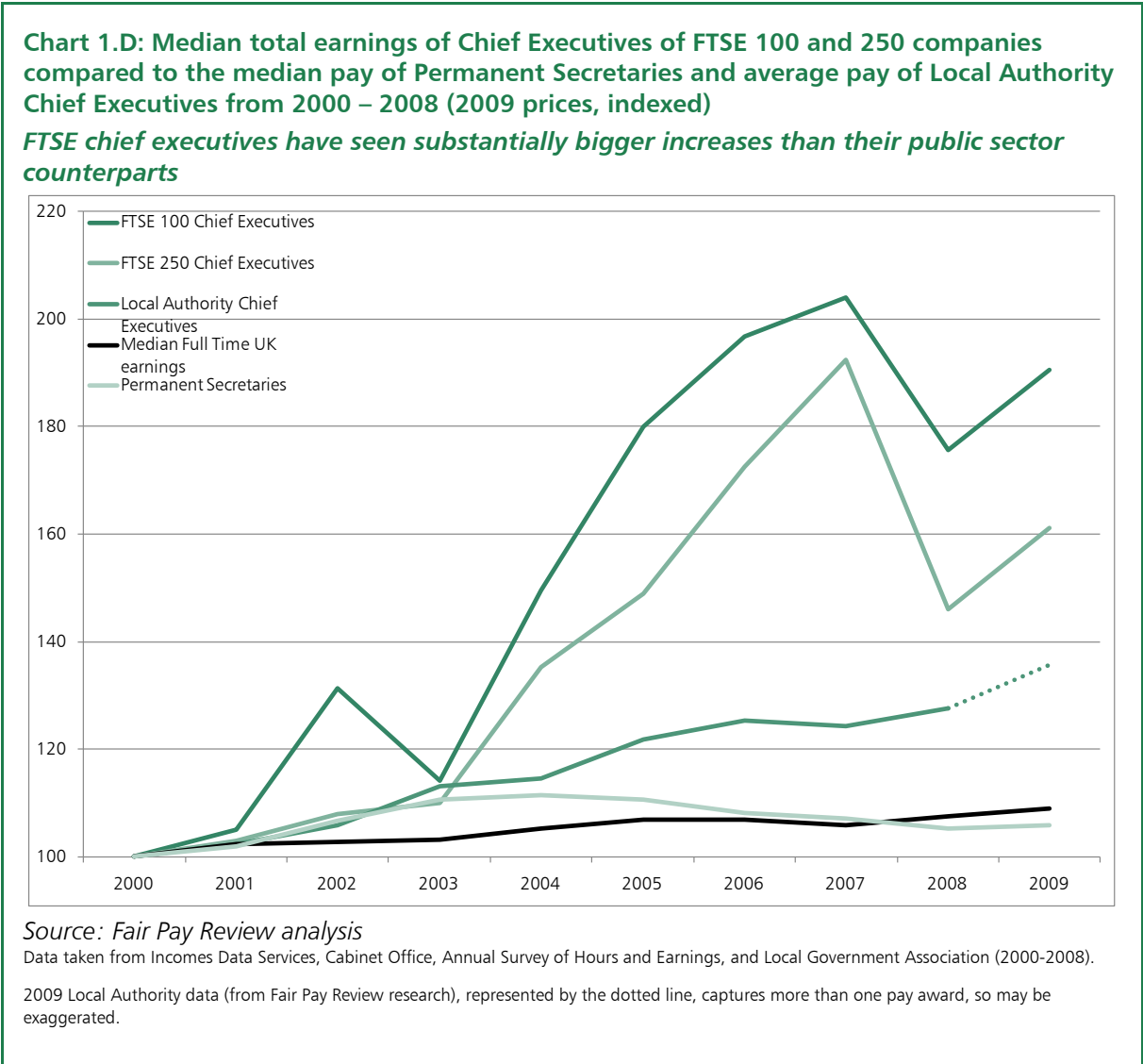
Note that the relationship between earnings and GDP can change over the course of an economic cycle, which can make inference difficult through time. This chart makes no attempt to adjust for these changes. The chart does not attempt to factor in changes in working hours: however according to ASHE the median working week was 37 hours in both 2000 and 2009 for all employees. The chart also makes no attempt to factor in changes in productivity between sectors.

1.10 There is a combination of factors that underlie these trends to greater pay dispersion. These will include technological change and the rising importance of skills in a knowledge-based economy, the decline of organised labour and other checks and balances, the deregulation and privatisation of major industries, the increasing importance of the stock market, share-based remuneration, different countries' responses to globalisation, and changing social norms. Some of the consequences of these factors on people's incomes will be fair, in the sense of being earned and deserved; others will have more to do with luck and economic rent. It is the dramatic extent of some rises in pay, and the extent to which these have been deserved, that make the debate so toxic.

Comparisons of executive pay in public and private sectors

1.11 The increase in the growth rate of the earnings of the very high earners is a private sector phenomenon. For all FTSE 100 chief executives the median pay has risen to 88 times UK median earning and 202 times the national minimum wage, up from 47 times and 124 times respectively in 2000. Whereas, **the share of top percentile wages earned by public sector workers has been declining, and now accounts for less than one per cent of those top wages.** In other words, while public sector employees represent around seven per cent of the highest one per cent of earners,

those seven per cent only receive one per cent of top earnings. Approximately one in 85 workers in the private sector earn over £150,000 a year, compared to just one in 280 public sector workers.³

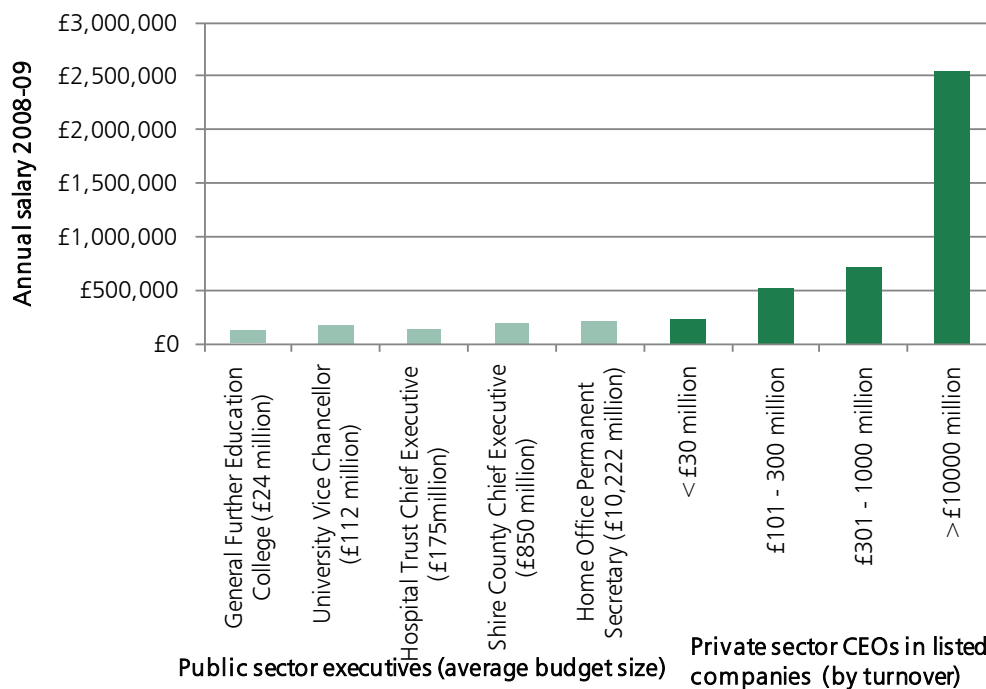


1.12 A comparison based on budget and turnover shows that executives in the private sector are consistently paid more, even where public sector executives are responsible for very large organisations (Chart 1E). CEOs of companies with a turnover of between £101 and £300 million earn more than twice their public sector counterparts, and the gap rises as turnover rises. The permanent secretary at the Home Office earned between £192,000 – 197,000 in 2009-2010, managing a turnover of £10 billion. Anyone running a private sector operation of that size is on a median package of £2.5 million.

³ Fair Pay Review Interim report, chapter 2

Chart 1.E: Average remuneration for selected senior public sector positions with average budget controlled compared to median realised remuneration for chief executives of private sector firms with a range of turnovers

Earning for public sector executives do not compare favourably with those in the private sector, even given size of budget



Source: Fair Pay Review analysis. Various sources for public sector, see Chart 2.1. Private Sector: Manifest/MM&K Executive Director Total Remuneration Survey, September 2009

'Realised remuneration' is the sum of salary, benefits, cash bonuses and the amount of long term incentives 'paid out', i.e. notional gains from options exercised in the year calculated at the date of exercise on options, plus the value of other share schemes that vest in the year. For more details, see Annex E below.

1.13 Simple comparisons of organisation size of course mask very real differences in the size of the role of the leader in what are very different types of organisation; and it may be objected that any private sector CEO can only be paid if his or her organisation is profitable - a crucial test that does not apply to the public sector. Yet when this is adjusted for, **analyses of job size and complexity still consistently find that public sector roles pay considerably less than equivalent roles in the private sector.**

- Independent comparisons based on job complexity have found that median total remuneration (including pensions) for civil service directors was just 53 per cent of median remuneration for comparable private sector jobs.⁴
- An evaluation of senior military roles rated 3* officers (Lieutenant-General or equivalent), who earn a maximum of £151,609, as a role of comparable size to the chief executive of a smaller FTSE 350 company (who typically earn £600,000 or above).⁵
- Another found that total remuneration (again including pensions) for local authority chief executives was just 51 per cent of that for comparable private sector roles.⁶

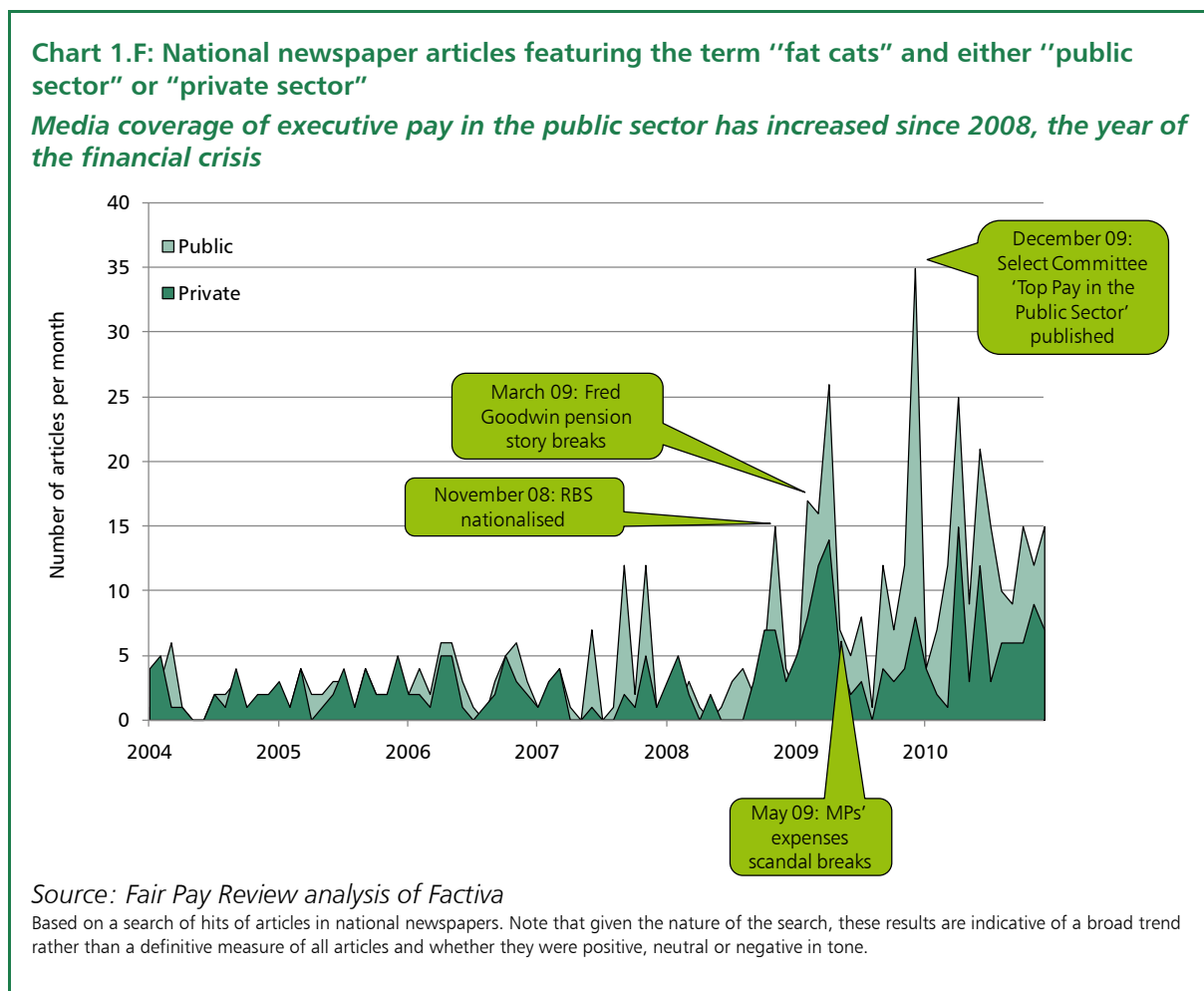
⁴ Hay Group analysis for Cabinet Office

⁵ Hay Group analysis for Ministry of Defence

⁶ Unpublished PwC analysis. <http://www.ukmediacentre.pwc.com/content/detail.aspx?releaseid=3267&newsareaid=2>

1.14 This picture is not reflected in public opinion. The public overestimate how much public sector executives are paid. According to a poll conducted by YouGov and ITV in October 2009, just 36 per cent of those surveyed thought that people who ran public sector organisations were paid less than their private sector counterparts, while 25 per cent thought they were paid more.⁷ Nor is there much of an understanding of what many public sector managers do, the contribution their organisation makes or the risks and responsibilities they confront.

1.15 Public sector executives have clearly been swept up in wider concerns about elite pay, notably bankers' bonuses, MPs' expenses and FTSE chief executive remuneration (Chart 1.F). The Interim Report noted that newspaper articles including all of the terms 'Public Sector', 'Chief Executives' and 'Pay' increased by over 200 per cent between 2004-05 and 2008-09.⁸ Newspaper reports including both the phrases 'Public Sector' and 'Fat Cats' increased by nearly 400 per cent over the same period.



1.16 The points set out above do not imply that public sector leaders should earn salaries on a direct par with their private sector equivalents (though 72 per cent of people think that those running public and private sector organisations should be paid about the same).⁹ Working in the public sector has traditionally been seen as providing a range of other benefits including pensions and job

⁷ YouGov 2009

⁸ Search made using Factiva looking at UK National Newspapers.

⁹ YouGov, 2009.

security.¹⁰ In addition, many individuals are inspired to work in the public sphere because of the chance to further the public good – the public service ‘ethos’. Effectively, **the public service ethos is part of the overall public sector reward package**. Employees working in public services may accept lower pay than their private sector counterparts, because they value the opportunity to serve the public.

The value of public service leadership

1.17 Public services require high calibre individuals to lead them. This is because public services are important contributors to wealth and well-being, have direct and important consequences for the lives of citizens, and must stand up to high standards of scrutiny:

- **The public sector is a co-creator of wealth and an important source of social well-being.**¹¹ Much of the hard and soft infrastructure that supports wealth generation – in energy, transport, science, education and skills, the protection of intellectual property and so on – is created by the public sector. The public sector mitigates personal risk otherwise borne by citizens, by providing national defence, law and order, and social security. Individual and public health is underwritten by the National Health Service.
- **Working in the public sector entails great responsibility.** When public bodies fail in their tasks, the consequences of this failure more commonly fall on wider society than failure by a private firm. Public bodies are engaged in delivering public goods, for example macroeconomic stability, climate change mitigation or the prevention of terrorism: any mistakes can be catastrophic for entire populations and industries. Public provision can directly and substantially affect health, liberty, safety and personal autonomy; in other words, peoples’ freedoms and aspirations.
- **Both because of their funding and their nature, public services must meet high expectations of accountability.** Public bodies acknowledge a legitimate public interest in their activities, and subject themselves to binding constraints and scrutiny. This scrutiny can come either via elected bodies such as Parliament or through the courts, for example through the process of judicial review.

1.18 The context for leadership of public services is changing. The Government is in the early stages of a programme of potentially significant public service reform. Its publicly stated intentions are to localise power and funding, increase the diversity of provision in public services, and supporting communities, citizens and volunteers to play a bigger role in shaping and providing services.¹² Through such reforms the Government hopes to promote innovation, release energy and a greater customer focus. These ambitions will accelerate existing trends which are seeing both public and private sectors ‘disaggregate’ – that is, see industrial scale organisations, which grew larger in the search for economies of scale, give way to a network of more varied autonomous units, which gain in autonomy, adaptability and flexibility.

1.19 Despite this changing context, there is a quality of “publicness” to the extent that the provision of services should be universally available without exception. And they must remain accountable and participatory: for the quality of service that is provided and to whom, for how taxpayers’ money is spent, to demonstrate that power has not been abused, and to provide redress and maintain democratic oversight.

¹⁰ ‘Labour market flows: facts from the United Kingdom’, Pedro Gomes, Bank of England Working Paper No. 367, April 2009

¹¹ *Growing Public: Volume 1 The Story, Social Spending and Economic Growth since the Eighteenth Century*, Peter Lindert (2004), Cambridge University Press.

¹² http://www.hm-treasury.gov.uk/spend_sr2010_reform.htm

1.20 Outsourcing challenges these values of universality, accountability and participation. Some argue that a well-defined contract, monitored and enforced by government, will ensure that these values be maintained. Obviously some spheres of activity – notably those that involve routinised or commoditised production like back office processing of data or administering congestion charging - are comparatively easier to contract. They allow the tight specification, and measurable outcomes, along with more competition, which combine the best of public and private. Yet where functions cannot be specified in a contract with much precision or elude clear evaluation or that they are available on the market only from monopoly providers, it is much harder to specify all the likely eventualities needed to protect publicness. For example, one of the problems of the Public Private Partnership for the London Underground was that it was simply impossible to write robust contracts that covered the range of eventualities, leaving the way open for impossibly difficult wrangling over how to interpret the contracts that ultimately contributed to the PPP's collapse. Profit-maximising private firms often have incentives to reduce costs regardless of the consequences for the (non-contractible) quality of the public good, however important.

1.21 It is in this context that many public sector leadership roles are becoming more complex. For instance, even within the non-contracted out public sector, Foundation Trusts have greater freedom and local accountability than previous provider organisations. The size of the job of the chief executive and directors has typically grown. Similarly, as schools have moved away from local authority control to greater autonomy, there has been greater accountability for headteachers. And more recently, there has been a trend towards clustering or even merging of schools under executive heads, who have greater responsibility. In some instances, commercialisation (a move from agency to trading fund or government-owned company) also brings greater freedom – to set strategy, develop new areas of business, reinvest, borrow, and so on.¹³

1.22 Public sector leaders are increasingly, and rightly, expected to be held accountable. However, this can sometimes lead to instances where an individual is publicly vilified in the national media following a failure, a notable example being Sharon Shoosmith, the Director of Children and Young People's Services in Haringey, following the 'Baby P' case.

1.23 In parallel to these structural changes to public services, the 'package' of rewards for public sector leaders are being recast. Changes, including those set out below, are likely to make leadership roles more complex and more risky:

- **Length of tenure.** Average tenure for local authority chief executives is approximately four to five years, and there are real concerns in the NHS, where the average tenure of NHS acute trust chief executives is just two years and four months.¹⁴ Such short tenures not only compare unfavourably with the private sector (average tenure for FTSE 100 chief executives is currently 5.9 years),¹⁵ but are also not conducive to successful management: business management research suggests that most chief executives need an average of 30 months to complete their learning curve upon taking up a new role.¹⁶
- **Job security.** Clearly, at a time of public spending restraint and job losses there will be an impact on job security. The latest forecast from the Office of Budgetary Responsibility is for 330,000 jobs to be lost over the next 4 years.

¹³ Evidence to the Review from Hay Group

¹⁴ *NHS Chief Executives: Bold and Old*, Hoggett Bowers, June 2009.

¹⁵ Data on FTSE 100 CEO tenure as published in the survey by Accountancy Magazine, November 2010.

¹⁶ *Dynamics of executive succession*, Kakabadse and Kakabadse, Cranfield School of Management, 2001.

- **Pay.** Public spending restraint has fed through to executive pay in at least some areas. All Senior Civil Servants have been subject to a two year pay freeze, and 25 per cent of Local Authority chief executives are reported to have taken pay cuts in the last year.¹⁷
- **Pensions.** Following the recommendations of Lord Hutton's Independent Public Service Pensions Commission, public sector employees will have to work longer before being able to draw their pensions, while high earners will be likely to see pension benefits reduced as a result of a shift from final salary to career average pensions.¹⁸

The need for a change in the top pay debate

1.24 The public will be readier to acknowledge the vital role of public service leaders if they know whether managers have performed or not, and whether they are receiving their due. The Interim Report noted that, as in the example of the headteacher of Tidemill Primary School in Lewisham, the public is ready to regard packages of £200,000, including bonuses, as genuinely deserved when they can see for themselves that the individual in receipt of such remuneration has really made a difference.

1.25 The current discourse is unbalanced. A fear of witch hunts of high earners – without a frame of reference by which to judge fairness – has made some public organisations resist greater transparency less appealing.¹⁹ According to recent research on the pay of university vice-chancellors, fear of being publicly identified as an outlier has led institutions to constrain pay without regard to the weight of role or individual performance.²⁰ It can also perversely drive pay up, with candidates for particularly exposed jobs demanding 'danger money' to compensate them for the risk of coming under intense media scrutiny: Sharon Shoemsmith's successor now earns approximately two thirds more than she did.²¹

1.26 Government responses (both the previous and current administrations) have not been sufficient to quell the public outrage – itself the consequence of a distorted media narrative. Rather, there is a trend to compare the salaries of all public servants with that of the Prime Minister which makes matters worse – and feeds the narrative. This measure has the advantage of simplicity, but is profoundly flawed:

- Firstly, it does not capture the Prime Minister's total remuneration – not least because David Cameron has chosen not to take the full salary to which he is entitled (£198,660). If the value of the Prime Minister's living arrangements and allowances are included, his total remuneration would be significantly greater than even this higher salary: one estimate put it as over £580,000.²²
- Secondly, and more importantly, the Prime Ministers' pay is not objectively linked to the value of his job, or to the need to recruit and retain individuals. The rate is determined by politics more than by responsibility, (hence Prime Ministers are prepared to accept a considerable 'political discount' to their salary). The Prime Minister's salary has no relation to labour markets. There is not a shortage of applicants and no job specification and there is no market or recruitment process for Prime Ministers. Hence

¹⁷ Local Government Chronicle, 27/01/11, based on a sample of 138 Local Authorities

¹⁸ Independent Public Service Pensions Commission: Final Report

¹⁹ <http://www.telegraph.co.uk/news/uknews/7259289/Councils-afraid-to-say-how-muchthey-pay-chiefs.html>

²⁰ 'The Legitimacy of Pay and Performance Comparisons: An Analysis of UK University Vice Chancellors Pay Awards' Heather Tarbert, Kaihong Tee and Robert Watson (2008), British Journal of Industrial Relations 46(4): 771–805.

²¹ Haringey's annual accounts 09-10 record their director of children's social services as earning a salary of £230,000. Sharon Shoemsmith was reported to have earned in the region of £133,000 - £140,000 according to newspaper reports (she is not named in previous years' accounts).

²² Radio 4's 'More or less' calculated that the PM's total package could be worth £581,651, including an estimate of the annual cash value of the pension (£45,651), a nominal rental value of accommodation at Downing Street and Chequers of £338,000.

any comparison with a job for which pay is set by reference to a need to recruit and retain in a market is an invalid one.

1.27 With some 9,000 individuals earning more than this across the public sector²³, widespread use of this benchmark would risk damaging a wide range of organisations' ability to recruit and retain talented individuals. The United States, which does benchmark public servants pay to that of politicians, may serve as a warning (Box 1.A).

Box 1.A: Executive pay in the public sector – a warning from the United States²⁴

John Donahue of Harvard's Kennedy School of Government has argued that in recent decades, public and private sector pay in the United States has become increasingly detached, with potentially serious consequences for government performance. Analysis by the World Bank, based on performance rankings, shows that the US Government's effectiveness fell significantly from 1996 to 2009.²⁵

It is difficult to prove definitively that pay compression has damaged government performance, especially compared to the private sector. But many concerns have been expressed that, for example, very well paid financial executives will always outwit less well paid regulators. Pay scales are so low that for an entire year a crucial post of director of the Office of Drug Safety was vacant while controversy raged over drug safety rulings.

There is evidence that frustration with constrained rewards and rigid work structures has induced many talented, energetic and publicly-spirited professionals either to move out of government or shun it altogether. Empirical work shows this trend follows quite faithfully the widening dispersion in pay between public and private sectors which began to take off in the 1970s. And there is evidence that too often, talented workers find their career progression blocked by undue deference to senior employees who have the credentials on paper but who fall short in practice.

²⁶

These problems contrast with public administrations that are recognised as high performing. For example, in Singapore, workforce structures prepare young administrative service officers to be ready for senior management positions by their mid-30s, while those already in senior positions are enabled to move on quickly, including into the private sector.²⁷

To address this escalating crisis, Donahue calls for greater efforts to rehabilitate the prestige of public service and a partial shift to market provision of public services. Most important, he recommends more concerted efforts to facilitate the flow of people between public and private sector, something which would break with the traditional career path. In this way, careers of periodic public service intermingled with more profitable private work along with appropriate sequencing of jobs at different stages of people's lives would become the norm and a circuit-breaker for persistent pay differentials.

1.28 A delicate balance needs to be struck:

- On the one hand, there are genuine concerns about executive pay in the public sector, as highlighted by the Interim Report: the fact that in many areas top pay has

²³ According to data compiled by BBC Panorama.

²⁴ *The warping of government work*, John D Donahue, 2008

²⁵ World Bank World Governance Indicators available at <http://info.worldbank.org/governance/wgi/resources.htm>

²⁶ 'The Wage Structure and the Sorting of Workers into the Public Sector', George Borjas (2002), NBER Working Paper No.9313

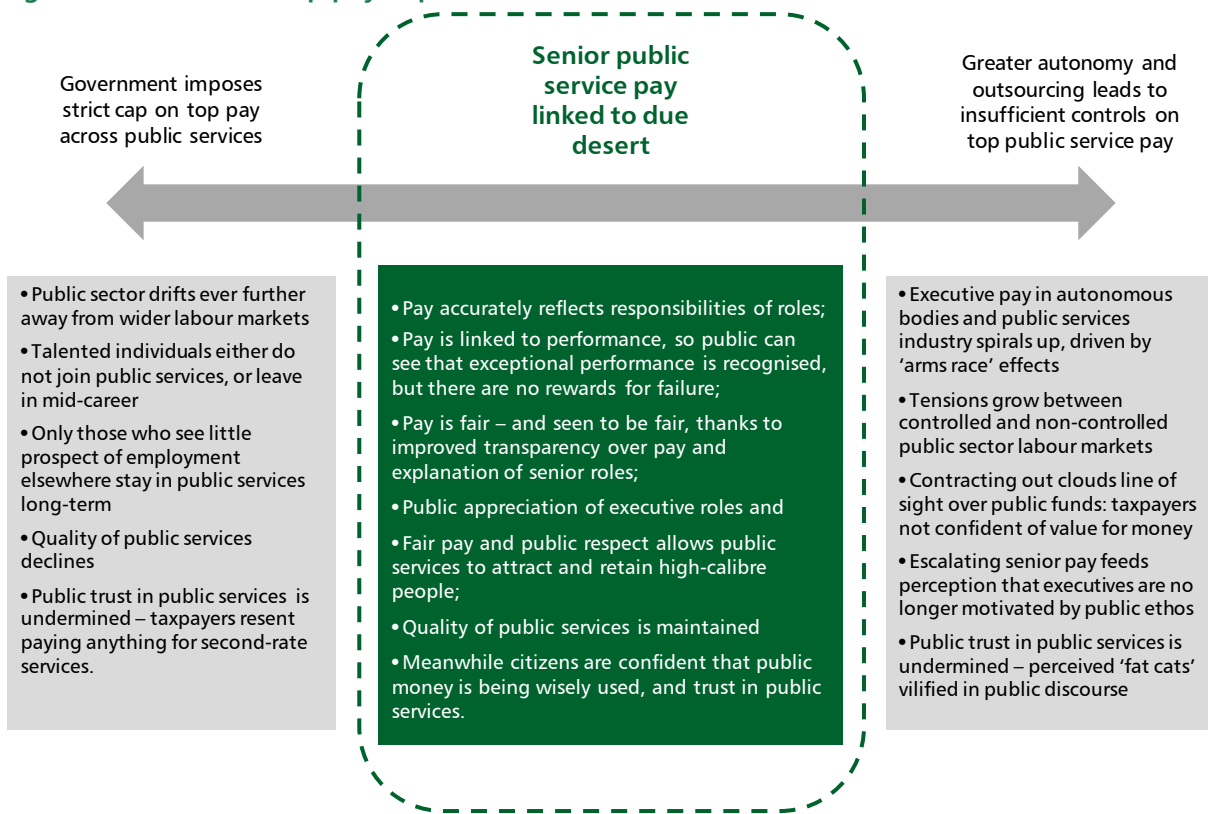
²⁷ 'Talent Management in the 21st Century: Lessons from Singapore', Peter Cappelli (2007) Human Capital Institute Working Paper

outstripped low pay; a patchwork quilt of governance arrangements; inadequate transparency; insufficient competition when top roles are recruited; and the risk of pay escalation where autonomy over pay is being granted. **Taxpayers are right to demand value for money from public resources, and an assurance that their money is not being wasted on excessive executive salaries.** Without that assurance trust in public services cannot be maintained.

- On the other hand, **the UK has to guard against making the public sector a fundamentally unattractive place for those with talent and drive.** Management roles in the public sector are becoming more complex and risky whilst elements of the reward package are being cut back. At the same time, there is a growing cynicism about the motivations of people in the public sector, heightened by the narrative of ‘fat cats’. The undervaluation of public service will inevitably undermine the public sector ethos. The talented and motivated will increasingly avoid a public service career or demand the going rate elsewhere. The capacity to recruit high calibre individuals will become ever harder and the public sector will become increasingly ineffective.

1.29 In short, how it rewards those who lead its public services will be a major determinant of the kind of public services the UK gets. There are a range of foreseeable futures (Figure 1A).

Figure 1.A: Visions of top pay in public services



A framework by which top pay is fair and seen to be fair

1.30 A key challenge for Government is to maintain and improve the standard of public service leadership as the structures of public service delivery are reformed. Vital to this will be to ensure that public service leaders are adequately and fairly rewarded for their contributions, and that the ethos that motivates many to work delivering public services is maintained.

1.31 A framework for senior pay is required that is understood by both citizens and public servants **to be fair – that pay is duly deserved for contributions that citizens want and value.** This must be clearly understood by all, so that citizens can better challenge public bodies about executive pay, and

that can equip those same bodies with a clear frame of reference through which to respond. To get around the increasing difficulty of defining public and private boundaries, it must be applied broadly to all providers of public services whether public or private or in partnership.

1.32 The Interim Report pointed the way to a framework for fairness covering disclosure requirements based on a pay ratio; better use of performance pay; a renewed emphasis on the competitiveness of executive labour markets through ensuring a wide pool of candidates; and better governance and transparency.

1.33 This final report sets out recommendations in these four areas as follows:

- **Chapter 2 makes recommendations on the role of pay multiples, transparency and public accountability.**
- **Chapter 3 makes recommendations on ensuring that pay reflects performance.**
- **Chapter 4 makes recommendations on strengthening the talent pipeline to senior positions.**
- **Chapter 5 recommends a Fair Pay Code to set standards of governance.**

1.34 The Terms of Reference committed the Review to maintaining a focus on shaping wider social norms on fair pay. **Chapter 6 recommends action in the private sector to help embed these norms.**

2

Pay multiples, transparency and public accountability

Chapter summary

A pay cap based on a 20:1 top to bottom multiple would impact as few as 70 senior managers across public services. And **any single limit on pay dispersion would unfairly hit some organisations more than others**, could create perverse incentives and even become a target for those executives earning less.

Rather than complying with a cap, organisations should track, publish and explain their pay multiples over time. The most appropriate metric is top to median earnings. This will ensure organisations delivering public services are accountable for the relationship between the pay of their executives and the wider workforce ('pay dispersion').

The Government should commission the Senior Salaries Review Body to publish annual Fair Pay Reports, setting out the data on pay multiples across public services and identifying organisations that fail to produce specific and verifiable explanations for their multiples and for any changes. If in the light of these reports the Government judges that pay multiples have increased without proper justification, it should consider intervening directly to restrict executive pay.

Given the inconsistencies in their executive pay, **the Government should establish benchmarks for executive pay in Non-Departmental Public Bodies** in parallel with requiring them to publish pay multiples.

To ensure that transparency is as full as possible, and to establish greater understanding of senior roles and their remuneration, **all organisations delivering public services should disclose full details of executive remuneration, together with an explanation of how executive pay relates to the weight of roles and individuals' performance.** The Government should establish an online system for comprehensive disclosure of pay data in a consistent, re-usable format to allow citizens and third-party organisations to collate and analyse these data.

Greater transparency, disclosure and explanation will enable a more rational and informed debate on senior public service pay. **This will remove the need for simplistic benchmarks, such as the pay of the Prime Minister.**

A pay multiple as a maximum limit

2.1 The Review's Terms of Reference asked it to explore the case for a fixed limit on pay dispersion in the public sector, through a requirement that no public sector manager can earn more than 20 times the lowest paid person in their organisation.

Advantages of a maximum pay multiple

2.2 The Interim Report noted that in principle a fixed limit on pay dispersion in the public sector would have a range of advantages. A fixed pay limit based on a multiple:

- would be a clear statement of fairness that would reassure the public, while avoiding the substantial disadvantages of the Prime Minister’s pay as a benchmark;
- could thus address inaccurate public perceptions;
- would address the collective action problem whereby individual organisations act rationally when setting top pay, but the collectively undesirable outcome of ever-escalating executive remuneration still results; and
- could benefit society as a whole, through limiting income inequality, and supporting social mobility and social cohesion.

2.3 The Interim Report concluded that there was a strong case for a maximum pay multiple, but noted that in order to give organisations flexibility to pay higher rates in exceptional circumstances where there was a clear justification for doing so, any multiple should operate primarily as a disclosure mechanism, allowing exceptions on a ‘comply or explain’ basis. This would address the concern that any strict cap would hinder public bodies’ ability to recruit and retain high quality staff for essential leadership positions.

Disadvantages of a maximum pay multiple

2.4 The Interim Report noted that most top to bottom pay multiples in the public sector are in the region of 8:1 to 12:1 (see chart E in Annex D).¹ A 20:1 maximum pay multiple would therefore impact on relatively few individuals. Even using the National Minimum Wage as the multiple’s base, the most stringent definition, would produce an earnings limit of £228,186 p.a.. At present, there are only around 300 public sector executives earning more than this figure, out of a total public sector workforce of just under 6 million. **And a 20:1 multiple based on the lowest earner in each organisation would currently hit only around 70 top managers.**²

2.5 In addition, any single limit on pay dispersion, even one established on a ‘comply or explain’ basis, would have considerable disadvantages:

- **Unfairness.** A single pay multiple limit would not take account of the nature of diverse organisations and their different workforces. The relationship between top and bottom pay will necessarily be different in a large delivery organisation with substantial numbers of lower-paid administrative staff (for example JobCentre Plus) from that in a small, highly-skilled specialised body (such as the Met Office). A single pay multiple limit would produce different top pay limits for differently structured organisations, without any clear rationale. For example, a 20:1 maximum pay multiple would limit the chief executive of HMRC (with a workforce of over 80,000) to around £270,000, but allow the chief executive of the Land Registry (workforce just over 6,000) to be as high as £315,000. It is not clear how this would be either rational or fair. Even applying the limit on a ‘comply or explain’ basis would mean that some, typically large, organisations would find themselves obliged to explain breaching the limit every year, while smaller bodies could routinely offer relatively excessive pay without being required to justify themselves. **Therefore a single maximum pay multiple would quickly become meaningless.**
- **The multiple becomes a target.** A fixed limit on pay multiples could risk being seen as an acceptable norm, encouraging executives earning below the limit to push for higher pay, and pay-setters to take a more relaxed approach unless nearing the limit.
- **Perverse incentives.** Even under a ‘comply or explain’ regime, a fixed limit could create perverse incentives, for example to remove lower-paid employees from an

¹ Fair Pay Review Interim Report, Chart 2.L on p. 48. [Reproduced in Annex D below.

² Based on analysis of BBC Panorama data published September 2010. For further details on these data, see Fair Pay Review Interim Report, Annex C.

organisation's workforce (e.g. through outsourcing) in order to create more 'headroom' for top earnings to rise.

2.6 For these reasons, it would not be fair or wise for the Government to impose a single maximum pay multiple across the public sector.

Tracking pay multiples

2.7 However, there is real merit in public service organisations disclosing how executives' remuneration relates to the pay of their wider workforces ('pay dispersion'). The public are understandably concerned about the relationship between the pay of top executives and the earnings of the rest. And they need reassurance that public sector leaders are not unfairly monopolising the rewards for what is collective achievement by the whole workforce, but rather are rewarded solely for their own contribution (their due desert). **Public bodies and organisations that deliver public services should be required to monitor pay dispersion within their workforces, and to publish their pay multiples each year.** Organisations should be required to explain any changes in their pay multiple year-on-year, including explaining shifts in the multiple's base or any changes in top pay.

2.8 The Interim Report discussed the case for and against a range of options for defining a pay multiple.³ For the following reasons, **the most appropriate multiple to track is that of top executive earnings to the median earnings of each organisation's workforce:**

- Median earnings are more representative of the pay of the whole of an organisation's employees, so a median-based multiple would be a more appropriate mechanism for linking executive pay to that of the wider workforce.
- A multiple based upon median earnings would be less sensitive to changes in the bottom of the workforce structure, and so would be less susceptible to manipulation, for example through the outsourcing of low-paid workers.
- Such a measure would be more consistent with international practice in monitoring pay dispersion, notably that from 2011 listed companies in the United States will have to publish the multiple of their chief executive to median earnings.⁴

2.9 In order to ensure that disclosures are comparable, there must be a clear definition of the elements of reward to be included. For the measure to be as effective as possible, it should be as inclusive as possible, covering all elements of remuneration that can be valued. **The pay multiple should therefore be calculated on the basis of all taxable earnings for the given year,** including base salary, variable pay, bonuses, allowances and the cash value of any benefits-in-kind. The median earnings figure should be that of all employees of each organisation on a fixed date each year, usually coinciding with each organisation's financial reporting year-end.

2.10 This definition excludes changes in pension benefits, which due to their variety and complexity cannot be accurately included in a pay multiple disclosure. Existing valuation methods are both sensitive to actuarial assumptions (for example over longevity and discount rates) and require the

³ Fair Pay Review Interim Report, Chapter 5, in particular paras 5.6-5.12.

⁴ This disclosure requirement is imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act signed into law in July 2010. According to this Act, within 360 days of signature:

"The [Securities and Exchange] Commission shall amend section 229.402 of title 17, Code of Federal Regulations, to require each issuer to disclose in any filing of the issuer described in section 229.10(a) of title 17, Code of Federal Regulations (or any successor thereto):

- A. the median of the annual total compensation of all employees of the issuer, except the chief executive officer (or any equivalent position) of the issuer,
- B. the annual total compensation of the chief executive officer (or any equivalent position) of the issuer; and
- C. the ratio of the amount described in subparagraph (A) to the amount described in subparagraph (B)."

Dodd-Frank Wall Street Reform and Consumer Protection Act, Title IX (Investor Protections and Improvements to the Regulation of Securities), Subtitle E (Accountability and Executive Compensation). The full text of the legislation is available at <http://thomas.loc.gov/cgi-bin/bdquery/z?d111:H.R.4173>:

collection of substantial amounts of individualised personal data (for example on career history and pension scheme membership). Including these valuations within a pay multiple would be impracticable and would introduce uncertainties and potential inaccuracies into the multiple calculation.

2.11 However, the risk of significant amounts of remuneration being deliberately excluded from a pay multiple through pension contributions will be limited because:

- the multiple is not operating as a fixed cap but as a mechanism for disclosure and explanation;
- changes to tax relief on pension contributions due to take effect this year will significantly reduce the tax incentives to reward high earners through pension contributions; and
- should the Government accept the recommendation of the Independent Public Service Pensions Commission that pension schemes move to a career average rather than final salary basis, the disproportionate benefits that high earners can currently enjoy in existing public sector pension schemes will be reduced.⁵

⁵ Independent Public Service Pensions Commission: Final Report (2011)

Box 2.A: Including pension rights in a pay multiple

It has not been possible to produce a method for accurately valuing pension rights that would be appropriate to use for a pay multiple. Two possible options were considered by this Review: using the employee contribution rate, or calculating the increase in the Cash Equivalent Transfer Value (CETV) of individuals' defined pension benefits. Neither, however, would be appropriate to include in a pay multiple, for the reasons discussed below.

Employer Contribution Rate

The employer contribution rate is an actuarial calculation of the amount that an employer needs to set aside in order to meet its future pension liabilities to current employees, expressed as a percentage of employees' gross salaries. This has been used to calculate the total remuneration of public sector employees, for example by the ONS in comparing total remuneration in public and private sectors.

The employer contribution rate is, however, only an average value for all employees enrolled in a particular scheme, based on actuarial assumptions (e.g. on longevity) about the population as a whole. These values will not necessarily be accurate for any individual employees, so the contribution rate cannot accurately be used to value any one person's pension rights, as would be needed for a pay multiple. In addition, in pension schemes with a single employer contribution rate for all employees, using the contribution rate would increase both top and median earnings by the same proportion, so the inclusion of pension rights would make no difference to the pay multiple.

Cash Equivalent Transfer Value (CETV)

A method that is specific to individual employees is to use the increase in the Cash Equivalent Transfer Value (CETV) of the employee's pension rights each year. The CETV method is widely used to calculate the value of executives' pension rights for the purposes of disclosures in organisations' annual account, as well as for other purposes, such as valuing pensions for divorce settlements. The CETV has the advantage of allowing comparability between defined benefit and defined contribution pension schemes: the CETV of a defined benefit pension is essentially an estimate of the value of asset pot that would be required in a defined contribution scheme to fund equivalent pension benefits to those offered by the defined benefit scheme.

Using the CETV to include pension rights within a pay multiple would, however, be problematic as calculating CETVs requires significant amounts of personal data for each specific individual: on the value of pension rights already accrued, the terms of the scheme, the employee's income in the given year, any additional contributions made by the employee or employer and (for final salary schemes) the employee's total length of service to date. This information is not held by employers, but by pension schemes: when organisations disclose executives' CETV each year, they need to purchase this data from the pension schemes. Using CETV for a pay multiple would require the collection of these data for a very large number of individuals, potentially an organisation's entire workforce, in order to calculate the median total remuneration including pension rights. This would impose a very significant administrative burden and cost on organisations, as well as potentially facing legal difficulties over the protection of personal data.

RECOMMENDATION 1: Using pay multiples to track executive pay against that of all employees

The Government should not cap pay across public services, but should require that from 2011-12 all public service organisations publish their top to median pay multiples each year to allow the public to hold them to account.

The Government should require that public bodies annually publish chief executive's (or equivalent) earnings, median earnings of the organisation's workforce, and the ratio between these two figures in their annual remuneration reports. All taxable earnings should be included within this multiple. Year-on-year movements in the chief executive's earnings and median earnings should be disclosed and explained. Disclosures should begin in remuneration reports covering the financial year 2011-12, including prior year comparators.

To this end, the Government, with advice from the Financial Reporting Advisory Board, should at the earliest opportunity amend the disclosure requirements in the Financial Reporting Manual (FReM) to require organisations to include the disclosures above, and should work with relevant bodies to make similar amendments to other relevant guidance including the NHS Manuals, the NHSFT FReM the IFRS based Code of Practice on Local Authority Accounting, and guidance for remuneration reports by NDPBs not covered by the FReM.

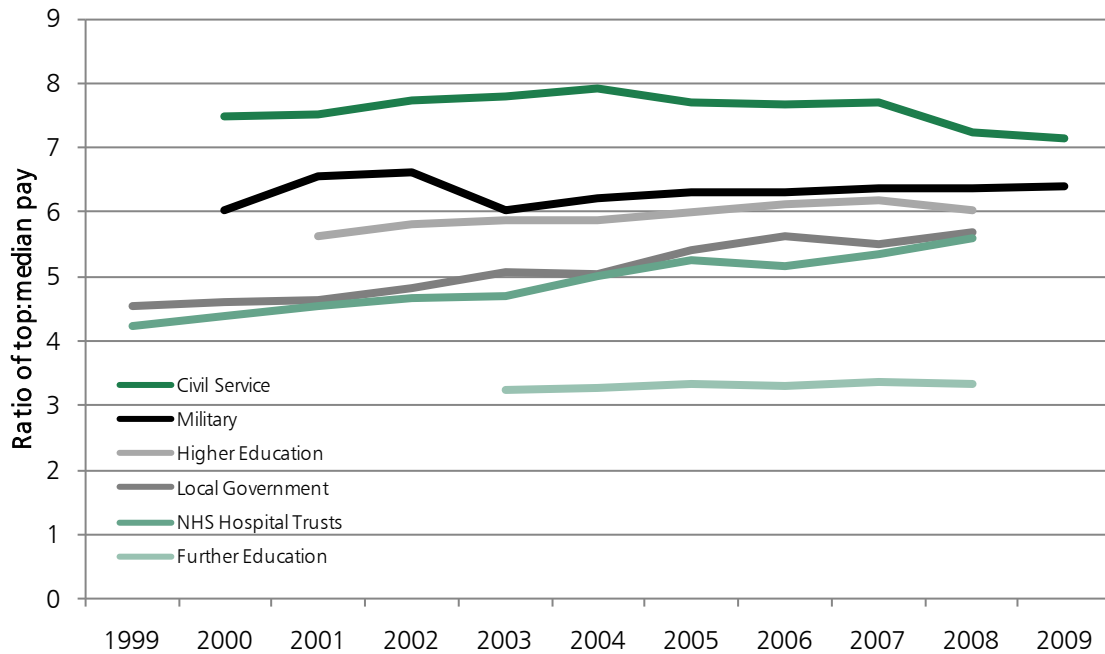
The Government should encourage major suppliers to the public sector, and organisations that play a major role in delivering public services, but which are not subject to public sector financial reporting requirements, to include such disclosures on a voluntary basis, such that tracking and explaining senior pay in this way can become a norm across all public services.

2.12 The key comparison to make is of year-on-year changes in the multiple of a single organisation.

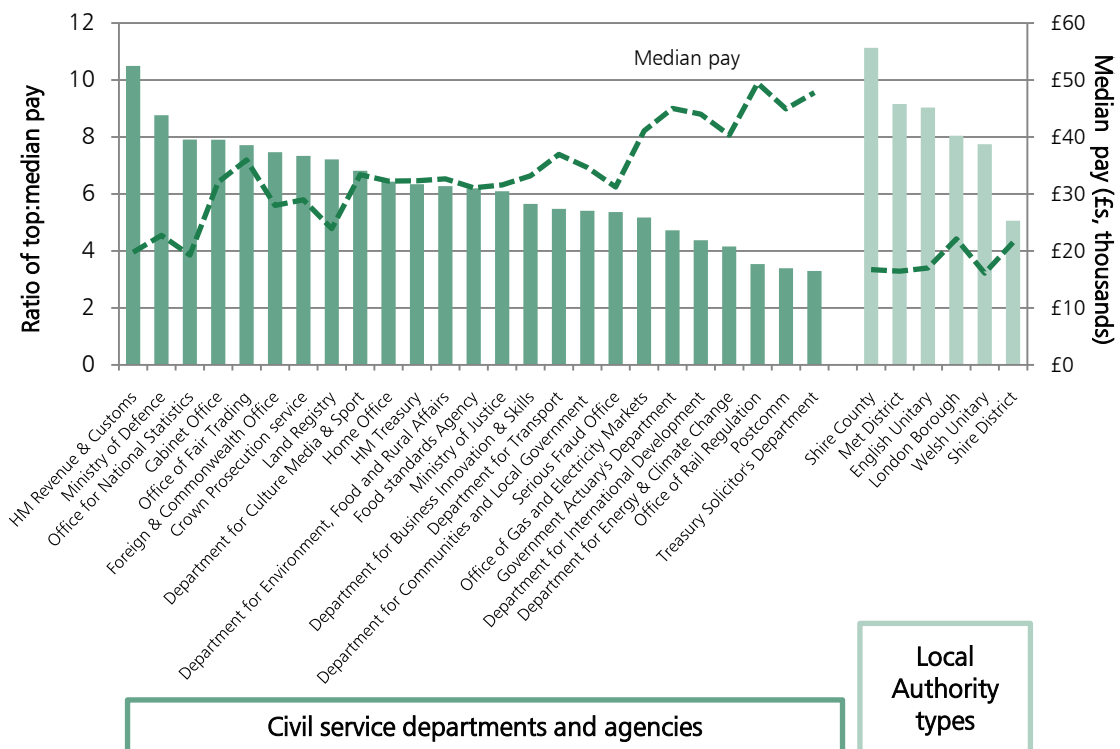
Horizontal comparisons between the pay multiples of dissimilar organisations will be unhelpful: as above, there should be no expectation that HMRC and the Met Office conform to a similar pay multiple.⁶ However, **over time norms for pay multiples should emerge within each sector (in health, in local government etc.), and citizens will be able to challenge outliers** – those individual institutions whose pay multiples deviate significantly from those of comparable bodies within their particular sector. The size of the multiple itself is not necessarily an indicator of fairness. Overall top to median pay multiples for some parts of the public sector are shown in Chart 2.A below:

⁶ A recent study of pay multiples in private sector organisations published by the Hay Group shows pay multiples varying significantly between different industry sectors, owing to differences in firm structure and business models, making comparisons between, for example, financial services firms that primarily deal with corporate clients and retailers selling directly to consumers misleading. The Hay Group paper notes that for horizontal comparisons to be valid, they must be between similar firms, such as two similar retailers or pharmaceutical firms, but argued that tracking year-on-year changes in pay multiples would be more illuminating. *Getting the balance right: the ratio of CEO to average employee pay and what it means for company performance*, Hay Group, 2011.

Chart 2.A: Top to median pay multiples for different parts of the public sector
Pay multiples for broad areas of public services have shown modest increases over the last decade



But within these broad categories there is significant variation in pay multiples among individual organisations, reflecting different workforce medians as well as top pay



Source: Fair Pay Review analysis of various sources
 See Annexes D and E for methodology and sources

Restraining unfair pay inflation

2.13 The recommendation above will enable organisations with pay multiples that increase significantly over time to be challenged by their stakeholders. But in some cases, and if multiples continue to rise over time, more interventionist measures may be needed.

2.14 Recent academic research from the field of regulation theory suggests that **the optimal way to secure restraint in executive pay may be through a 'pyramid' of gradually escalating enforcement interventions**, beginning with self-regulation, and progressively becoming tougher in the face of non-compliance.⁷ The flexibility of such an approach:

- avoids an over-reliance on sanctions that would alienate organisations that would otherwise restrain pay voluntarily;
- is more likely to secure compliance in sectors where Government does not have pay-setting powers because it rewards early co-operation with reduced intrusion from Government;
- is more likely to be accepted as procedurally fair by public bodies because the approach begins with a reliance on persuasion and trust; and
- enhances the credibility of sanctions, by making it easier for Government to escalate its intervention in the event of breaches (by contrast, if Government has only one single, cataclysmic, sanction at its disposal, organisations may judge that it is unlikely to be used, undermining its credibility as a deterrent).

2.15 Figure 2.A sets out how such a pyramid of escalating interventions could look. Beginning with self-regulation and central monitoring, the Government should first consider targeted interventions to control senior pay in particular organisations. Should this approach also fail to address problems that were systemic rather than specific to individual institutions, the Government should escalate further and establish centrally-set pay benchmarks across public services as a whole. Direct intervention by central Government in the pay policies of autonomous organisations would be a major departure from the Government's wider policy of greater devolution of control and diversity in public services, and could reduce the benefits to services that greater autonomy could bring. This option should be understood as a last resort, but one that in extremis Government would be prepared to consider.

⁷ *Responsive regulation: Transcending the deregulation debate*, Ian Ayres and John Braithwaite (1992), Oxford University Press.

Figure 2.A: Pyramid of escalating interventions into executive pay



2.16 The pyramid of enforcement proposed above requires a central monitoring role. This would need to be conducted by an entity:

- independent of political influence; and
- with expertise in executive remuneration.

2.17 A clear contender for such a role would be the Senior Salaries Review Body, which fulfils both criteria. It could assemble the data on pay multiples and their trends in an annual report, highlighting outlier organisations and those whose pay multiples showed significant year-on-year changes. Such reports would identify those organisations that had failed to produce specific and verifiable explanations for their pay multiples and changes. This will expose organisations delivering public services to rational scrutiny, and will encourage them to self-regulate in order to avoid public censure. If, however, over the medium term public accountability proves ineffective in preventing unfair executive pay inflation, then the Government will need to consider tougher enforcement options.

RECOMMENDATION 2: Informing the public debate through annual Fair Pay Reports

To support citizen accountability, the Government should commission the Senior Salaries Review Body to publish annual Fair Pay Reports, starting from 2011-12. These reports should set out trends in pay multiples across public services, highlight year-on-year changes and identify organisations that fail to produce meaningful, specific and verifiable explanations for their pay multiples and for changes.

As trends emerge from the SSRB’s annual Fair Pay Reports, if the Government judges that pay multiples in individual organisations have shown continued unjustified increases, it should consider intervening directly to control senior pay in the organisations concerned.

If pay multiples continue to rise across public services without adequate justification, as a last resort the Government should restrict organisations’ autonomy over senior pay and instead impose centrally-set pay bands.

Executive pay in Non-Departmental Public Bodies

2.18 Particular concerns have been raised, by the SSRB and the House of Commons Public Administration Select Committee amongst others, about inconsistencies in NDPB executive pay, which experts have argued bears little relationship to the weight of roles or the size and impact of the organisations.⁸

2.19 In addition, the recommendations above, to enable citizens and stakeholders to monitor organisations' pay multiples over time, will be less effective for NDPBs as they lack the constituency of affected stakeholders that for example, a Local Authority or hospital has.

2.20 For these reasons, there is an argument for taking a more interventionist approach from Government to pay amongst these bodies. Executive pay in NDPBs should be validated by introducing benchmarks which will help organisations judge what is an appropriate level of pay for the size or weight of the chief executive role in their organisation. This should ensure that the monitoring of pay multiples, which will fully apply to NDPBs, starts from a sound baseline.

RECOMMENDATION 3: Re-calibrating the pay of Non-Departmental Public Body chief executives

To address particular concerns that the pay of Non-Departmental Public Body chief executives has become detached from the responsibilities of their roles, the Government should by December 2011 establish a series of pay benchmarks for NDPB chief executives, following advice from the Senior Salaries Review Body.

Departments should work with the NDPBs they sponsor to assess which pay benchmark is appropriate, given the weight of each chief executive position, and should publish their decisions. The Government should perform a check for consistency once the initial assessments have been made.

Where NDPBs wish to pay a chief executive (incumbent or newly recruited) more than the recommended benchmark, they should obtain Ministerial approval from their sponsoring department.

In addition to the disclosure provisions set out in other recommendations of this Review, NDPBs should also publicly explain in annual remuneration reports any deviation in their chief executive's pay from the recommended benchmark, and the basis of the Ministerial decision to approve.

The Government should ask the SSRB to conduct periodic reviews of the benchmarks, and of their implementation.

Once the scheme is fully operational, it should no longer be necessary for the Chief Secretary to the Treasury to sign off any NDPB salaries in excess of £142,500. Rather, the scheme should provide a more rational basis for Ministerial approvals, including where pay below £142,500 is being proposed but is still excessive for the organisation in question.

From disclosure of pay to explanation of pay

2.21 The Interim Report noted that disclosure requirements for senior salaries vary significantly across the public sector. In the words of the SSRB, *'it is more established practice in the private sector*

⁸ *Initial Report on Public Sector Senior Remuneration*, Senior Salaries Review Body, March 2010, Chapter 4, pp. 43ff. *Top Pay in the Public Sector*, House of Commons Public Administration Select Committee, December 2009, Chapter 6, pp. 34ff.

that remuneration policies and the full remuneration packages of senior executives are placed in the public domain. Public sector practice is well behind this, with less justification.’⁹

2.22 As noted in Chapter 1, public understanding of senior public service roles is very limited – one cause of misplaced perceptions of public sector pay. Yet when senior pay in public bodies is disclosed, it is rarely explained in terms of the nature of roles, how individuals’ work contributes to organisations’ objectives or how individual public servants’ performance is assessed.

2.23 There is therefore a need for a universal standard in executive pay disclosures to be established, and for organisations delivering public services to do much more to explain how they approach senior remuneration, what exactly their executive team is paid in precise terms, and how this relates to their contribution (their role and performance) in furthering the organisation’s objectives.

RECOMMENDATION 4: From disclosure to explanation: ensuring complete transparency over executive roles and remuneration

To enable citizens to understand executive remuneration and the nature of executive responsibilities, from 2011-12 the Government should require that all organisations delivering public services disclose in precise numbers the full remuneration of all executives, alongside an explanation of the responsibilities of each role and of how executives’ pay reflects individual performance.

In parallel with the actions outlined in Recommendation 1, the Government should improve disclosure requirements for public organisations in the following ways:

- Organisations delivering public services must annually disclose the full remuneration of all executives (defined as the chief executive or equivalent, members of the executive board and any other direct reports of the chief executive).
- Executive remuneration must be disclosed in actual numbers, and broken down into base salary, allowances, variable/performance pay, and the cash value of benefits-in-kind.
- Employer contributions to Defined Contribution pension schemes for executives should be disclosed. For executives who are members of Defined Benefit pension schemes, any additional pension rights purchased for them by their employers should also be disclosed.
- Alongside these disclosures, organisations should provide a clear, meaningful explanation of executive pay, in terms easily understandable by the public. Organisations should explain how executives’ remuneration relates to the weight of executive roles, including the organisation’s characteristics and the role’s level of accountability.
- Organisations should also disclose what proportion of executives’ base salaries are variable according to performance, alongside an explanation of the basis upon which their performance is assessed.

2.24 An illustrative example of the disclosure of executive remuneration and explanation of executive roles and performance is included at Annex F.

⁹ *Initial Report on Public Sector Senior Remuneration*, Senior Salaries Review Body, March 2010, p. 50

Enabling citizen analysis

2.25 Not only do executive pay disclosures vary in terms of what details are included, it is difficult to access the data that such disclosures provide. As a result, it has been challenging even for a Government-commissioned Review to assemble a comprehensive picture of senior pay across public services, and citizens wishing to hold public service organisations to account face formidable barriers.¹⁰

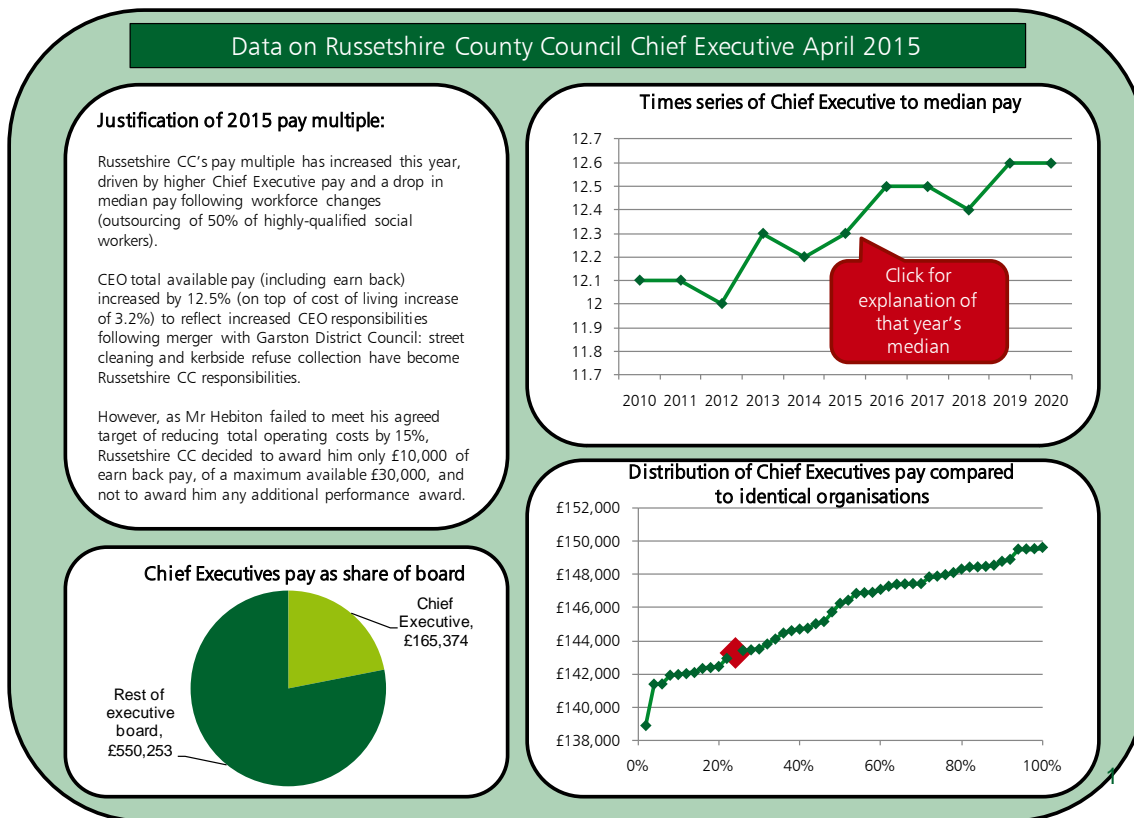
2.26 In other fields of data disclosure the UK is a world leader, with a rich variety of re-usable datasets available on the data.gov.uk website. The Government has committed to even greater transparency in public services, for example through the publication of online street-level crime maps.

2.27 Though steps have been taken to provide greater disclosure of Senior Civil Service pay, **there is much more that could be done to expand transparency and explanation of executive pay across public services as a whole. It would be a very small burden for organisations to disclose consistent data in a re-usable format, submitted through a common template and made available through the data.gov.uk website. Citizens, stakeholders and third-party organisations would then be able to collate and analyse these data in flexible, customised ways most relevant to them.**

2.28 The ability to analyse information on public service executive pay in this way will enable citizens to hold public services to account effectively, and equip them for more informed participation in the delivery of their public services. For example, a resident of the North West could compare the pay of finance directors in all NHS Trusts and Local Authorities in her region, or a research organisation could monitor changes over time in pay multiples in central government departments and executive agencies. Chart 2.C presents an example of the kind of analysis that might be possible.

¹⁰ For a discussion of the range of different datasets used by this Review, see Fair Pay Review Interim Report Box 2.B, p. 33. Further details on data used by this Review are available in Fair Pay Review Interim Report Annex C.

Figure 2.B: An example of how online data on executive pay might be analysed



RECOMMENDATION 5: Enabling citizen analysis of executive pay

From 2011-12, the Government should require public organisations to submit executive pay data through an online template, and make this data available on data.gov.uk, to allow citizens to access and analyse this data and thus have the information required to hold public service organisations to account.

The Government should request that the National Archives develop a template to be used in the capture of all disclosures on executive pay, ensuring that all the data captured is available in a consistent and reusable format.

The Government should instruct data.gov.uk to host this template and make the information gathered through it available to the public according to standard data.gov.uk practice.

Government departments should require bodies and sectors in which they have an interest to complete this template on an annual basis alongside their remuneration reports, for the year 2011-12 onwards.

A more informed debate on senior pay in public services

2.29 As set out in Chapter 1, comparisons between the pay of senior public servants and politicians are invalid. Prime Ministers are not recruited in the same way as senior managers, their pay is not a significant factor in attracting or retaining candidates for their office, and that pay is set in a political process that need not consider the impact on recruitment or retention of high calibre people. A

public discourse focused on the figure of £142,500, which is the pay the Prime Minister chooses to take, is not one that enables understanding, and if widely adopted could harm many organisations' ability to recruit top candidates (as other countries have experienced – Box 1.A), whilst letting other organisations under the benchmark escape without scrutiny.

2.30 The package of recommendations set out above should together encourage a more rational and informed debate about the nature of executive public service roles and the fair reward of individuals in those roles. If these measures are adopted, there should be no further need to resort to the 'pay of the prime minister' as a benchmark.

RECOMMENDATION 6: Abandoning arbitrary benchmarks for public service pay

Once this framework of recommendations is in place, the Government should refrain from using the pay of the Prime Minister or other politicians as a benchmark for the remuneration of senior public servants, whose pay should reflect their due desert and be proportional to the weight of their roles and their performance.

3

Ensuring pay reflects performance

Chapter summary

Despite well-rehearsed objections to performance pay in the public sector, **there are compelling reasons why performance pay for senior staff should not be jettisoned in the face of public criticism of bonuses, or because of difficulties of implementation.** An outright rejection of performance pay implies that there should be no financial reward to differentiate the good from the poor performer.

The public demands penalties for failure as well as rewards for success, and behavioural studies suggest individuals are motivated more by loss than by gain. **There therefore needs to be a better balance between rewards and penalties in performance pay schemes. The Government should give serious consideration to reconfiguring performance pay systems for those at the top to include an element of 'earn-back' pay.** Such a scheme would see executives required to meet agreed objectives in order to **earn back** an element of base pay placed at risk, and only if objectives are clearly exceeded can additional awards be made.

The public sector may be missing out on high calibre individuals because it does not offer sufficient opportunities and incentives to perform. It is also the case that the public sector may not do a satisfactory job of spotting and equipping future senior managers in the midcourse of their careers. **If employees were not eligible for bonuses unless they also signed up to earn-back, this could prove a useful way of helping to attract and identify strong performers.**

It should be possible to design team-based incentives that reconcile the importance of due desert with the reality that outcomes are collectively produced by the whole of an organisation's workforce. In this context, **gainsharing – the sharing of productivity gains and resultant savings – is an option that should feature more often.**

The rise of performance pay in the public sector, and its critics

3.1 Traditionally, the public sector's pay schemes have been based on the concept of pay-for-grade: all staff of a certain grade are paid the same or within a narrow band. Any variability in pay is based on service-based increments: pay increasing with length of service.

3.2 An argument for such systems is that employees are compensated for the average improvement in their productivity as they learn new skills, and that compensation represents a form of deferred income conceived to minimise shirking and increase attachment to the organisation. However, such systems risk hardening into a contractual or automatic entitlement for staff with only a weak link to productivity. A recent report by the CIPD observed that length of service is five to six times more likely to be cited as a criteria for progression in the public sector than the private sector.¹

¹ *Annual Survey Report 2010: Reward Management*, Chartered Institute of Personnel and Development

3.3 From the mid-1980s performance pay systems became increasingly prevalent in the public sector. This followed innovations in the private sector, and an increasing awareness that the public sector system was too indifferent to whether performance was good or poor. At the core of this shift was the idea that differential performance should be differentially rewarded, so as to embody principles of fairness and enhance motivation and accountability.² At the same time, structural changes were reducing the effectiveness of promotion as a motivator. In the civil service of the 1980s it took a newly promoted Senior Executive Officer, on average, over 20 years to reach the position of Principal, the first grade to wield real managerial clout.³

3.4 Yet there has been a strong backlash against the use of performance pay. While many have sympathised with the principle of performance pay, they have become disenchanted with it in practice. Arguments against it have tended to emphasise the following points:

- **Public sector complexity.** To a greater degree than in a profit-seeking firm, workers in public services must balance a number of different and potentially conflicting objectives – from cost-effectiveness to equity objectives – and also answer to different stakeholders – from service users and taxpayers to local and national politicians. Outcomes from public service work (e.g. health, law enforcement and education) may take years to be revealed, and even then be very difficult to accurately attribute. This makes it more likely that outcome measures will be wrongly targeted and that the activities being measured will be privileged over those that are not measured. Perverse incentives and misdirected strategic behaviour may result.⁴
- **Inadequate performance management systems.** A performance pay system requires a robust system of performance appraisal, which few workers in the public sector believe is in place in their organisation.⁵ Partly this may result from the complexity discussed above, but it may also have something to do with a culture that remains unwilling or unable to deal with poor performance. For example, reports suggest managers in local

² Performance pay and incentives more general have been subject to empirical examination in a number of contexts ranging from CEOs and white collar office workers to British jockeys and Chinese agriculture: see 'The Provision of Incentives in Firms', Carol Prendergast (1999) *Journal of Economic Literature* 37, 7-63 and 'Performance Pay and Productivity', Edward Lazear (2000) *The American Economic Review* 90 (5):1346-1361

³ 'The Paradox of Performance Related Pay Systems: Why Do We Keep Adopting Them in the Face of Evidence that they Fail to Motivate?', David Marsden (2009) CEP Discussion Paper No 946. To be clear, not parts of the public sector have been affected in the same way. For instance, in higher education, the drive for scientific prestige and consultancy work, as well as an "up-or-out" system for fixed-term contract research staff, function as performance incentives.

⁴ Performance measures can be and are manipulated as various attempts in history to administratively engineer outcomes have balefully demonstrated. This can take several forms:

- Ratchet effects: these are likely where the target is set as an incremental advance on current output or performance, encouraging individuals to do the bare minimum because they fear that otherwise that the measure will be toughened up in the future.
- Threshold effects: these arise where rewards are made conditional on hitting thresholds. The resulting focus of resources on the borderline that might miss the target in the absence of intervention adversely affects both ends of the distribution, including the most serious or needy cases.
- Tunnel vision: these occur where behaviours are quantified in the performance management scheme, leading agents to hit the target at the expense of effort directed at real, albeit unquantified, improvements in performance.
- Myopia: these arise where short-term targets are privileged over desirable long-term objectives. The administrative demand for measures to be reasonably achieved and time-bound so that it conforms to the cycle of annual feedback reinforces this bias.

These consequences of the haphazard use of targets have a number of sources: the difficulty of measuring complex phenomena with accuracy or finesse, the tendency to introduce arbitrary kinks or cut-offs in otherwise continuous data, and the inability to collect and process information or adapt to new circumstances.

See 'On the unintended consequences of publishing performance data in the public sector', Peter Smith (1995) *International Journal of Public Administration* 18(2):277-310 and 'Goals Gone Wild: The Systematic Side Effects of Over-Prescribing Goal Setting', Lisa Ordóñez, Maurice Schweitzer, Adam Galinsky and Max Bazerman (2009) Harvard Business School NOM Unit Working Paper No. 09-083

⁵ The CIPD's 2009 Employee Pay Attitude survey found that the proportion of public sector employees who were satisfied with their employer's ability to measure individual or team performance was outweighed by the proportion that thought otherwise, resulting in net satisfaction scores of -9 per cent for individual performance and -6 per cent for team performance. By contrast, the net satisfaction scores among private sector employees were +22 per cent for individual performance and +21 per cent for team performance.

government are uncomfortable in establishing what 'poor performance' means and confronting staff where such behaviour is exhibited.⁶

- **Incompatibility with the ethos of public service.** A widely held view is that performance pay is not necessary to motivate workers in public services, who have strong incentives to perform simply because they are working for the benefit of the public. Indeed, some argue that performance pay detracts from the ethos. Such views are arguably more strongly held in some sectors (police, armed forces) than others (civil service) or in some posts (for example, front-line workers) than others (for example, specialist positions).

3.5 In addition to these general concerns, performance pay specifically for senior managers has been the subject of much public criticism (current arrangements are set out in table 3A). Part of the problem is the terminology of the 'bonus', in the wake of the ongoing debate concerning remuneration in the financial sector. This is despite that fact that in the public sector performance elements are often paid out of a pot set aside for that use: so 'bonuses' are not really additional. In other words, there is a set amount of cash for remuneration but its allocation amongst staff will vary according to performance. 'Variable pay' is often a more accurate and less misleading term than 'bonus'.

Table 3.A: Table

Workforce	Average size of variable pay
Senior Civil Service	For 2010, only the top 25 per cent of performers can be awarded a variable pay award. Average value in 2009/10 was £6,080 for Deputy Directors and £9,670 for Directors General. These equate to approximately 10 per cent of salary.
NHS Very Senior Managers	Those rated as having exceeded expectations can receive a variable pay award of up to 5 per cent of their salary. Government has restricted such awards to the top 25 per cent of earners.
Non-Departmental Public Bodies chief executives	Comprehensive data is not published for NDPBs. Typically, NDPB chief executives can receive bonuses of up to 20-25 per cent of base salary, with some exceptions, e.g. CEO of Olympic Delivery Authority received bonus of £210,000 in 2008-09, equivalent to 55 per cent of base salary of £384,000. Bonuses tend to be higher in infrastructure-related NDPBs, e.g. Transport for London (Commissioner bonus £146,440, which is 42 per cent of base salary of £348,444 in 2008-09).
Local Authority chief executives	There is no comprehensive data available, but based on a small sample bonuses typically range from 0 – 20 per cent of base salary.
Chief executives of competitive public sector bodies	Arrangements vary substantially, but can be as much as 100 per cent of salary.

Source: Fair Pay Review

3.6 Though public opinion may overstate the problem, it is certain that performance pay for executives in some areas has not been their due desert. The Senior Salaries Review Body has summarised the problems as having occurred because:

- additional pay awards have been applied across the board, regardless of context;

⁶ <http://www.hrmagazine.co.uk/news/1023184/Local-government-compares-badly-private-sector-maximising-use-staff/>. This view is shared by large parts of the public sector itself, as results from Civil Service People Surveys demonstrate: <http://www.civilservice.gov.uk/about/improving/engagement/people-survey-2010.aspx>

- the size of the award has looked out of scale with the measurability of the outcome;
- the rationale for awards and levels that are set has not been made clear; and/or
- the prevalence in some areas of the public sector of enforcing top-down appraisal distribution quotas ('tranching'), which override individual performance outcomes, militates against motivation and perceived fairness.⁷

The case for performance pay in the public sector

3.7 Every pay system creates winners and losers because each produces tangible and intangible rewards and risks that benefit some workers more than others. No system can be perfect. While pay can readily demotivate, it alone cannot achieve a committed and productive workforce. **But there are compelling reasons why performance pay for senior staff should not be jettisoned in the face of public criticism of bonuses, or because of difficulties of implementation.**

3.8 Firstly, some of the general arguments against performance pay in the public sector can be challenged:

- **Public sector complexity.** The argument that profit-seeking organisations are innately more suited to setting clear metrics for performance pay should be put to the test. In the private sector, the need to reconcile short-run performance with long-run adaptability as well as the need to find crisp performance measures for amorphous activities such as research and development can give firms headaches that would undoubtedly trouble their public sector counterparts.⁸ In a similar vein, many public sector organisations have a relatively consistent mandate, delivering services to the public across a national network of providers: activities that invite meaningful comparisons with private operators such as high street banks and even supermarkets. A large scale, representative cross-section of private manufacturing, private services and public services in the UK found that pay practices vary markedly, even between organisations with similar workforces. Whereas there is little difference across sectors in the use of performance pay for manual occupations, there is a much lower likelihood of performance pay in the public sector at a managerial and professional level. The authors interpret this finding as evidence that the public sector is being inefficiently incentivised.⁹
- **Inadequate performance management systems.** There is a genuine risk that performance pay will demotivate workforces if the performance management systems it is based on are inadequate. But, rather than being an argument against performance pay per se, this adds weight to arguments that more attention should be focused on appraisal and development schemes, and that through training and support, public organisations develop a managerial culture that is willing and able to deal with poor performance. Clearly performance pay cannot create processes from scratch. However, its introduction can help focus attention on improving performance management by forcing managers to clarify organisational priorities, communicate better, and strengthen channels for employee voice. An LSE study of performance pay in schools found that a clear majority of teachers (60 per cent) and headteachers (82 per cent) felt

⁷ *Initial report on Public Sector Senior Remuneration 2010*, Senior Salaries Review Body, March 2010.

⁸ Of course, this may mean that incentives are being set inefficiently high in the private sector. See 'Corporate governance practices and companies' R&D orientation: Evidence from European countries', Florence Honoré, Federico Munari and Bruno Van Pottelsberghe (2011) *Bruegel Working Paper* 2011/01

⁹ 'The Use of Incentive Schemes in the Public and Private Sectors: Evidence from British Establishments', Simon Burgess and Paul Metcalfe (1999) *CMPO Working Paper* 99/015

that it had improved goal-setting by clarifying targets and had given teachers organisational support helping them identify professional development needs.¹⁰ Research also suggested a positive relationship between schools' reported improvements in goal-setting on the one hand and improved academic results on the other, with teachers within the scheme producing better results than their peers by almost half a GCSE grade per pupil on average.¹¹

- **Incompatibility with the ethos of public service.** This argument, strongly put in evidence to the Review from a number of stakeholders, can also be challenged. For a start, it could be argued that the ethos of public service means workers will be less likely to act opportunistically – for instance, by skimming off the easiest problems or clients (though this inclination may weaken where very aggressive performance-oriented systems are in operation).¹² There is also evidence that complaints about public sector performance pay often have more to do with aspects of implementation rather than the principle.¹³

3.9 Secondly, despite the breadth of arguments against them, **there is a surprising lack of empirical evidence evaluating the effects of performance-based reward programmes** let alone their full welfare costs.¹⁴ There have been only been a handful of rigorous empirical studies on UK public sector financial incentive programmes in the last decade.¹⁵ Only one – on headteachers – deals explicitly with executives.¹⁶ To put it schematically, the impact performance pay has is most positive for civil servants and teachers but relatively weak for healthcare workers.¹⁷ And if the impact is often quite small, this may owe more to the fact that the incentive is small as well. Many researchers have demonstrated that there is a minimum threshold that must be crossed for a pay increase to be noticed – typically around 7-10 per cent.¹⁸ In general, unconsolidated bonuses in the UK's public sector stand out as parsimonious compared to practices in other OECD countries where they can run as high as 40-50 per cent of base salary.¹⁹

3.10 Thirdly, **whilst there have been failures in adapting performance pay to the public sector, they have been part of a process of experimentation and learning that has yielded subsequent improvements.**²⁰ For instance, the first generation of reforms were unsuccessful because they:

- tended to graft performance pay onto pre-existing performance appraisal systems, even though they had not been designed for remuneration purposes;
- were accompanied by a tick-box approach to data gathering, with performance indicators either excessively narrow or weighed down in gratuitous detail;

¹⁰ 'Pay for Performance Where Output is Hard to Measure: The Case of Performance Pay for School Teachers', David Marsden and Richard Belfield (2006) LSE Research Online.

¹¹ 'Evaluating the Impact of Performance-related Pay for Teachers in England', Adele Atkinson, Simon Burgess, Bronwyn Croxson, Paul Gregg, Carol Propper, Helen Slater and Deborah Wilson (2004) CMPO Working Paper No. 04/113

¹² 'The Performance of Performance Standards', James Heckman, Carolyn Heinrich and Jeffrey Smith (2002) *Journal of Human Resources* Vol. 37(4):778-811

¹³ See for example the evidence gathered by the Wright Review of the NHS Very Senior Management framework. The NHS Very Senior Managers' pay framework: an independent evaluation, June 2008.

¹⁴ Considerable doubts have also been raised about limitations in research design such as the lack of robust counterfactuals and controls (most control groups are non-equivalent) and the reliance on unrepresentative samples.

¹⁵ For a good discussion, see 'The Use and Usefulness of Performance Measures in the Public Sector', Carol Propper and Deborah Wilson (2003) *Oxford Review of Economic Policy* Vol.19(2):250-267. See also 'The Role of Incentives in the Public Sector: Issues and Evidence' (2003) *Oxford Review of Economic Policy* Vol.19(2):285-300 and 'The use of sanctions and rewards in the public sector', Deloitte (2008) Literature review accompanying the report prepared for the NAO by Deloitte

¹⁶ 'Are Public Sector CEOs Different? Leadership Wages and Performance in Schools', Timothy Besley and Stephen Machin (2008) LSE EOPP Paper

¹⁷ 'Performance pay in the public sector: A review of the issues and evidence', Graham Prentice, Simon Burgess and Carol Propper (2007) Paper commissioned by Office of Manpower Economics.

¹⁸ 'A drop in the bucket: When is a pay raise a pay raise?', Atul Mitra, Nina Gupta and Douglas Jenkins (1997) *Journal of Organizational Behavior*, 18: 117-137.

¹⁹ 'Performance-related Pay Policies for Government Employees' OECD (2005)

²⁰ This point is made expertly in 'The Paradox of Performance Related Pay Systems: Why Do We Keep Adopting Them in the Face of Evidence that they Fail to Motivate?', David Marsden (2009) CEP Discussion Paper No 946

- assessed employees on common criteria that had little bearing on the content or responsibilities of individual jobs;
- gave too little recognition to the different abilities of employees or the different environments in which they worked; and
- used crudely designed targets with little attention to unintended consequences.

3.11 The introduction of more personalised contractual arrangements attempted to resolve some of these issues. Objectives would be discussed and agreed between employees and their respective line managers and would form the basis of the end of year performance review. However, this was in turn subject to criticism for being too subjective and too prone to falsification. In the absence of strong oversight, managers were accused of giving employees better evaluations than they actually deserved to build trust and cooperation in the workplace.²¹ In other cases, there was a suspicion that performance pay would fall prey to budgetary pressures and that ratings would be rationed to save money, regardless of how well individuals performed.

3.12 Today there is greater recognition of the subtleties of running performance pay in the public sector, allowing for a very different future to be conceived. It is noteworthy –though perhaps no coincidence– that opposition to performance pay has been softening,²² and there is now a greater consensus on what works:

- It is recognised that performance is better measured on outcomes over time rather than against peers. For instance, the value added by a school is better gauged by tracking the performance of the same pupil over time rather than comparing pupils against one another. This acknowledges that each pupil has differing levels of achievement and ability that reflects differences in parental investment, socio-economic background and other personal characteristics – factors that are beyond the school’s control.
- The pitfalls of strictly quantifiable measures are also increasingly understood, not least where they are used to rank every individual and organisation in assiduous detail. It is recognised that positions on such ranks may jump around chaotically in response to the choice of performance measures.²³ However, objective measures can be a powerful way of starting a conversation in which staff have to account for their performance and undergo more finely-tuned judgemental assessments, including 360 degree and stakeholder reviews. Where necessary, there should be a move away from specific targets to the use of more general success criteria, such as benchmarks, milestones and directions of travel which are harder to manipulate.²⁴
- There is an understanding that the performance appraisal process is the backbone of the whole system, without which pay decisions become arbitrary. A high priority should be attached to consultation with employees, as well as to simple and regular communication so that different goals are recognised and objectives are transparent. One study found that *perceptions* of pay fairness were a 25-times stronger predictor of

²¹ The unwillingness to differentiate performance may also reflect a number of well-known biases such as centrality bias (the tendency to offer all employees ratings that depart little from the norm) and leniency bias (the practice of overstating the performance of the poor performers).

²² One of the most recent studies to track changing attitudes to performance pay is ‘Pay for Performance Where Output is Hard to Measure: The Case of Performance Pay for School Teachers’, David Marsden and Richard Belfield (2006) LSE Research Online . They found that between 1999 and 2004 support for the principle and application of linking pay to performance had almost doubled.

²³ ‘The Limitations of Using School League Tables to Inform School Choice’, George Leckie and Harvey Goldstein (2009), *Journal of the Royal Statistical Society* 172(4): 835-851 and ‘Composite performance measures in the public sector’, Rowena Jacobs, Maria Goddard and Peter C. Smith (2007) Centre for Health Economics Policy Discussion Briefing, University of York

²⁴ This was pointed out by the National Audit Commission while noting that over a number of Spending Reviews that Public Service Agreements (PSAs) had become more focussed on key priorities and better described. ‘Taking the Measure of Government Performance’, National Audit Office (2010). Softer measures ensure that the pay-performance relationship is more linear without kinks or discontinuities and consequently the manager’s payoff is not dependent on what the particular target is.

employee commitment than pay satisfaction. It also found that overall pay fairness is influenced most strongly by pay *process* fairness.²⁵

- Where feasible, performance indicators should be based on alternative, independent and manipulation-proof information sources such as general household surveys and ratings. The distribution of rewards should be controlled and coordinated by independent committees. These tasks have been made easier by advances in technology that allow for the rapid collection and processing of information.
- It is clearer that rating systems should avoid forced rankings – relative assessments can do more harm than good and create divisiveness amongst employees. If necessary to use ranking systems, they should be used more as a sense check of the distribution than as a rigid quota.
- Finally, objectives should be relatively stable over time and as far as possible be protected from political interference. Performance assessments should involve defining medium-term measures of success and putting considerable weight on them. In part this can be done by requiring that the choice of short-term performance measures correlates empirically and theoretically with positive long-term outcomes.

3.13 Finally, there is a much stronger case for linking pay to performance at the senior levels of public organisations, as opposed to the rest of the workforce:

- Executives have the autonomy and discretion to influence outcomes in a way that frontline staff may not. This makes it easier to link individual performance to organisational goals which are generally easier to measure and benchmark.²⁶
- Management should already be skilled in coping with a larger number of performance targets and measures, increasing the likelihood that all aspects of the overall desired outcome will be achieved.²⁷
- Restricting the scheme to senior management will lead to a system that is considerably less resource intensive and bureaucratically unwieldy than one which covers the whole workforce. This avoids the pretence of consistent performance management where in practise the capacity to undertake reviews and train managers in their operation is spread around thinly and weakly.
- Variable pay schemes are more likely to be self-financing than when they are extended further down the organisation.²⁸
- Performance pay is associated with greater job satisfaction when individuals are performing autonomous jobs and are employed on permanent contracts.²⁹

The case for 'earn back' pay for senior managers

3.14 The approach to performance pay for managers in the public sector could help or hinder the need for greater fairness. On the one hand, greater use of performance pay risks worsening public perceptions of managers further. The concept is dogged by the perception that it is synonymous with bonuses and undeserving windfalls for fat cats. Yet a rejection of performance pay implies that

²⁵ 'Performance Related Pay: Rewarding A while Hoping for B' Adrian Ward (2006) Work Foundation unpublished. See also 'Engaging for Success: Enhancing Performance Through Employee Engagement' David MacLeod and Nita Clarke (2009) A report to Government

²⁶ 'Managing with style: the effect of managers on corporate policy', Marianne Bertrand and Antoinette Schoar (2003) *Quarterly Journal of Economics* 118:1169–208a

²⁷ 'Perversity in public service performance measurement', Mike Pidd (2005) *International Journal of Productivity and Performance Management*: 54 (5/6), 482-493.

²⁸ 'Rewarding performance in national government networks', John Makinson (2000) *Public Services Productivity Panel*, HM Treasury

²⁹ 'Confronting Objections To Performance Pay: The Impact Of Individual And Gain-Sharing Incentives On Job Satisfaction', Kostas Pouliakas and Ioannis Theodossiou (2009) *Scottish Journal of Political Economy*, 56: 5

there should be no financial reward to differentiate the good from the poor performer. It implies that incentives must come solely from the ethos of public service and from opportunities for progression – opportunities that may be increasingly scarce given the reductions in public sector headcount that will dominate in the coming years. It also implies that managers should be spared from the consequences of poor performance when they lead to cuts and layoffs in the rest of the organisation.

3.15 The public demands penalties for failure as well as rewards for success.³⁰ There therefore needs to be a better balance between rewards and penalties in performance pay schemes. The majority of performance pay schemes entail upside opportunities to earn more for performance that is better than average, but do not feature equivalent downside risks: employees do not lose pay for performance that is poorer than average. This situation is inconsistent with the findings of behavioural economics, which state that individuals are motivated more by a loss than by a gain of equivalent size (Box 3.A).

³⁰ For example, see evidence from the Taxpayers Alliance, *Top Pay in the Public Sector*, Sixth Report of the 2009-10 Session, House of Commons Public Administration Select Committee, December 2009.

Box 3.A: Performance pay – lessons from behavioural economics

Insights from behavioural economics can help uncover why some incentives work and others backfire. **Key lessons for the design of performance pay schemes include:**

- **Schemes should feature a downside as well as an upside.** One of behavioural economics' seminal findings is that people value gains differently than losses. Individuals are loss averse, which means they pay more attention to losses than seemingly identical gains. Evidence suggests losses are perceived more intensely than gains by a factor of around 2 depending on the circumstances.³¹ In other words, people will work as hard to avoid losing £500 as they will to earn £1000. In the health service, waiting times for elective surgery in hospital dropped more quickly in England than in Scotland in the early 2000s, when the English performance indicators were tied to an aggressive system of sanctions for target failures that was absent in Scotland at that time.³²
- **There should be a limit to the variable element.** Up to a certain size, incentives can induce individuals to learn and perform better; but beyond that point, incentives can become so overwhelming that it actually interferes with the ability to focus on and carry out activities – a reason why even the calmest sports stars 'choke' at decisive moments in matches.³³
- **Schemes must convey a strong message about the public service benefit of the objectives to be tied to variable pay.** People care how their actions are perceived and wish to be seen as cooperative and principled. Thus paying people to donate blood may have the unanticipated effect of reducing supply, since it signals that the donor is only in it for the money. By contrast, other incentives - say taxing the use of plastic shopping bags - have been shown to work effectively where they emphasise and target the social desirability or undesirability of the activity in question.³⁴ Given the importance of the ethos of public service as a motivator, financial incentives and rewards must seek to align with employees' existing desire to achieve good outcomes for the public.
- **Schemes should reward teamwork.** Team incentives are powerful because they leverage people's desire to work harder when others' welfare is at stake, and make the most of different specialisms. For example, field experiments have found that the exercise-shy are more likely to attend a gym when 'buddied' with a regular gym goer and share a financial incentive with their buddy, even if they are offered a higher financial reward for attending by themselves.³⁵

³¹ 'Advances in Prospect Theory: Cumulative Representation of Uncertainty', Daniel Kahneman and Amos Tversky (1992 *Journal of Risk and Uncertainty* 5:297-324. 'Prospect Theory in the Wild: Evidence from the Field', Colin Camerer in Colin Camerer, George Loewenstein and Matthew Rabin eds. (2004) *Advances in Behavioral Economics*, Princeton University Press; and 'Individual-Level Loss Aversion in Riskless and Risky Choices', 2010-20 Discussion Paper from The Centre for Decision Research and Experimental Economics 2010-20, University of Nottingham. The last paper finds that loss aversion increases with age, income, and wealth, but decreases with education. In particular correlation between loss aversion and income and wealth is surprising.

³² 'Did "Targets and Terror" Reduce Waiting Times in England for Hospital Care?', Carol Propper, Matt Sutton, Carolyn Whitnall and Frank Windmeijer (2008) *Journal of Economic Analysis and Policy* 8: 2

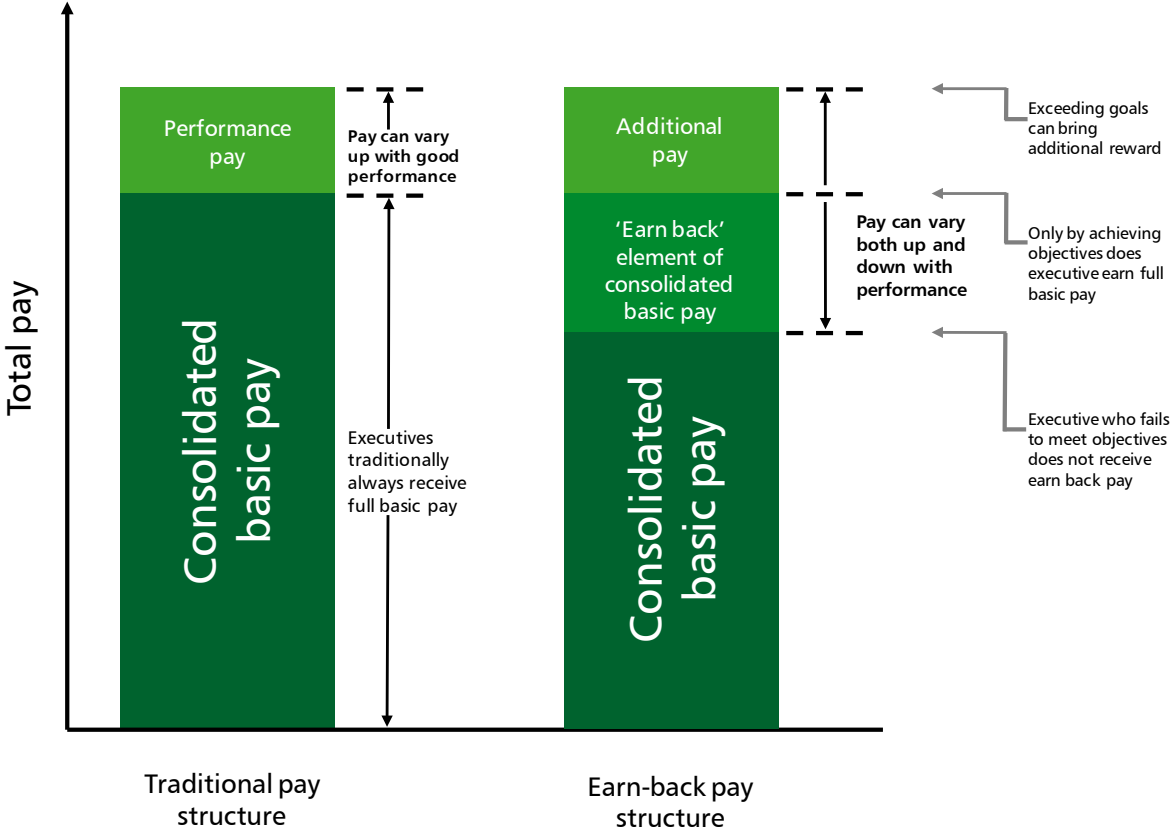
³³ 'Large Stakes and Big Mistakes' Dan Ariely, Uri Gneezy, George Loewenstein, and Nina Mazar (2009) *Review of Economic Studies*, 76 (2): 451-469

³⁴ 'Policies Designed for Self-Interested Citizens May Undermine the Moral Sentiments: Evidence from Economic Experiments', Samuel Bowles (2008) *Science* Vol.320 (5883):1605-1609

³⁵ 'Letting Down the Team? Evidence of Social Effects of Team Incentives', Philip Babcock, Kelly Bedard, Gary Charness, John Hartman, and Heather Royer (2011), *NBER Working Paper* No. 16687

3.16 These findings suggest that **serious consideration should be given to reconfiguring performance pay systems to include an element of ‘pay at risk’**. Such a scheme would see executives required to **meet agreed objectives in order to earn back an element of base pay placed at risk**. If they do not succeed against all objectives, some or all the earn-back pay will be lost. There would still be the possibility of awarding bonuses for performance that is genuinely beyond expectations. Splitting the scheme in this way introduces the visible possibility that pay will run in both directions – downwards as well as upwards (Figure 3.A). The key factor that differentiates this from other schemes is that a failure to earn back all base pay implies that objectives have not been met: this variable element is therefore clearly distinguishable from a bonus. There are a number of successful international examples that build some downside risk into remuneration arrangements (Box 3.B).

Figure 3.A: How earn-back pay differs from traditional performance pay arrangements



Note: Consolidated pay is that pay which is pensionable and which can be expected to be earned in a following year. The introduction of earn-back pay would not have to come out of existing basic pay. An alternative method of implementation would be to make future increases in pay in the form of earn-back: thus the earn-back element would gradually be introduced over time.

Box 3.B: Selected international examples of 'pay at risk'

The **Canadian** Performance Management Program (PMP), including a new compensation scheme, was introduced in 1999/2000 following a period of considerable restraint in the federal public sector and a concern that the compensation of senior executives had fallen significantly behind market comparators. Rather than narrowing this gap through an unconditional increase in base salary, future pay rises took the form of at-risk pay. Consequently, at-risk pay has come to be seen as executives' staple remuneration on a par, if not synonymous, with base salary.

Alongside pensions and benefits, the new compensation scheme provides a base salary and performance pay divided into two elements: at-risk and bonus. Each year, a proportion of total compensation is put at risk and must be re-earned. It is distinguishable from a bonus which is awarded only when an individual's demonstrated performance surpasses expectations.

Pay-outs are based on performance agreements which comprise objectives and their related performance measures in three key categories: policy and program results, management results and leadership results. Overall performance is rated on a five-point scale.

The scheme applies to federal senior civil servants, heads of agencies, chief executives of Crown corporations and some other appointees, covering in 2008/2009 nearly 5,800 officials. The proportion of pay that is at-risk increases with the level of responsibility, running as high as 30 per cent of total remuneration. At the upper echelons of the public sector, many appear to have received none or only some of their at-risk pay. Between 2003/2004 and 2009/2010, the figure has averaged around 60 per cent.³⁶ Satisfaction with the scheme amongst employees has increased over time. And though there has been no evaluation of public satisfaction, it appears that the distinguishing of at-risk pay and bonuses, and the disclosure of annual results has resulted in fewer media enquiries and questions from MPs regarding executive pay in public organisations.

The at-risk element counts towards pension calculations, unlike bonuses.

The Kowloon Canton Railway in **Hong Kong** ran a widely regarded incentive scheme whereby monthly deductions were made from the members of the management committee (15-20 per cent according to seniority). If targets were met, full contributions were returned. If not, each participant would lose part or all of their contribution according to the extent to which targets had been met. If targets were exceeded, they would receive a bonus on top of the sum they contributed to the pool.³⁷

3.17 Application of pay at risk in public organisations in the UK could bring important benefits:

- **It will signal to citizens that due desert is being respected in its fullest sense and that there are real consequences for substandard performance in the public sector.** As such, it could play a major role in taking the venom out of the high pay debate and moving it to a more balanced place where rewards are a basic guarantee of quality and people can have confidence in the integrity of public sector pay-setting processes.
- **It will help bring greater focus on setting objectives for those who lead public organisations,** helping encourage a more highly performing public sector.

³⁶ General web site on PMP: <http://www.tbs-sct.gc.ca/prg/mran-eng.asp> and annual performance results for the most senior executive <http://www.pco-bcp.gc.ca/index.asp?lang=eng&page=secretariats&sub=spsp-psps&doc=pmp-pgr/resul-eng.htm>

³⁷ 'Synthesis Report of studies on Formulating the Concept, Principles, and Parameters for Performance-Related Incentives (PRI) in Government', Indian Institute of Management (2008) *Indian Sixth Central Pay Commission*: <http://india.gov.in/govt/studies/iimabad.pdf>

- As penalties can have powerful incentive effects (more than rewards) **such a scheme may well have a stronger impact on motivation than traditional performance pay.**

RECOMMENDATION 7: Preventing rewards for failure through earn-back pay for senior public servants

To allow pay to vary down as well as up with performance, all public service executives should have an element of their basic pay that needs to be earned back each year through meeting pre-agreed objectives.

The Government should by September 2011 bring forward proposals for Senior Civil Service pay to include an element of base pay at risk, and should encourage the application of earn-back pay to other organisations delivering public services. This earn-back should be conditional upon meeting pre-agreed objectives; excellent performers who go beyond their objectives should be eligible for additional pay. To be effective, the at-risk element must exceed 10 per cent of basic salary.

The scheme will need to be phased in, in order to avoid adversely impacting current employees and avoiding contractual difficulties

3.18 Any shift to a system of earn-back pay must be handled with care. As individuals are extremely sensitive to even implied pay cuts –with lower earnings found to lead to a sense of relative deprivation- there must be safeguards to ensure that they have confidence in the veracity of the pay-setting process. The magnifying effect of loss aversion means that care needs to be taken when setting the level of earn-back pay: if it is set too high, individuals may work less effectively and demand an increase in base pay or camouflaged payments in the form of recruitment and retention premia to compensate for additional risk.

3.19 The potential dangers of earn-back pay are that organisations will be reluctant to enforce penalties for underperformance; or alternatively that budgetary pressures or changes in political priorities overrule the integrity of the system. Improving the strength and independent composition of remuneration committees will be crucial, and this is discussed in chapter 5.

Opt-in performance pay

3.20 Performance pay can also have a secondary but significant influence on an organisation's productivity by attracting higher performing employees. There is good evidence that performance pay acts as a sorting device to identify and attract the most capable employees. One study, on a glass installation company, found that that performance pay resulted in a 44 per cent increase in productivity. Roughly one half of this increase was due to employees working harder; the other half came from less productive workers leaving the organisation because the new pay system was less generous to them and being replaced by more productive workers who wanted the opportunity to make more money than elsewhere.³⁸ Similar results have also been documented in the public sector.³⁹

3.21 The public sector may be missing out on high calibre individuals because it does not offer sufficient opportunities and incentives to perform. A recent PWC survey of over 300 Young Global Leaders, an initiative for grooming future leaders across private, public and third sectors, found that 76 per cent would consider a position in the public sector. However, because the performance

³⁸ Personnel Economics for Managers, Edward Lazear (1998) Wiley, New York.

³⁹ "Are Public Sector CEOs Different? Leadership Wages and Performance in Schools", Timothy Besley and Stephen Machin (2008) LSE EOPP Paper

culture is seen to be unattractive, less than 15 per cent had or were presently engaged in public office.⁴⁰

3.22 In this respect, it is a concern that the public sector does not do a satisfactory job of spotting and equipping future senior managers in the midcourse of their careers. In the context of pay-for-grade, the main losers are young high-performers who want opportunities to distinguish themselves and expect to move upwards quickly but feel stifled by a culture that, in some quarters, is slow and regimented.⁴¹ Talent management programmes are discussed in Chapter 4, but even if they can be strengthened, many fail to spot good candidates. In part this has been aggravated by traditional schemes that have fast-tracked people on the basis of raw potential rather than actual performance which is the bottom-line of the organisation and a more reliable measure of ability.⁴²

3.23 An alternative and inexpensive way to identify people is to rely on self-selection and encourage people to reveal information about themselves that employers or HR systems cannot readily discover.⁴³ **If employees were not eligible for bonuses unless they also signed up to put some of their base pay at risk, this could prove a useful way of helping to attract and identify strong performers.** Stronger or more ambitious individuals would nominate themselves confident that they can secure greater pay, and, more importantly signal their ability to enhance their career prospects. Weaker or uninterested individuals would avoid the scheme and continue on the current pay system. Individuals who overestimate or misrepresent their abilities would be found out.

3.24 Such an approach would make it easier to target scarce training and career development resources. This addresses a concern that many traditional practices for workforce planning are increasingly obsolete as they have been premised on a stable environment and predictable demand for talent, which may not continue as reform of the public sector progresses. Investments in talent management are becoming more expensive, especially as workers become more mobile and can take that training with them, so anything to make them more efficient must be welcome.

3.25 A scheme which allows individuals to opt in to performance pay, moreover, may well attract bolder and more dynamic people who are arguably better suited for senior management jobs which require individuals to be comfortable in making major decisions against a backdrop of risk and uncertainty.⁴⁴

3.26 Finally, an opt-in rather than a mandatory scheme recognises that, as a matter of procedural fairness, people are to free to choose their remuneration scheme.

RECOMMENDATION 8: Extending earn-back pay to high performing middle managers

To identify and reward high fliers, once earn-back pay has been implemented at the most senior levels, Government departments and other public service organisations should consider offering this pay structure to middle managers on an opt-in basis.

⁴⁰ 'The War for Talent Goes Public', Produced by PwC in collaboration with the World Economic Forum's Young Global Leaders (2011)

⁴¹ 'Modernising the Policy Process', Michael Bichard (1999) *Public Management and Policy Association*

⁴² *Talent on Demand: Managing Talent in an Age of Uncertainty*, Peter Cappelli (2008) Harvard Business School Press

⁴³ The problem is that individuals do not always have an incentive to be truthful when revealing information about their ability. In the jargon of the trade, talk can be cheap. In this sense, an opt-in scheme provides a cheap and reliable signal. See 'Informational Aspects of Market Structure: An Introduction', Michael Spence (1976) *The Quarterly Journal of Economics* Vol. 90(4):591-597.

⁴⁴ 'Cheap Talk'. Joseph Farrell and Matthew Rabin (1996) *Journal of Economic Perspectives* 10 (3): 103-118

⁴⁴ This would counter the evidence that more risk-averse people sort into public sector employment: 'Risk Aversion and Sorting into Public Sector Employment', Christian Pfeifer (2008) IZA Discussion Paper No. 3503

3.27 Care should be taken that an opt-in scheme does not supplant or become surrogate for other career development schemes. There may be legitimate reasons why talented candidates may not or indeed cannot put themselves forward for the scheme. For example, employees with lower wealth or more dependents will be more sensitive to changes in their pay and so more risk averse. There is some, albeit inconclusive, evidence that performance pay is not gender-neutral. As such, an opt-in scheme should be only one element in an overall approach to talent management in which all groups have equal opportunities to progress.⁴⁵

The role and benefits of team-based incentives

3.28 There are many ways to link pay to performance and, as highlighted in the Review's Interim Report, it is arguable that the public sector has not used the full range of options. **It should be possible to design team-based incentives that reconcile the importance of due desert with the reality that outcomes are collectively produced by the whole of an organisation's workforce.**

3.29 One reason why team incentives are increasingly popular is that the social effects of teams can be powerful tools for motivating people (Box 3.B). Another reason is that, further down the rungs of the organisation, outcomes are produced by teams rather than individuals. Insofar as performance pay may generate competition, fostering it between teams through team rewards may be more beneficial and less divisive than internal competition within the team.

3.30 However, team rewards are not free from difficulties or challenges. Because individual contributions are not recognised, free-rider problems may arise. Nonetheless, a number of evaluations of team rewards in JobCentre Plus and HM Customs & Excise that followed the Makinson Report in 2000 found positive results, though responses varied with team size and the degree to which teams deployed resources strategically.⁴⁶ An examination of team incentives in the NHS found that they could be sustained in a team of as large as 3,000 members without loss of effectiveness.⁴⁷ Free-riding can also be reduced through schemes that blend both team and individual performance, thereby taking account of differential contributions.

3.31 Difficulties remain in defining the team. In the NHS, for instance, a team could be defined in terms of the ward, the specialty, the support team, the care pathway or the entire hospital – each with different advantages and disadvantages. There is then the issue of how to treat joiners and leavers throughout the year. Many of these issues are becoming cloudier rather than neater as public sector organisations are increasingly expected to work as partners across professional, organisational, functional and sectoral boundaries to realise shared objectives.

3.32 Because teams can be hard to define, **gainsharing – the sharing of productivity gains and resultant savings - is an attractive option.** It has the virtue of definitional clarity, as productivity gains are made either at the level of the entire organisation or at the point of control for individual budgets. Hence it is clearer who has contributed to the outcome. Gainsharing also addresses the perverse practice of clawing back surpluses from organisations that deliver at a lower cost than expected. An instructive counterpoint to this practice is the public sector in Finland which has required that one-third of any improvement in results be devoted to staff rewards. Clearly, safeguards would be necessary to ensure that payouts are contingent on maintaining performance, so that any scheme is not reduced to a charter for cost-cutting.

⁴⁵ 'Pay, Performance Appraisal and Attitudes to Women's Work', Stephen Bevan and Marc Thompson (1992) *Equal Opportunities Commission and Institute for Employment Studies Report 234* and 'Gender Differences in Pay Expectations: The Roles of Job Intention and Self-View', Mary Hogue, Cathy L. Z. DuBois and Lee Fox-Cardamone (2010) *Psychology of Women Quarterly*, 34 : 215–22

⁴⁶ 'Evaluation of the Introduction of the Makinson Incentive Scheme in Jobcentre Plus' Simon Burgess, Carol Propper, Marisa Ratto and Emma Tominey Evaluation of the Introduction of the Makinson Incentive Scheme in HM Customs and Excise

⁴⁷ 'Team Based Pay in the UK, Peter Reilly, Jane Phillipson and Peter Smith (2005) *Compensation Benefits Review*, 37(4):54-60. This is a surprising finding. Dunbar's number, for instance, suggests that groups above 150 are likely to suffer breakdowns in communication and coordination which he attributes to the limits of the brains capacity to process information about the social environment.

RECOMMENDATION 9: Sharing the rewards of greater productivity

To prevent executives monopolising the rewards of productivity increases, and allow all employees who have contributed to share the benefits, government departments should identify ways of offering gainsharing schemes linked to achievement of the efficiency aspects of their business plans. The Government should also explore options for gainsharing schemes across public services more widely.

4

Strengthening the talent pipeline

Chapter summary

The ability to attract, retain and develop high calibre employees is a vital prerequisite of high quality and innovative public services. Action is needed to support and expand the 'pipeline' of talent that supplies public organisations. Priorities are to:

- broaden the talent pool from which executives are recruited – both in terms of recruiters looking widely and applicants applying widely – **minimising the risks of senior pay inflation from a lack of supply of candidates;**
- support managers at all stages of their development and offering a range of career paths – **maximising the opportunities for progression for managers within public service;**
- encourage career paths that can span different areas of public services – **providing the cross-sectoral skills vital for public service reform to succeed;** and
- raise the profile of public sector leadership roles and reinforce the value and ethos of public service – **helping the public sector to compete for the best.**

Action is needed to promote a cultural shift in recruiters – inviting them to be more open to talent across the public sector – and to give them the infrastructure to do this. **An online recruitment portal for the advertisement of management roles across public services would help achieve this. There would also be great benefit in a 'passport' scheme that helped open up movement across different areas of public services, and with the private sector.** This would not just help ensure adequate competition for top jobs to restrain unnecessary pay inflation, but also help match public servants' desire for greater opportunity and progression with the need to develop people capable of leading public services as they are reformed.

Attention also needs to be given to the leaders of the future. Given that factors such as career prospects and job security are so important to attracting graduate candidates there are clear risks in a time of public spending restraint. **Greater collaboration between graduate schemes can help ensure graduates see a career in public services as having varied career prospects. It should also help graduate recruits to develop the cross-sectoral experience and genuine generalist skills that leaders of the future will need.**

The importance of talent management

4.1 The ability to attract, retain and develop high calibre employees is a vital prerequisite of high quality and innovative public services. For the public sector to thrive in the difficult years ahead, it will need motivated staff able to work flexibly within a changing landscape. Yet the ongoing consolidation of public finances will impact job security and opportunities for progression, potentially making it harder to recruit and retain the best. Financial pressures will also take their toll on human

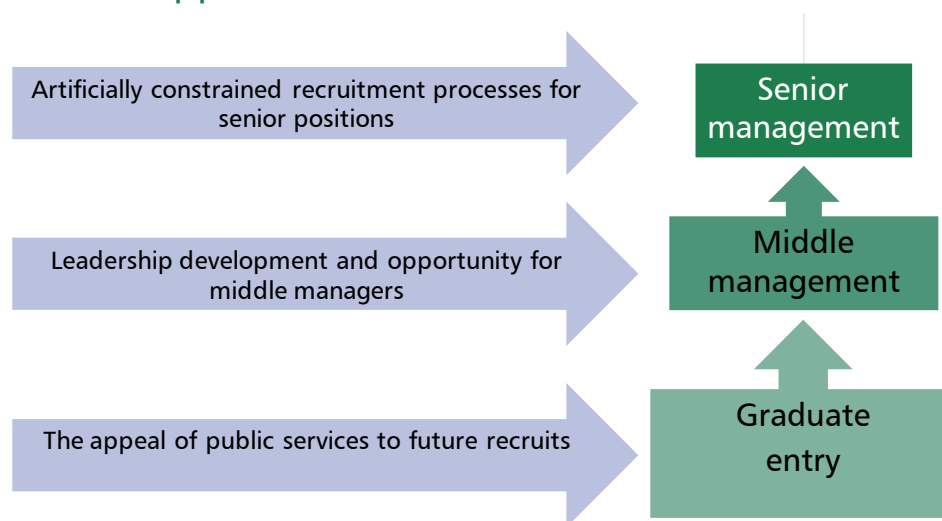
resource budgets, including training and development programmes. Hence talent management will be more important and at the same time more challenging than ever before.

4.2 The Review's Interim Report set out that markets for public sector executives are relatively closed. In some areas, an excessive focus on experienced candidates from within sectors may have led to pay inflation. Recruiting from too narrow a pool of candidates also limits the extent to which the public sector can benefit from new ideas and expertise. The public sector also faces real challenges in nurturing talent to supply senior positions.¹

4.3 This chapter explores the issues raised at the Interim Report in greater depth, looking at the current problems in sections of the 'pipeline' in turn (Figure 4.A):

- artificially constrained recruitment processes for senior positions;
- leadership development and opportunity for middle managers; and
- the appeal of public services to future recruits.

Figure 4.A: The talent pipeline



Artificially constrained recruitment processes for senior positions

4.4 Labour markets for executive positions in much of the public sector are relatively closed, with a clear majority of top managers being promoted from within their own sectors. For example, within the civil service in 2009 internal promotion accounted for about 78 per cent of Senior Civil Service recruitment.² Just one out of 23 chief executive appointments in local authorities between July 2010 and January 2011 were made to an individual without previous local government employment.³ In higher education, over 80 per cent of appointees to Vice Chancellor positions were from the sector.⁴

4.5 This is not necessarily a problem: it is to be expected that many senior managers would be recruited from those with experience within their own sectors. What is of concern is if good candidates from outside the sector are not even considered. But there is evidence that this is often the case. Such artificial constraining of the pool of recruits occurs for three reasons:

¹ As noted in the interim report (p. 82) concerns have been raised about talent development in both the Civil Service and Local Government

² *Outsiders and Insiders: External appointments to the Senior Civil Service: Further Report*, (2010), Public Administration Select Committee

³ Local Government Chronicle 27/01/11

⁴ *The Characteristics, Roles and Selection of Vice Chancellors*, Final Report, 2008 G. M Breakwell and M Y Tytherleigh, VCs Office, Uni of Bath

- Firstly, there appears to be a **preference for experienced candidates** - it has been observed in several sectors that there is an undue premium placed on previous experience. The Audit Commission identified this as a particular issue in local government: the Comprehensive Performance Assessment (CPA), while it was in force, encouraged the hiring of previous chief executives with successful CPA scores (although there is no evidence that this actually led to an improvement in underperforming authorities).⁵ Even with the abolition of the CPA, this bias towards existing chief executives has continued.⁶
- Secondly, there can be **ineffective use of recruitment consultants**. Consultants should be able to use their expertise and networks to widen the pool, but some have argued that recruiters rarely push them to do so.⁷
- Restrictions can also be inadvertent. **How a position is advertised can restrict the number of entrants**. Overly specific language, or use of sector jargon puts off external candidates.⁸ Reliance on a narrow range of recruitment channels also serves to reduce applications from individuals with alternative backgrounds.

4.6 Action is needed to promote a cultural shift in recruiters – inviting them to be more open to talent across the public sector – and to give them the infrastructure to do this. One option would be to establish a central portal for recruiters across public services to advertise managerial positions, and for job-hunters of a certain seniority to post CVs.⁹ The benefits of this could include:

- encouraging recruiters to look beyond their usual recruitment channels;
- enabling applicants to view a wide range of roles at a glance; and
- supporting individual HR departments and reducing the reliance on recruitment consultants.

Leadership development and opportunity for middle managers

4.7 It is vital that individuals in the middle of their career are given the support and opportunity to be able to progress and in time apply for top leadership roles. There are a number of successful schemes across the public sector ranging from small scale specific training schemes. These include the Leeds Castle programme, aimed at improving the quality of existing leaders in Local Government, to the Top Leaders programme in the Civil Service, which aims to develop senior managers into the leaders of the future.

4.8 Such programmes may suffer as budgets are cut back. The Audit Commission has already highlighted concerns about HR in local government, citing issues of senior management engagement, particularly in the area of developing workforce strategy.¹⁰

4.9 As noted in chapter 3, more important than development schemes is the simple lack of opportunity for promotion and career progression, which are frequently cited by public sector employees as a reason for quitting. The top three reasons for individuals leaving public organisations are: “promotion outside organisation” (50 per cent), “career change” (49 per cent) and “lack of

⁵ *Tougher at the Top*, (2008) Audit Commission,

⁶ Unpublished Audit Commission data shows that existing Chief Executives have consistently accounted for around 30% of Chief Executive recruitment between 2005 and 2009 when calculated as a three year average.

⁷ Hamish Davidson evidence to ‘Top Pay in the Public Sector’, (2009), Public Administration Select Committee

⁸ *Leading Lights*, N Keohane (2008) New Local Government Network

⁹ An example of international good practice is the public sector in the Republic of Ireland, which runs publicjobs.ie - a “recruitment facility for public service recruiters and is the main access route for candidates interested in joining the public service”. It not only acts as central point of recruitment but also offers consultancy and training services and is also developing a candidate database to enlarge their immediate talent pool.

¹⁰ *Tomorrow’s People*, (2008) Audit Commission

development opportunities (37 per cent).¹¹ In 2010, just 28 per cent of civil servants felt that there were opportunities for them to develop their careers within their current organisation.¹² This figure is down 10 per cent from 2009, a worrying decline if the civil service is to retain its high calibre individuals in an era of spending restraint.

4.10 Diversity is also an important factor. A number of recruitment consultants have commented on the prevalence of ‘pale, male and stale’ candidates.¹³ Whilst some areas, for example the Senior Civil Service, are increasing the representation of people from an ethnic minority¹⁴ and those with a disability, no doubt more could be done to encourage candidates from all backgrounds to achieve promotion.

4.11 The context for these talent management challenges is that, for the following reasons, successful public services will need managers and leaders who are effective at working across organisational and sectoral boundaries:

- Public service reform is likely to see the public sector disaggregate: individuals will be expected to work within networks of diverse service providers – and to have careers within them.
- Awareness has never been greater of the need for greater collaboration between sectors to solve ‘wicked problems’ such as child poverty or drug addiction.¹⁵ The Institute for Government has noted that ‘complex, boundary-spanning problems are simply a fact of modern Government’.¹⁶

4.12 To facilitate the development of these kind of leaders, individuals should be supported in developing a cross-sectoral perspective. They should be given opportunities to work for different organisations in different areas, and encouraged to build up their own networks of contacts across sectors to inform and co-ordinate effective policy and delivery.

4.13 In summary, **there would be great benefit in any scheme that helped open up movement across different areas of public services, and between the public and private sectors. This is not just about ensuring adequate competition for top jobs to restrain unnecessary pay inflation. More importantly, it is about matching public servants’ desire for greater opportunity and progression with the need to develop people capable of leading public services in an era of disaggregation.**

¹¹ *Recruitment, retention and turnover*, (2009) CIPD

¹² 2010 Civil Service People Survey

¹³ *Top Pay in the Public Sector*, (2009), Public Administration Select Committee

¹⁴ *32nd Report on Senior Salaries*, (2010), Senior Salaries Review Body

¹⁵ *Tackling wicked problems*, V Brown, J. A. Harris and J. Y. Russell (2010)

¹⁶ *Shaping Up – A Whitehall for the Future*, Simon Parker, Akash Paun, Jonathan McClory, Kate Blachford (2010)

RECOMMENDATION 10a: Opening up opportunities for future generations of public service leaders

To increase the supply of candidates for top positions and reinforce public service management as a career, the Government should facilitate greater opportunities for managers to move across different public services, and between the public and private sectors.

By the end of 2011 the Government should establish a single online portal for advertisements and applications for public service management roles, and work with major public service employers to establish a passport scheme for middle and senior managers across public services.

The online portal should include a repository for potential applicants to upload CVs.

The passport scheme should be designed to encourage employers to look more widely when recruiting, and feature organisations from a range of sectors – public and private – making commitments to:

- supplying adequate induction and support to entrants from other sectors;
- arranging joint training and development schemes focused on leadership and transferable skills;
- relying upon greater use of secondments and employee exchange schemes (minimising personal financial barriers to movement);
- advancing the use of existing professional groups; and
- hosting regular cross-sectoral networks.

4.14 None of this should be read as underestimating the real differences in working environments across public services. There are very different political contexts, organisational structures and specialist skills needed between health, local government, central government, and education. Nonetheless, with sufficient induction and support, there are great gains to be made from encouraging some greater movement between sectors.

The appeal of public services to future recruits

4.15 The recommendation above focuses on middle and senior managers. It is also important that public service organisations continue to attract the best and brightest of the next generation to ensure a flow of high calibre individuals into management positions. The public sector operates a number of graduate recruitment schemes, which remain successful:

- Three schemes are recognised in the top 10 of the Times 100 Top Graduate Employers rankings: in 2010, the Civil Service Fast Stream was ranked 3rd in the Top 100, NHS Graduate Management Training Scheme 6th, and Teach First 7th (the Army scheme was 11th, the Police scheme 34th and the Local Government scheme was ranked 47th).
- In 2010-11 the Civil Service Fast Stream attracted 14,911 applicants for 585 vacancies¹⁷, the NHS Graduate Management Training Scheme attracted more than 12,000 applicants for 220 places¹⁸ and the Local Government National Graduate Development Programme attracts typically 1600 applicants a year for 80 places.¹⁹

¹⁷ 2009 Fast Stream Recruitment Report

¹⁸ According to Idea <http://www.idea.gov.uk/idk/aio/9454233>

¹⁹ Although this was an increase of 83% on the previous year <http://www.hr magazine.co.uk/news/871842/83-rise-nhs-graduate-training-applications/>

- They produce individuals capable of achieving leadership positions. The Fast Stream provides 25% of all senior civil servants²⁰ and one former NGDP graduate has already reached 2nd tier officer level - despite the fact that that scheme is less than ten years old. Similarly, the NHS Chief Executive is a graduate of the NHS Graduate Management Training Scheme.

4.16 Evidence suggests the quality of applicants to the public sector remains high. Administrators of the graduate schemes remain happy with the quality of candidates. The share of graduates with a 1st class degree from the elite Russell Group of universities joining public administration has increased between 1995 and 2008.²¹

4.17 Nonetheless, the public sector has to compete in a tough market. In terms of bespoke graduate schemes, the public sector accounted for less than a sixth of recruitment places between 2009 and 2010 (around one fifth of places are for accounting and professional services and around another fifth are for banking and finance).²² A consistently higher number of graduates with a 1st class degree from Russell Group universities find work in the financial sector than in public administration.²³ Of greater concern is that: just 22 per cent of graduate applicants think the public sector is “prestigious for high fliers”, although 69 per cent think it retains “real status and kudos”.²⁴

4.18 Graduate starting salaries in the public sector tend towards the lower end (Chart 4.A).²⁵ Salaries need to be seen in the context of graduate aspirations: 77 per cent of final year students expected to own their own property by the age of 30.²⁶ Nonetheless, it is a range of non-financial rewards that make the public sector attractive to graduates (Chart 4.B). Civil Service Fast Stream applicants identify ‘variety of work’ and ‘promotion opportunities / career prospects’ as amongst the most attractive elements of the scheme.²⁷ The New Local Government Network interviewed graduates who had completed the NGDP scheme and found that:

“career opportunities remain the dominant factor in deciding whether they are satisfied with their employer. The second most significant factor was being able to make a difference through public service. Other contributing factors were visionary management and leadership and clear career paths. Pay featured rarely and only as a marginal concern.”²⁸

²⁰ *Outsiders and Insiders: External appointments to the Senior Civil Service*, (2010), Public Administration Select Committee

²⁰ Based on Fair Pay Review analysis of data obtained from the Higher Education Statistics Authority. The data set contains information on graduates’ university, their degree classification and the Standard Industry Classification of the employment sector that they are employed in. Our analysis focused on the ‘Public administration & defence; social security’ and ‘Financial activities’ (‘Public administration and defence; compulsory social security’ and ‘Financial and insurance activities’ after 2007) classifications. As such it focuses on administrative activities in the public sector and does include teachers, doctors, etc. Further information on what is included in these SIC classifications can be found at: <http://www.ons.gov.uk/about-statistics/classifications/current/index.html>. Our definition of ‘Russell Group’ universities was based on the membership as of 2011.

²¹ Based on Fair Pay Review analysis of data obtained from the Higher Education Statistics Authority. The data set contains information on graduates’ university, their degree classification and the Standard Industry Classification of the employment sector that they are employed in. Our analysis focused on the ‘Public administration & defence; social security’ and ‘Financial activities’ (‘Public administration and defence; compulsory social security’ and ‘Financial and insurance activities’ after 2007) classifications. As such it focuses on administrative activities in the public sector and does include teachers, doctors, etc. Further information on what is included in these SIC classifications can be found at: <http://www.ons.gov.uk/about-statistics/classifications/current/index.html>. Our definition of ‘Russell Group’ universities was based on the membership as of 2011.

²² *The Graduate Market in 2010*, (2010), High Fliers

²³ See footnote 19

²⁴ *The UK Graduate Careers Survey 2009*, (2009), High Fliers

²⁵ Salary progression is of equal, if not greater importance

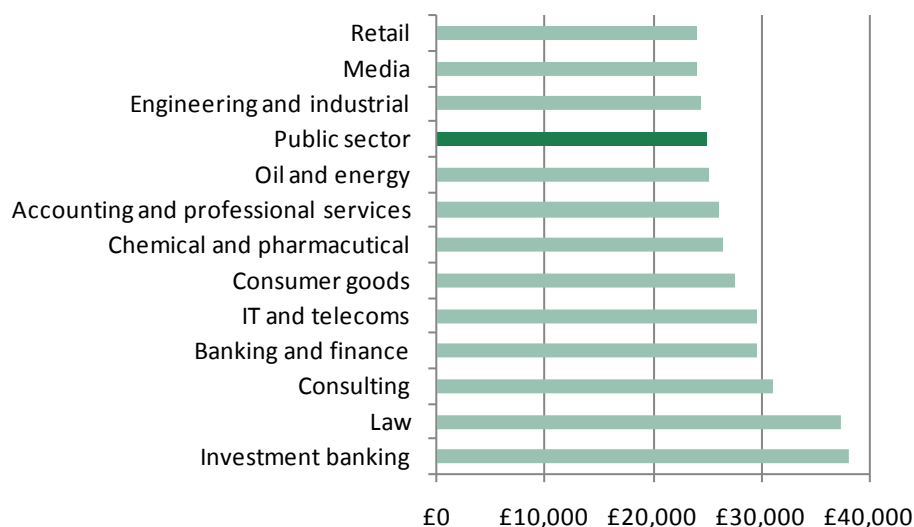
²⁶ *UK Graduate Careers Survey 2010*

²⁷ 2008 survey of Civil Service Fast Streamers

²⁸ *Leading Lights*, N Keohane (2008) New Local Government Network

Chart 4.A: Starting salaries in 2010 for major sectors

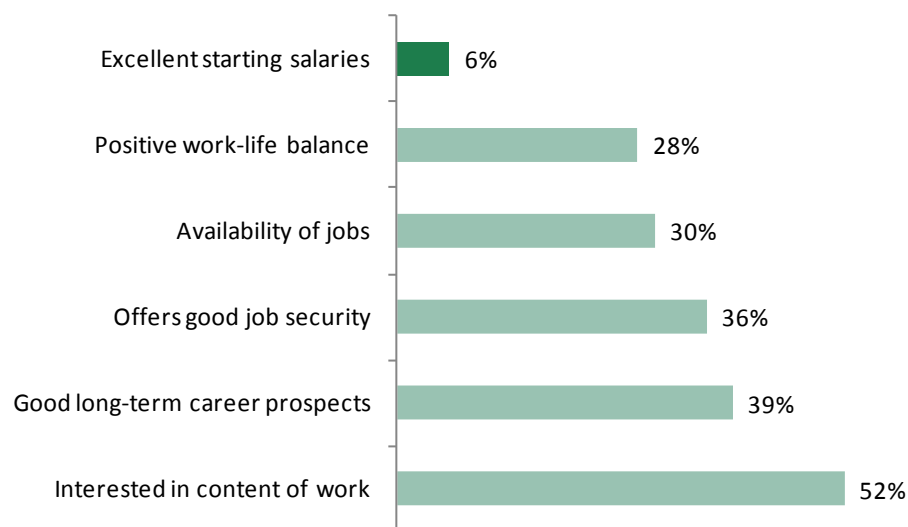
Starting salaries in the public sector do not compare favourably with many others



Source: *The Graduate Market 2010, High Fliers*

Chart 4.B: Finalists' reasons for applying for graduate jobs in the public sector

Content of work, career prospects, job security and availability and work-life balance all rank considerably more highly than pay in attracting graduates to the public sector



Source: *The UK Graduate Careers Survey 2009, High Fliers*

4.19 Given that factors other than salary are so important to attracting graduate candidates there are clear risks in a time of public spending restraint. The public sector is less likely to be viewed as a sector with good long term career prospects, job security and a wide availability of jobs. There could well be a decline in the number or quality of applicants to the sector – even if existing graduate schemes continue. It is highly unlikely that pay levels could be increased to ‘compensate’ for the loss of these other aspects.

4.20 Action should be taken to ensure public sector graduates do continue to have wide prospects. Graduate recruits must develop genuine cross-sectoral experience that leaders of the future will need. Greater collaboration between graduate schemes can help open up cross-sectoral opportunities.

RECOMMENDATION 10b : Opening up opportunities for future generations of public service leaders

The Government should drive and prioritise the ongoing collaboration between public sector graduate recruitment and development schemes. Important elements where greater collaboration could lead to real benefits are:

- integrating recruitment and selection processes;
- emphasising transferable skills within induction programmes;
- developing a common core competency profile that will equip graduates with genuine generalist skills for careers spanning public services;
- promoting opportunities for rotations across different workforces as part of the graduate package;
- supporting the Local Government scheme in developing internship opportunities - along the lines of existing NHS and Civil Service schemes; and
- reducing the barriers to greater rotation between schemes created by differences in employment conditions.

4.21 Together, these recommendations should help support and expand the 'pipeline' of talent that supplies public organisations, by:

- broadening the talent pool from which executives are recruited – both in terms of recruiters looking widely and applicants applying widely – **minimising the risks of senior pay inflation from a lack of supply of candidates;**
- supporting managers at all stages of their development and offering a range of career paths – **maximising the opportunities for progression for managers within public service;**
- encouraging career paths that can span different areas of public services – **providing the cross-sectoral skills vital for public service reform to succeed;** and
- raising the profile of public sector leadership roles and reinforce the value and ethos of public service – **helping the public sector to compete for the best.**

5

A Fair Pay Code

Chapter summary

Independent pay-setting is vital, particularly where pay can vary with performance. Employees must perceive that the process is fair, and be assured that it is free from arbitrary influences such as political interference. And taxpayers must be confident that decisions about pay and performance are robust and protected against undue managerial influence.

Pay governance practices currently vary significantly across public services. Such variation is not necessarily a problem, but to reassure the public **a consistent framework of pay principles should be established**.

The Senior Salaries Review Body has produced a draft Code of Practice on senior pay. This has much to recommend it, but does not include fairness among its principles. Building upon this work, **the Fair Pay Review has therefore produced a Fair Pay Code, to be adopted by all organisations delivering public services on a 'comply or explain' basis**.

This new Code includes provisions on proportionality in executive pay, the use of variable pay and enhanced disclosure of executive pay in line with the recommendations of this Report. It also requires improved independent pay-determination processes.

To ensure that decisions on executive pay take account of the whole workforce context, and that executive pay decisions are justifiable to all employees, **organisations delivering public services should include an employee representative in the membership of their remuneration committees**.

There are risks in a 'comply or explain' approach; hence the importance of supporting governance with the potential for tougher regulatory intervention, as set out in Chapter 2.

Governance over senior pay

5.1 Greater transparency of senior pay and pay multiples, linking pay more directly to performance, and opening up the flow of talent into senior positions, will all play important roles in making senior pay in public services fairer. But pay-setters play a central role. It is the results of their decisions which are to be disclosed and explained, it is they who must judge how pay should reflect performance, and they should also have an interest in ensuring that sufficient talent is coming through to the senior roles.

5.2 Independent pay-setting is vital, particularly where pay can vary with performance. Employees must perceive that the process is fair, and be assured that it is free from arbitrary influences such as political interference. And taxpayers must be confident that decisions about pay and performance are robust and protected against undue managerial influence.

5.3 Practices in remuneration governance vary from sector to sector and between organisations – (table 5A). For instance, smaller organisations are less likely to have independent remuneration committees. Some smaller organisations club together, as in the model used by academic Research Councils, where executive pay is currently set by a joint remuneration committee serving a number of

bodies. Practices have changed over time and continue to evolve – for instance the Government’s Localism Bill may mandate that executive pay in local authorities is voted on by the full council.

Table 5.A: Practices in remuneration governance

Sector	Typical arrangements for remuneration governance for board level executives¹
Civil Service	Remuneration is determined by reference to bands set by Ministers with advice from the Senior Salaries Review Body. Annual changes in the pay of permanent secretaries is decided by a remuneration committee comprised of members of the Senior Salaries Review Body and attended by the Cabinet Secretary. Changes in pay of other executives will be determined by a senior pay committee within that department, and such committees do not necessarily include independent members.
NDPBs	Arrangements vary considerably. Many, though not all, NDPBs have remuneration committees staffed by non-executives. Some executive posts are linked to existing pay structures, such as senior civil service pay bands and the NHS Very Senior Manager framework, especially where individuals are on loan from other public organisations.
Local Authorities	Arrangements vary considerably. One third of authorities operate a remuneration committee. Such committees vary in the seniority of manager they cover. Only 22 per cent of committees have representation from outside the authority; otherwise, members are elected members drawn from the council. ²
NHS Foundation Trusts	Most trusts operate remuneration committees, typically formed of the Chair of the Trust and around three non-executives drawn from the board of directors.
Universities	Use of remuneration committees varies, but typically comprise the chair of the governing body and at least three other lay/independent members (usually but not necessarily member of the governing body).
Academy schools	There is no requirement for academy schools to operate a remuneration committee, though pay issues may be covered by the finance committee (which is required). Members will be drawn from the board, which may comprise governors representing sponsors, the local authority, parents and staff.

1 Actual arrangements will vary from organisation to organisation
2 According to *Local Government Workforce Survey 2009 England*, Local Government Employers

Source: Fair Pay Review

Encouraging consistency: the SSRB Code of Practice

5.4 Variation in remuneration governance is not in itself a problem, provided that control systems in each organisation function effectively. But control is patchy, and the Senior Salaries Review Body have highlighted the following issues:

- the lack of a clear remuneration framework of pay principles and guidance for the public sector as a whole, to help different institutions determine what level of pay is reasonable;
- variable use of independent decision-making structures in setting senior executive pay; and

- the lack of a clear system for assessing exceptional cases, for example for determining how much of a premium could be paid to recruit particular skills in from the private sector.¹

5.5 In their recent reports on senior pay in the public sector, both the Senior Salaries Review Body and the Public Administration Select Committee called for clearer and more consistent pay principles to be established. The Senior Salaries Review Body has recommended that this be delivered through a Code of Practice on senior pay which sets consistent standards on pay governance, appropriate remuneration and public disclosure.

A Fair Pay Code

5.6 The Senior Salaries Review Body's draft Code of Practice has much to recommend it, in particular its requirement that senior pay should be set through processes independent of the executives whose pay is under consideration, according to consistent established rules and procedures and subject to public scrutiny. The principles behind the Senior Salaries Review Body's draft Code should certainly form a key part of a framework for fairness in senior pay.

5.7 However, the Senior Salaries Review Body's draft Code would need to be taken further in the light of the fairness principles set out by this Review. **This report sets out a new Fair Pay Code for senior pay, to be adopted by all organisations delivering public services, on a 'comply or explain' basis.** This Code builds upon the Senior Salaries Review Body's draft, bringing some additional clarity in some specific areas of definition, and incorporating the key fairness principles articulated by this Review. The Fair Pay Code is set out in Annex B.

Fair and appropriate pay levels

5.8 The Fair Pay Code sets out the principle that **executive remuneration should fairly reward individuals' due desert and contribution to their organisations' success, and should be sufficient to recruit, retain and motivate executives of sufficient calibre, but organisations should avoid paying more than is necessary in order to ensure value for money in the use of public resources.** Under this principle, the Code includes provisions on:

- executive pay reflecting individuals' due desert, being proportional to the weight of executive roles and the performance of individuals;
- variable pay, including earn-back pay for executives;
- enhanced disclosure and explanation of senior pay in terms of job weight and individual performance; and
- the disclosure of pay multiples, setting the pay of executives in the context of the wider workforce.

Fair and Transparent Process for Setting Executive Pay

5.9 The Code sets out the principle that **executive remuneration should be determined through a fair and transparent process via bodies that are independent of the executives whose pay is being set, qualified in the field of remuneration, and allow scope for employee and citizen participation.** Processes for setting executive remuneration should be open and transparent to allow public scrutiny. Accountability for executive remuneration rests with each organisation's Board or Governing Body, within a defined framework of delegated authority where appropriate. Under this principle, the Code includes provisions that executive pay should be set:

¹ *Initial report on Public Sector Senior Remuneration 2010*, Senior Salaries Review Body, March 2010

- within a formal framework, in the context of the wider workforce strategy, and with comprehensive contracts of employment; and
- by an independent remuneration committee (or independent pay review body or advisory remuneration committee where pay is set by politicians);

and that such remuneration committees:

- have a role in talent and succession strategies;
- are primarily comprised of non-executive members, and also comprising and/or having access to expert advice on remuneration; and
- also include a representative of the organisation's workforce.

5.10 This final point requires further explanation. In order to avoid unfair pay disparities in organisations delivering public services, and to recognise that organisations' successes are the result of collective endeavour by the workforce as a whole, executive pay should be decided in the context of the pay of all the organisation's employees. Those setting executive pay should have particular regard to the impact on wider employee engagement and morale of any differential treatment for executive and non-executive staff.

5.11 A powerful way to ensuring that the wider workforce context is considered when executive pay is being determined is through the presence of an employee representative on the remuneration committee. Participation is an important part of a fair process, as established in Chapter 1. The participation of this employee representative will give the wider workforce a direct voice in the executive pay-determination process, and will help ensure that decisions can be justified to all employees. The presence of an employee representative could also improve the quality of executive pay decisions, both by contributing information on the working of the organisation that is independent of its management, and by increasing the diversity of remuneration committee membership. Indeed, employees have an incentive to monitor executive pay and performance since they have so much staked on the success of the organisation – arguably even more than shareholders (as selling shares is typically easier than changing job).²

5.12 Employee participation in remuneration committees would be an evolutionary step, and would be consistent with the Government's wider vision of greater employee power in public services, including through the encouragement of mutualisation and the formation of staff co-operatives in public services. In many public service organisations employees already play a significant role in corporate governance: for example, NHS Foundation Trusts have staff governors on their boards of governors, many schools have teachers serving as Governors, and university governing bodies frequently include academic or non-academic staff members.

Risks of 'comply or explain'

5.13 The Fair Pay Code is intended to be applied on a 'comply or explain' basis, in line with existing practice in private sector corporate governance and the Senior Salaries Review Body's recommendations for its own draft Code. Under this regime, organisations delivering public services should each year either:

- publicly state that they have abided by the provisions of the Code of Practice; or

² 'Voluntary Co-determination Produces Sustainable Competitive Advantage', Margit Osterloh, Bruno Frey and Hossam Zeiton (2010) in Lorenzo Sacconi, Margaret Blair, R. Edward Freeman and Alessandro Vercelli eds. Corporate Social Responsibility and Corporate Governance The Contribution of Economic Theory and Related Disciplines, Palgrave Macmillan.

- where they have not complied with any of its provisions, provide meaningful explanations of why they have not complied.

5.14 Explanations must refer to specific and verifiable circumstances or conditions that make compliance inappropriate or impossible, and must include supporting evidence. Organisations that do not comply with the provisions of the Code must also explain how their alternative arrangements meet the principles of the Code. These statements should be included in organisations' remuneration reports or similar public disclosures, and should be available on their websites and to the public on demand.

5.15 Although it brings flexibility, there are risks to the approach. One risk is that compliance and explanation are not in practice seen as genuine alternatives.³ The second risk is that comply or explain focuses on individual organisations, so does not address systemic problems with the market, especially any 'arms race' in pay. Thirdly, individual dispersed stakeholders may rationally choose not to devote time and energy to challenging organisations' explanations. Where people do engage, that engagement might be unrepresentative: for example, only the better educated and more affluent put the energy in, risking unequal accountability and outcomes; alternatively, those hostile to high pay on any terms may dominate discussion, to the detriment of recruitment and retention.⁴

5.16 A 'comply or explain' regime therefore needs to be supported by the possibility of greater regulatory intervention, as recommended in Chapter 2.

RECOMMENDATION 11: A Fair Pay Code

To embed fairness principles and ensure fair process in executive remuneration, all public service organisations should adopt the Fair Pay Code proposed by this Review. Government departments should by July 2011 bring forward proposals for the application of this Code to all bodies and sectors in which they have an interest.

³ 5.15 'Corporate governance in the UK: Is the comply or explain approach working?', Sridhar Arcota, Valentina Brunob and Antoine Faure-Grimaudc (2010) *International Review of Law and Economics* 30: 193–201

⁴ 'Remuneration committees and CEO pay in the UK privatised water industry', Stuart Ogden and Robert Watson (2004) *Socio-Economic Review*, 2: 33–63; 'The Legitimacy of Pay and Performance Comparisons: An Analysis of UK University Vice Chancellors Pay Awards' Heather Tarbert, Kaihong Tee and Robert Watson (2008), *British Journal of Industrial Relations* 46(4): 771–805

6

Fair pay as a social norm

Chapter summary

The principle set out in this Review that pay should reflect due desert, set within a fair process, applies more widely than the issue of differentials between top pay and the pay of the rest. It is unfair that anyone should be rewarded or punished for the brute luck of having been born male or female, or into any given ethnic or socio-economic background.

The revolution in executive remuneration is a part of a wider trend to greater pay dispersion; some of which will be fair and deserved; but some will be down to brute luck and economic rent. There is growing concern that such pay is not justified, and that it has detrimental results on organisations and on society at large.

The pay norms that are accepted where public meets private will affect the ability of public sector organisations to recruit and retain. Hence **it is important that the Fair Pay Code and as far as possible the other recommendations proposed by this Review are extended into the public services industry.**

The framework of tracking multiples, of transparency and explanation, of earn-back, of escalating intervention, and of widening the talent pool, should be applied to the private sector.

The importance of the principles of fair pay

6.1 The Review's terms of reference required it to help to shape broader social norms in relation to pay fairness, and in particular to examine the extent to which market failures and distortions have created disproportionately excessive private sector executive pay with attendant pressures and unwelcome spill-overs on the public sector.

6.2 The trends to greater pay dispersion set out in Chapter 1 are the result of a combination of factors.¹ Some of the consequences of these factors on people's incomes will be fair, as they will be earned and deserved; others will have more to do with luck and economic rent. The income of some high earners will reflect their due desert, a reward for their effort, skills, creativity and so on. Others will have been in the right place at the right time, or able to extract rent. And people recognise this difference: in a recent poll, far more people saw Alan Sugar and J.K. Rowling, both self-made individuals, as more deserving of their wealth than the Duke of Westminster or Roman Abramovich.² Attitudes about the poor also reflect an understanding of due desert:

¹ 'Skill-Biased Technological Change and Rising Wage Inequality: Some Problems and Puzzles', David Card and John DiNardo *Journal of Labor Economics* (2002) 20(4): 783-783. See also 'Unions And The Labour Market For Managers', John Dinardo, Kevin F Hallock and Jörn-Steffen Pischke; 'Globalization and Income Inequality: A European Perspective', Thomas Harjes (2007) IMF Working Paper WPI/07/169. 'Controversies about the Rise of American Inequality: A Survey' Robert J. Gordon Ian Dew-Becker (2010) NBER Working Paper 13982; 'Fairness and Redistribution: U.S. versus Europe', Alberto Alesina, and George-Marios Angeletos (2005) *The American Economic Review* 95: 913-35; 'CEO Compensation' Carola Frydman and Dirk Jenter (2010) NBER Working Paper 16585

² Unpublished Yougov/Fabian Society poll

people's support for government policies to redistribute wealth reflects the extent to which they think poverty is the product of choice or circumstance.³

6.3 The principle set out in this Review that pay should reflect due desert, set within a fair process, applies more widely than the issue of differentials between top pay and the pay of the rest. It is unfair that anyone should be rewarded or punished for the brute luck of having been born male or female, or into any given ethnic or socio-economic background. Fair pay means rewarding equal contributions equally, with clear and accountable processes for ensuring that this is so. And it is fair that all workers should receive some minimum level of reward for their contribution, especially if that minimum is the precondition for dignified participation in a market economy. This is what the concept of due desert has to say on the problems of pay discrimination on grounds of race, gender or disability, issues of regional variation in pay and the question of the minimum level of pay required for a decent and fulfilling life: the 'Living Wage' debate. However, the burden for resolving such issues rests on a series of remedies – from tax and benefit, through training and equal rights legislation to minimum wage legislation – that are outside the scope of this Review.

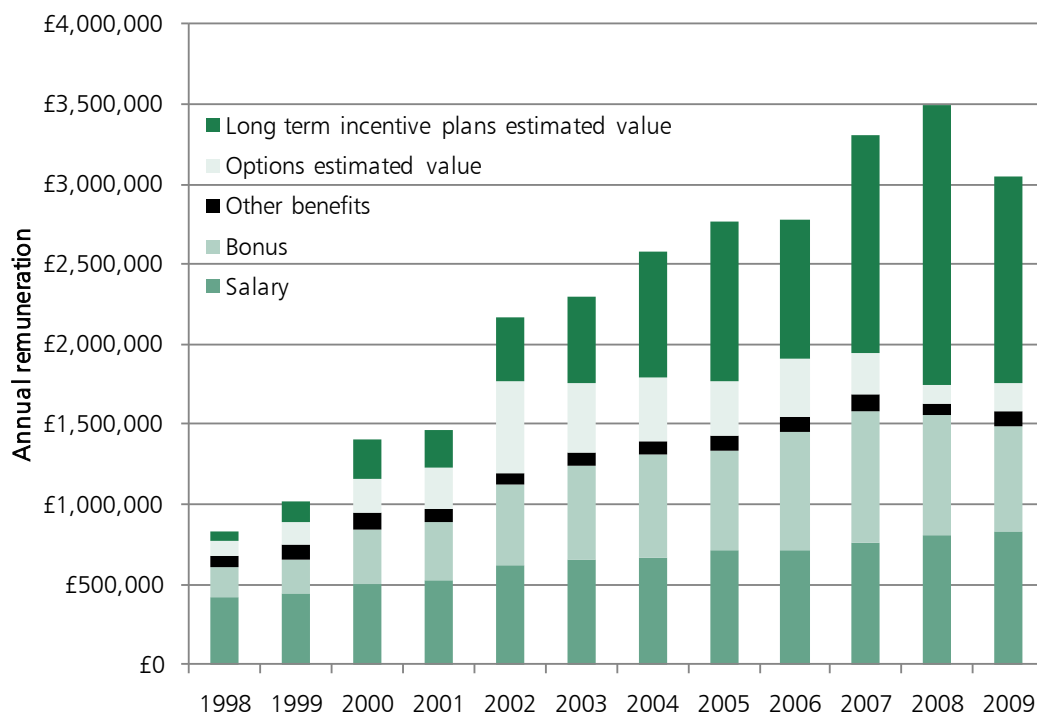
Distortions and failures in executive labour markets

6.4 The revolution in executive remuneration is a part of this wider trend to greater pay dispersion; hence the importance of assessing its fairness. The Interim Report described how over the 1980s and 1990s the executive remuneration package, in listed companies in the US and then in the UK, changed as shareholders made greater use of share-based incentives that sought to tackle head on the principal-agent problem. Survey data suggests major above-inflation rises from the late 1980s, with bonuses and long-term incentive elements becoming much more important from the mid 1990s onwards (Chart 6.A).

³ 'Strong reciprocity and the welfare state', Christina Fong, Samuel Bowles and Herbert Gintis (2006) in Serge-Christophe Kolm and Jean Mercier Ythier ed. Handbook on the Economics of Giving, Reciprocity and Altruism Volume 2, Elsevier

Chart 6.A: Chart F: Median FTSE 100 chief executive total remuneration (excl. pension) composition 1998 – 2009

The relative importance of Long-Term Incentive Plans has grown dramatically in the last decade



Source: The Manifest/MM&K Executive Director Total Remuneration Survey – 2010

In order to best capture the changing nature of CEO compensation figures given are for 'Total Remuneration' and as such include awards that may have not been cashed that year. This explains the apparently larger size of remuneration compared to other charts. For further information see Annexes D and E.

6.5 The Interim Report explained that this revolution in PLCs is hard to justify on grounds of due desert:⁴

- The increased use of equity-based incentives has explicitly tied pay to performance, and has required executives to accept more personal risk. In theory, this risk justifies a higher level remuneration. But **there are good reasons to question whether equity-based incentives as currently formulated represent fair pay**: they can be a poor proxy for a manager's personal performance, they can be manipulated, and they are often geared towards value-destroying short-term activities.
- In an age of larger and more complex firms, the role of the executive has undoubtedly become more complex, and executives' contribution larger. But executive pay has continued to grow as firm size has levelled off; **it is hard to believe that greater job size justifies the realised growth in pay.**
- Recent decades have also seen the rise of generalist managers, able to move between sectors and demand higher pay to stay where they are. Yet the supply of generalist managers has risen with demand. There are justified concerns that

⁴ Full arguments and evidence for these points are set out in Chapter 3 of the Interim Report

boards set too much store on recruiting big name executives, overlooking other candidates and limiting the pool of talent unnecessarily.

- Counter-intuitively, the revolution in pay has been accompanied by great improvements in corporate governance and transparency. **Corporate governance has only served to limit pay at the margin.** Remuneration committees do not want to send the signal that they are comfortable with below average chief executives, and benchmark their pay accordingly. With firms benchmarking each other, a single increase can ripple out across many firms. Executives can still exert influence over the pay-setting process, and shareholder activism has been limited in its impact. Ultimately, **excessive executive pay inflation is a collective action problem.**

6.6 It is therefore unsurprising that there is growing concern, even among some institutional investors, that this level of pay is not justified. In the US some chief executives have reported they now consider themselves to be overpaid, and around 80 per cent of American non-executive directors believe this to be the case.⁵

6.7 This may have damaging results for the organisations concerned. The more that leadership teams are disproportionately paid without a clear rationale or framework of performance, then the more employees will feel that different rules apply to their bosses – undermining the reciprocity that is at the heart of any organisation. If employees promise to work harder to achieve a deadline, make sacrifices or seize unprompted opportunities, they must get something similar in return. They must feel that their leaders will behave reciprocally in times of need and are in the same boat, playing by the same rules. A wide range of academic studies, covering large and small businesses across different sectors in North America and Europe, suggest there is a strong correlation between narrower pay dispersion within an organisation and improved organisation performance, in particular where the input of many employees is important to performance.⁶ According to this research, wide gaps between top and bottom pay within an organisation harm performance.⁷ This is not to say that organisations with high pay differentials between the top and the rest will be poorly performing, rather that there will be gains to morale and productivity in organisations where everyone is seen to be paid according to their contribution.

6.8 More broadly, extremes of executive pay contribute to greater income inequality in society, and its entrenchment. There is now good evidence that income inequality can become entrenched across generations, as elites monopolise top jobs regardless of their talent, gaining preferential access to capital and opportunities.⁸ This harms social mobility, which has been shown to be to the detriment of long-run economic growth.⁹

6.9 Finally, if labour markets are producing large rewards that are not deserved, they will draw people to them and away from genuinely productive activity. Hence the widespread concern that, for

⁵ 'We are overpaid, say US executives', Francesco Guerrera (2007) Financial Times, October 14.

⁶ 'Product Quality and Pay Equity Between Lower-Level Employees and Top Management: An Investigation of Distributive Justice Theory', Douglas Cowherd and David Levine (1992), *Administrative Science Quarterly* 37(2):302-320; 'The Performance Effects of Pay Dispersion on Individuals and Organizations', Matt Bloom (1999), *Academy of Management Journal*, 42(1): 25-40; 'Pay Dispersion and Workforce Performance: Moderating Effects of Incentives and Interdependence', Jason Shaw, Nina Gupta and John Delery (2002) *Strategic Management Journal*, 23(2): 491-512; 'Dispersion in wage premiums and firm performance', Pedro Martins (2008) *Economics Letters* 101:63-65; 'The Effect of Executive-Employee Pay Disparity on Labor Productivity', Olubunmi Faleye, Ebru Reis and Anand Venkateswaran (2010) Unpublished.

⁷ The interim report looked at the counter argument: that greater pay dispersion increases incentives for employees (tournament theory) but found that this is subject to challenge. Using large pay jumps as the sole incentive and signal for promotion can be self-defeating: the criteria for job success changes as executives rise in the hierarchy and ability to respond to cash incentives is only one of them. In any case organisational success often requires executives to collaborate as much as compete.

⁸ 'Equity, efficiency and inequality traps: A research agenda,' François Bourguignon and Francisco Ferreira and Michael Walton (2007), *Journal of Economic Inequality* 5:235–256; *Poverty Traps*, Samuel Bowles, Steven Durlauf, and Karla Hoff eds. (2006) Princeton University Press.

⁹ *World Development Report 2006: Equity and Development*, World Bank, Oxford University Press; 'The Allocation of Talent: Implications for Growth', Kevin Murphy, Andrei Shleifer and Robert Vishny (1991) *The Quarterly Journal of Economics*, 106(2):503.

example, excessive pay in financial services is not just unwarranted but is siphoning off talent from elsewhere in the economy.

The wider application of a framework for fairness

6.10 Wider application of the principles of fair pay set out by this Review should bring benefits to organisations and to society. The remainder of this chapter provides some pointers for how this could be done within the public service industry and amongst public limited companies.

The public services industry

6.11 The UK certainly needs to capture the benefits of private participation in the delivery of public services and cannot resist the trend to disaggregation. The UK public services industry is the most developed in the world and second in size only to the US, with turnover (largely from taxpayer funds) in 2007-08 of £79 billion. The industry has more than doubled in size since 1995-96.¹⁰ There is also the Private Finance Initiative. There are £58 billion of outstanding PFI contracts in which private contractors deliver privately financed public infrastructure but at public direction. In all these circumstances the taxpayer has a legitimate interest in securing fair executive pay.

6.12 In many instances it remains the taxpayer who is funding public services, however they are provided, and who needs assurance that the publicness of their services is being preserved. Executive pay must thus match more testing criteria for performance: efficiency, quality and accountability. Whether in an increasingly heterogeneous public sector or in the borderlands between public and private in contracted-out public services and varying public-private partnerships, everyone will need to be more attentive to the issue of executive pay.

6.13 The pay norms that are accepted on the boundaries of the public sector will have far wider impacts. There have already been reports that the higher pay for managerial positions within contracted-out services is attracting talent from public sector organisations – potentially making recruitment and retention harder for them.¹¹ Hence **it is important that the Fair Pay Code and as far as possible the other recommendations of this Review are extended into the public services industry.**

Public limited companies

6.14 The principle of robustly linking pay to due desert should be applied to the private sector for many of the same reasons as the public sector. The arms race effects that may develop in the public sector are a reality in the private sector, with little discernable relationship with performance. There are also huge risks, as identified in the Interim Report that performance-vested stock options, which are meant to be the gold standard for performance pay, can be manipulated and have been granted too freely.¹² It bears repeating that average chief executive remuneration in the FTSE 100 has doubled in the last nine years, far outstripping the average performance in terms of share price. This is perhaps most dramatic in parts of the financial services sector but it is observable elsewhere too. Despite the concern expressed by shareholders and wider stakeholders, along with a considerable toughening up of corporate governance, the problem is evidently systemic, and requires systemic solutions.

6.15 Just as in public services, there should be **no rewards for poor performance**. As recommended in Chapter 3, there must be a downside risk as well as an upside risk. The increasing use of deferred bonuses and options, dependent upon longer term results, and claw back arrangements, is welcome.

¹⁰ The Public Services Industry Review (2008)

¹¹ For example, <http://www.guardian.co.uk/politics/2010/jul/16/civil-servants-lucrative-roles-private-sector>

¹² 'Performance-vested Stock Options and Earnings Management', Yu Flora Kuang, 2008 *Journal of Business Finance and Accounting* 35(9/10): 1049-1078

But the loss of a bonus or Long Term Incentives will rarely be perceived as a real downside risk, particularly at very high levels of income, and because individuals discount the value of future rewards.

6.16 This is why the concept of earn-back has relevance in the private sector. There have been interesting suggestions that bankers should have to put some of their base income at risk if they are to be eligible to receive a bonus or shares. This concept of 'double liability' could be made to work for executive remuneration as well. For instance, they could receive higher base pay but be required to place more of it at risk in order to be eligible for Long Term Incentive and bonus pay outs. And it should be absolutely clear that bonuses are only paid for exceptional performance or achieving abnormal rates of value generation over and above the cost of capital in a clearly articulated framework of strategic intent, strategic execution and performance indicators.¹³

6.17 As in public services, **reporting needs to move to clearer explanation** of how executive remuneration links to strategy and performance. Remuneration reporting by PLCs, while detailed, can nonetheless be extremely opaque. Disclosure of clearer metrics, in an easily accessible format, would help enable a powerful reorientation of the setting of pay away from a blind pursuit of the perceived market price. Instead, the focus must be on what the executive is expected to deliver. And better explanation will enable shareholders to hold remuneration committees to account for how they judge pay against performance.

6.18 Remuneration committees should also have greater involvement in talent development and succession planning. This will help them to recognise that it is rarely necessary to pay over the odds for the 'superstar CEO' from elsewhere. Greater participation by employees in executive remuneration may also serve as a check on excessive pay.

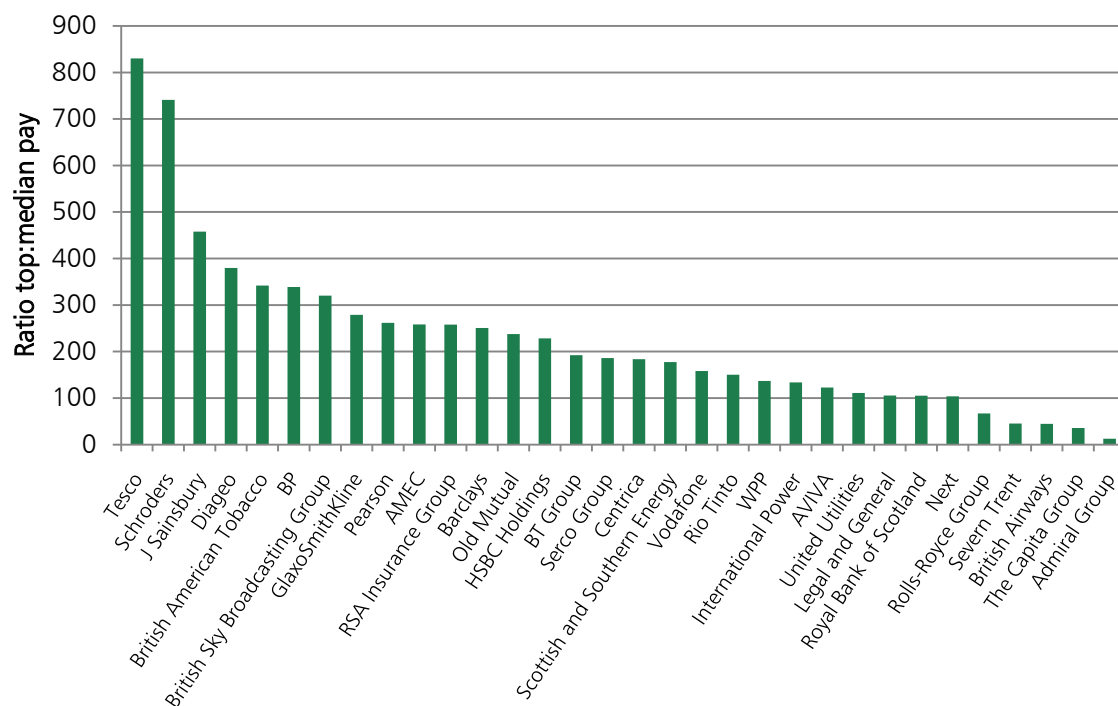
6.19 Finally, **executive remuneration must be brought back into the context of the pay of the rest of the workforce through the disclosure of the ratio of top to median pay.** In the Coalition Agreement, the Government has committed to investigating ways of improving corporate accountability and transparency. Disclosure of pay multiples in PLCs should form part of wider efforts to improve transparency and accountability, and would be in line with proposals in the United States likely to take effect in 2012.

6.20 There will be a range of multiples corresponding to differing pay structures and different sectors (Chart 6.B shows some indicative figures based on medians by sector). In high valued added companies with high wage workforces the multiples will tend to be lower than in low skilled companies with lower wages. However over time norms will appear in different sectors which companies and remuneration committees will be able to use to assess executive pay. Why is Company A's multiple higher than Company B's in the same sector? What performance or challenges justifies the wider multiple? Such data, as it becomes available, could usefully be collated by the Senior Salaries Review Body as part of its Fair Pay Reports.

¹³ Hesketh, A. & Lennon, A. (2011), 'Moving Beyond A Penny A Day? Measuring and Rewarding Executive Capital,' Lancaster University Management School Working Paper (Lancaster: LUMS)

Chart 6.B: Ratios of chief executive pay to UK median earnings, 2010, selected FTSE 100 companies

Top to median pay multiples will vary considerably across companies



Source: FPR analysis of FTSE100 CEO earnings based on Manifest data obtained from Accountancy Magazine (Nov 2010). Earnings represent realised remuneration, please see Annex C for a more detailed explanation. Median pay for the UK Workforce taken from ASHE 2010, ONS.

Note that these top to median ratios are indicative, not definitive, as they are based on total UK median earnings of £25,879. Actual workforce median pay will vary between organisations.

6.21 In terms of creating social norms, private sector institutional shareholders and their industry associations should address the perception and the reality of disproportionately paid executives. And they can do this by reworking this fair pay framework - of tracking multiples, of transparency and explanation, of earn-back, of escalating intervention, and of widening the talent pool – in a private sector context.

RECOMMENDATION 12: Tracking pay multiples across the economy

To make tracking pay multiples normal practice across the economy, as part of its commitment to improve corporate reporting, the Government should require listed companies to publish top to median pay multiples in their annual reporting from January 2012.

The Senior Salaries Review Body should collate and publish the multiples in a similar format to the one used for public sector leaders.

In reviewing corporate accountability and transparency requirements, the Government should also consider how clearer explanation of executive pay by private companies can be achieved.

The government, including local government, should use their influence as a major procurer with all major private sector contractors and suppliers to see that they observe the Fair Pay Code.

A

Summary of full recommendations

RECOMMENDATION 1: Using pay multiples to track executive pay against that of all employees

The Government should not cap pay across public services, but should require that from 2011-12 all public service organisations publish their top to median pay multiples each year to allow the public to hold them to account.

The Government should require that public bodies annually publish chief executive's (or equivalent) earnings, median earnings of the organisation's workforce, and the ratio between these two figures in their annual remuneration reports. All taxable earnings should be included within this multiple. Year-on-year movements in the chief executive's earnings and median earnings should be disclosed and explained. Disclosures should begin in remuneration reports covering the financial year 2011-12, including prior year comparators.

To this end, the Government, with advice from the Financial Reporting Advisory Board, should at the earliest opportunity amend the disclosure requirements in the Financial Reporting Manual (FRoM) to require organisations to include the disclosures above, and should work with relevant bodies to make similar amendments to other relevant guidance including the NHS Manuals, the NHSFT FRoM the IFRS based Code of Practice on Local Authority Accounting, and guidance for remuneration reports by NDPBs not covered by the FRoM.

The Government should encourage major suppliers to the public sector, and organisations that play a major role in delivering public services, but which are not subject to public sector financial reporting requirements, to include such disclosures on a voluntary basis, such that tracking and explaining senior pay in this way can become a norm across all public services.

RECOMMENDATION 2: Informing the public debate through annual Fair Pay Reports

To support citizen accountability, the Government should commission the Senior Salaries Review Body to publish annual Fair Pay Reports, starting from 2011-12. These reports should set out trends in pay multiples across public services, highlight year-on-year changes and identify organisations that fail to produce meaningful, specific and verifiable explanations for their pay multiples and for changes.

As trends emerge from the SSRB's annual Fair Pay Reports, if the Government judges that pay multiples in individual organisations have shown continued unjustified increases, it should consider intervening directly to control senior pay in the organisations concerned.

If pay multiples continue to rise across public services without adequate justification, as a last resort the Government should restrict organisations' autonomy over senior pay and instead impose centrally-set pay bands.

RECOMMENDATION 3: Re-calibrating the pay of Non-Departmental Public Body chief executives

To address particular concerns that the pay of Non-Departmental Public Body chief executives has

become detached from the responsibilities of their roles, the Government should by December 2011 establish a series of pay benchmarks for NDPB chief executives, following advice from the Senior Salaries Review Body.

Departments should work with the NDPBs they sponsor to assess which pay benchmark is appropriate, given the weight of each chief executive position, and should publish their decisions. The Government should perform a check for consistency once the initial assessments have been made.

Where NDPBs wish to pay a chief executive (incumbent or newly recruited) more than the recommended benchmark, they should obtain Ministerial approval from their sponsoring department.

In addition to the disclosure provisions set out in other recommendations of this Review, NDPBs should also publicly explain in annual remuneration reports any deviation in their chief executive's pay from the recommended benchmark, and the basis of the Ministerial decision to approve.

The Government should ask the SSRB to conduct periodic reviews of the benchmarks, and of their implementation.

Once the scheme is fully operational, it should no longer be necessary for the Chief Secretary to the Treasury to sign off any NDPB salaries in excess of £142,500. Rather, the scheme should provide a more rational basis for Ministerial approvals, including where pay below £142,500 is being proposed but is still excessive for the organisation in question.

RECOMMENDATION 4: From disclosure to explanation: ensuring complete transparency over executive roles and remuneration

To enable citizens to understand executive remuneration and the nature of executive responsibilities, from 2011-12 the Government should require that all organisations delivering public services disclose in precise numbers the full remuneration of all executives, alongside an explanation of the responsibilities of each role and of how executives' pay reflects individual performance.

In parallel with the actions outlined in Recommendation 1, the Government should improve disclosure requirements for public organisations in the following ways:

- Organisations delivering public services must annually disclose the full remuneration of all executives (defined as the chief executive or equivalent, members of the executive board and any other direct reports of the chief executive).
- Executive remuneration must be disclosed in actual numbers, and broken down into base salary, allowances, variable/performance pay, and the cash value of benefits-in-kind.
- Employer contributions to Defined Contribution pension schemes for executives should be disclosed. For executives who are members of Defined Benefit pension schemes, any additional pension rights purchased for them by their employers should also be disclosed.
- Alongside these disclosures, organisations should provide a clear, meaningful explanation of executive pay, in terms easily understandable by the public. Organisations should explain how executives' remuneration relates to the weight of executive roles, including the organisation's characteristics and the role's level of accountability.

- Organisations should also disclose what proportion of executives' base salaries are variable according to performance, alongside an explanation of the basis upon which their performance is assessed.

RECOMMENDATION 5: Enabling citizen analysis of executive pay

From 2011-12, the Government should require public organisations to submit executive pay data through an online template, and make this data available on data.gov.uk, to allow citizens to access and analyse this data and thus have the information required to hold public service organisations to account.

The Government should request that the National Archives develop a template to be used in the capture of all disclosures on executive pay, ensuring that all the data captured is available in a consistent and reusable format.

The Government should instruct data.gov.uk to host this template and make the information gathered through it available to the public according to standard data.gov.uk practice.

Government departments should require bodies and sectors in which they have an interest to complete this template on an annual basis alongside their remuneration reports, for the year 2011-12 onwards.

RECOMMENDATION 6: Abandoning arbitrary benchmarks for public service pay

Once this framework of recommendations is in place, the Government should refrain from using the pay of the Prime Minister or other politicians as a benchmark for the remuneration of senior public servants, whose pay should reflect their due desert and be proportional to the weight of their roles and their performance.

RECOMMENDATION 7: Preventing rewards for failure through earn-back pay for senior public servants

To allow pay to vary down as well as up with performance, all public service executives should have an element of their basic pay that needs to be earned back each year through meeting pre-agreed objectives.

The Government should by September 2011 bring forward proposals for Senior Civil Service pay to include an element of base pay at risk, and should encourage the application of earn-back pay to other organisations delivering public services. This earn-back should be conditional upon meeting pre-agreed objectives; excellent performers who go beyond their objectives should be eligible for additional pay. To be effective, the at-risk element must exceed 10 per cent of basic salary.

The scheme will need to be phased in, in order to avoid adversely impacting current employees and avoiding contractual difficulties

RECOMMENDATION 8: Extending earn-back pay to high performing middle managers

To identify and reward high fliers, once earn-back pay has been implemented at the most senior levels, Government departments and other public service organisations should consider offering this pay structure to middle managers on an opt-in basis.

RECOMMENDATION 9: Sharing the rewards of greater productivity

To prevent executives monopolising the rewards of productivity increases, and allow all employees who have contributed to share the benefits, government departments should identify ways of offering gainsharing schemes linked to achievement of the efficiency aspects of their business plans. The Government should also explore options for gainsharing schemes across public services more widely.

RECOMMENDATION 10 : Opening up opportunities for future generations of public service leaders

To increase the supply of candidates for top positions and reinforce public service management as a career, the Government should facilitate greater opportunities for managers to move across different public services, and between the public and private sectors.

By the end of 2011 the Government should establish a single online portal for advertisements and applications for public service management roles, and work with major public service employers to establish a passport scheme for middle and senior managers across public services.

The online portal should include a repository for potential applicants to upload CVs.

The passport scheme should be designed to encourage employers to look more widely when recruiting, and feature organisations from a range of sectors – public and private – making commitments to:

- supplying adequate induction and support to entrants from other sectors;
- arranging joint training and development schemes focused on leadership and transferable skills;
- relying upon greater use of secondments and employee exchange schemes (minimising personal financial barriers to movement);
- advancing the use of existing professional groups; and
- hosting regular cross-sectoral networks.

The Government should drive and prioritise the ongoing collaboration between public sector graduate recruitment and development schemes. Important elements where greater collaboration could lead to real benefits are:

- integrating recruitment and selection processes;
 - emphasising transferable skills within induction programmes;
 - developing a common core competency profile that will equip graduates with genuine generalist skills for careers spanning public services;
 - promoting opportunities for rotations across different workforces as part of the graduate package;
 - supporting the Local Government scheme in developing internship opportunities - along the lines of existing NHS and Civil Service schemes; and
- reducing the barriers to greater rotation between schemes created by differences in employment conditions.

RECOMMENDATION 11: A Fair Pay Code

To embed fairness principles and ensure fair process in executive remuneration, all public service organisations should adopt the Fair Pay Code proposed by this Review. Government departments should by July 2011 bring forward proposals for the application of this Code to all bodies and sectors in which they have an interest.

RECOMMENDATION 12: Tracking pay multiples across the economy

To make tracking pay multiples normal practice across the economy, as part of its commitment to improve corporate reporting, the Government should require listed companies to publish top to median pay multiples in their annual reporting from January 2012.

The Senior Salaries Review Body should collate and publish the multiples in a similar format to the one used for public sector leaders.

In reviewing corporate accountability and transparency requirements, the Government should also consider how clearer explanation of executive pay by private companies can be achieved.

The government, including local government, should use their influence as a major procurer with all major private sector contractors and suppliers to see that they observe the Fair Pay Code.

B

Fair Pay Code

1. Preamble: requirements of fair pay

Fairness in pay requires that pay meets three overarching requirements: fair and appropriate pay levels, procedural fairness in pay determination, and transparency and accountability for pay.

Fair and appropriate pay levels

A fair pay level is one that reflects each individual's due desert. To be fair, pay must be proportional to the individual's contributions towards meeting their organisation's goals. Pay levels should be proportional both to the size or weight of each individual post and to the individual's performance in that post.

A central objective of all organisations delivering public services is to deliver good value for money in the use of public resources, including in their levels of pay. Public service organisations should therefore pay enough to recruit, retain and motivate individuals of sufficient calibre to lead and deliver the high-quality public services that are essential to the well-being of society, but should not pay more than is necessary for this purpose. Public service organisations should refuse to meet pay demands that are excessive or disproportionate to the weight of posts or to individuals' performance, and in particular should avoid any appearance of offering rewards for failure.

Fair Pay Process

To meet the standards of procedural fairness, pay must be set through a process that is based on a consistent framework and independent decision-making based on accurate assessments of the weight of roles and individuals' performance in them. No individual should be involved in deciding his or her own pay.

To reflect the social nature of organisations and the fact that organisations' success is the product of collective efforts by the workforce as a whole, the process for determining senior pay must take account of the relationship between senior pay and that of all employees, and must give a voice to the wider workforce.

Transparency and Accountability

Citizens have a right to know that public funds are being properly used and that public services are being managed in the public interest. In particular, citizens must be assured that public service pay policy serves the public interest, and that public servants, especially senior public servants, are being fairly, but not excessively, rewarded for their work for the common good.

Organisations delivering public services must therefore fully disclose their executive pay policies and should disclose executive pay levels and explain them in terms of the weight of executive posts and the individuals' performance in them. Public service organisations must also disclose and explain the relationship between top executive remuneration and the pay of the workforce as a whole, to allow citizens to hold them to account for their senior pay policies.

Public service organisations should also open their executive pay processes to public scrutiny, to allow citizens to be sure that they adhere to the standards of procedural fairness.

Application of this Code: 'comply or explain' and coverage

'Comply or explain'

This Code is to be applied on a 'comply or explain' basis. This means that public bodies and organisations delivering public services should each year either publicly state that they have abided by the provisions of this Code, or else should provide meaningful explanations of why they have not complied.

Explanations must refer to specific, verifiable circumstances or conditions that make compliance impossible or inappropriate, and must include supporting evidence. Organisations that do not comply with the provisions of this Code must also publicly explain how their alternative arrangements meet the Principles of this Code. These statements should be included in organisations' annual accounts, remuneration reports or similar public reports, available on their websites and to the public on demand.

For example, some very small organisations may not have the administrative capacity to support a dedicated remuneration committee. In this situation, organisations must still ensure that executive pay is set independently of executives, by a body with sufficient expertise and according to consistent rules. This could be achieved through institutional forms or through co-operation with other organisations.

Coverage

This Code is intended to be applied by all organisations delivering public services. The 'comply or explain' regime allows the Code to be applied flexibly in different public service organisations, according to their legal status, structure and areas of activity. Organisations that are autonomous of central government should apply this Code as best practice on executive pay, with the support of those institutions that advise on governance issues.

This Code applies to the pay of all executives in public service organisations. For the purposes of this Code, 'executives' are understood to be: an organisation's chief executive (or equivalent), executive board members, and any others who report directly to the chief executive.

This Code's principles relate to all elements of executive remuneration (although the Code's disclosure provisions generally relate only to those elements whose monetary value can readily be calculated). Organisations must not attempt to evade the requirements of this Code through the use of 'hidden rewards', such as excessive notice periods for executives, undisclosed severance arrangements or contract changes or extensions that are not made on the basis of rigorous, fair and open processes.

Detailed principles

A. Fair and Appropriate Pay Levels

Main principle

Executive remuneration should fairly reward individuals' due desert and contribution to their organisations' success, and should be sufficient to recruit, retain and motivate executives of sufficient calibre, but organisations should avoid paying more than is necessary in order to ensure value for money in the use of public resources.

A.1 Reward proportional to weight of role:

A.1.1 Fair levels of reward that are individuals' due desert for their contributions should reflect the weight of each individual's post, with those in more senior positions having greater influence on their organisations' outcomes;

A.1.2 The weight of a role should be based on the responsibilities of the post and the level of knowledge and skill required to carry out those responsibilities. Criteria for assessing the weight of executive roles should include:

- i. Complexity (scale and range of decision-making, collaboration and contact, time-critical activity),
- ii. Impact (on public services, finances and people, including employees, partners and citizens),
- iii. Discretion (level of accountability, degree of autonomy and decision-making authority), and
- iv. Knowledge and skills required (including specialist skills).

A.1.3 When recruiting for executive posts, organisations should determine the appropriate remuneration package for each post before they are advertised, offered or awarded.

A.2 Reward proportional to individual performance:

A.2.1 Rewards that reflect individuals' due desert should take account of their performance in their roles. Executive pay should therefore vary according to individual performance;

A.2.2 Performance-related elements of executive pay should be clearly tied to the achievement of organisations' long-term objectives and core function;

A.2.3 To reassure taxpayers that organisations are not willing to reward failure on the part of executives, a proportion of all senior employees' pay should have to be earned back each year, with individuals required to meet a certain performance standard in order to be eligible for their full salaries;

A.2.3.1 This proportion of earn-back pay should increase with greater seniority of roles.

A.2.4 It is fair for exceptional performance to bring additional rewards. Executives whose performance exceeds the required performance standard should be eligible for additional remuneration awards, up

to a fixed proportion of their base salaries;

A.2.4.1 The maximum proportion of salary for additional performance awards should increase with greater seniority of roles.

A.2.5 Variable pay systems for executives should be based on robust performance appraisals;

A.2.5.1 Executives' performance objectives should be agreed by the organisation's Non-Executive Directors, in consultation with the Remuneration Committee, at the start of each reporting year, and should reflect the strategic objectives of the organisation,

A.2.5.2 Responsibility for assessment of executives' performance pay against their personal objectives should rest with Remuneration Committees,

A.2.5.3 Performance objectives for executives, and hence decisions about variable pay, should not normally be subject to alteration as a result of short-term political influences. Any changes that are made should be made in consultation with the Remuneration Committee,

A.2.5.4 Performance objectives for executives should be 'SMART' (specific, measurable, achievable, realistic/relevant and time-bound), and should be set as part of an annual process that includes mid-year review as well as formal end-of-year appraisal,

A.2.5.5 In assessing executives' performance, organisations should take account not only of factors that are directly under those executives' control, but also of factors outside executives' control, when those executives can control or influence the impact of those uncontrollable factors on the organisation's outcomes. The impact of risks which executives should reasonably be expected to have planned for and mitigated should be viewed as 'option luck' and not 'brute luck', hence it is appropriate for executives to be held to account their effectiveness in managing such exogenous risks and mitigating their impact.

A.3 Executive reward and value for money

A.3.1 To ensure value for money in the use of public resources, organisations should not pay executives more than is required to recruit, retain and motivate or disproportionately to the weight of posts and individuals' performance in them;

A.3.1.1 Senior pay should reflect the sense of public duty that is inherent in public service leadership, with the expectation that executive public service pay should be lower than for comparable roles in purely commercial organisations,

A.3.1.2 Public service organisations should be mindful that the 'best' candidate for a post will not necessarily be the 'best value for money' candidate, if the increase in remuneration needed to attract the 'best' over other candidates is disproportionately greater than the marginal increase in quality offered by the 'best' candidate over others,

A.3.1.3 Organisations delivering public services should also be mindful of the impact of their pay decisions on other public service bodies, and should avoid setting executive pay at a level that might fuel wider senior public service pay inflation, to the detriment of value for money across public services as a whole,

A.3.1.4 The appropriate level of remuneration for a post must be considered afresh at each appointment: the salary of a previous incumbent should not be an automatic benchmark as individual circumstances will be different and recruitment markets evolve,

A.3.1.5 Executive pay should not be set according to benchmarks drawn from private sector companies or from public bodies that are not valid comparators. Rather, executive pay levels should reflect the weight of the relevant post, assessed according to its level of accountability and responsibilities as described in A.1.2 above.

A.4 Pay disclosure: executive pay communicated to the public

A.4.1 Organisations delivering public services must annually disclose the full remuneration of all executives;

A.4.1.1 Executive remuneration must be disclosed in actual numbers, and broken down into base salary, allowances, variable/performance pay, and the cash value of benefits-in-kind,

A.4.1.2 Employer contributions to Defined Contribution pension schemes for executives should be disclosed,

A.4.1.3 For executives who are members of Defined Benefit pension schemes, the increase in Cash-Equivalent Transfer Value of their pension rights should be disclosed, along with separate disclosure of any added pension rights purchased for them by their employers.

A.4.2 Alongside these disclosures, organisations should provide a clear, meaningful explanation of executive pay, in terms easily understandable by the public;

A.4.2.1 Organisations should explain how executives' remuneration relates to the weight of executive roles, including the organisation's characteristics and the role's levels of accountability,

A.4.2.2 Organisations should also explain what proportion of executives' base salaries are 'at risk' in case of under-performance, and the maximum proportion of salary that may be awarded as an additional reward for exceptional performance,

A.4.2.3 Organisations should disclose executives' personal objectives and performance metrics for the previous year, along with an explanation of how executives' performance was judged against them.

A.5 Pay multiple: disclosure, tracking and explanation

A.5.1 Organisations delivering public services should annually publish the multiple of the remuneration of the chief executive and the median earnings of the organisation's whole workforce;

A.5.1.1 For the purposes of this multiple, 'earnings' should be defined as total taxable employment earnings, including base salary, allowances, variable/performance pay, and the cash value of benefits-in-kind,

A.5.1.2 The median earnings figure used for the multiple should be the median full-time-equivalent earnings of all staff employed by the organisation on the first day of the relevant accounting period.

A.5.2 When disclosing their pay multiples each year, organisations should also disclose the previous year's pay multiple and the year-on-year change in the multiple;

A.5.3 Alongside these disclosures, organisations should provide a clear and meaningful explanation for any changes in their pay multiples, describing what factors have caused movements in both median and top earnings and thus changes in the pay multiple from the previous year.

B. Fair and Transparent Process for Setting Executive Pay

Main principle

Executive remuneration should be determined through a fair and transparent process via bodies that are independent of the executives whose pay is being set, qualified in the field of remuneration, and allow scope for employee and citizen participation. Processes for setting executive remuneration should be open and transparent to allow public scrutiny. Accountability for executive remuneration rests with each organisation's Board or Governing Body, within a defined framework of delegated authority where appropriate.

B.1 Workforce and remuneration framework

B.1.1 All organisations must have a formal workforce and reward framework, which should inform individual remuneration decisions at all levels of the organisation;

B.1.1.1 Where appropriate, organisations' workforce and remuneration frameworks must be agreed by their sponsor Department or equivalent;

B.1.1.2 Workforce and reward frameworks should be made publicly available on organisations' websites. A statement of each organisation's policy on senior pay should be included within their wider workforce and reward strategies.

B.1.2 Executive pay should be determined in the context of each organisation's wider workforce strategy, and of the organisation's policy on non-executive pay. Particular regard should be paid to the impact on wider employee engagement and morale of any differential treatment for executive and non-executive staff.

B.1.3 There must be comprehensive contracts of employment between each organisation and its executive employees, which must unambiguously set out full details of the total remuneration package and other terms, including contract length, notice periods and arrangements for termination and any associated compensation.

B.2 Independent remuneration committees:

B.2.1 Executive pay should be determined by an independent Remuneration Committee established by each organisation's Board or Governing Body, with no individual executive being involved in deciding his or her own remuneration.

B.2.2 Remuneration Committees should have formal Terms of Reference set by each organisation's Board, and should be provided by the organisation with sufficient administrative support and resources to undertake independent research.

B.2.3 Remuneration Committees should be responsible for appointing any consultants in respect of executive remuneration.

B.2.4 Remuneration Committees should be subject to external verification of their effectiveness, expertise and independence at least every 3 years.

B.2.5 Remuneration Committees should contribute to the development of organisations' internal talent and succession strategies for executive posts.

B.3 Remuneration committee membership:

B.3.1 Remuneration Committees should be primarily constituted of independent Non-Executive Directors, independent of the organisation's management. Membership may include the organisation's Chair, provided that the Chair does not have an executive function in that organisation.

B.3.2 A Non-Executive Director is considered independent of the organisation's management if he or she:

- i. Has not been an employee of the organisation, or had a material business relationship with the organisation within the last 5 years,
- ii. Has no close family ties with any of the organisation's advisers, directors or senior employees,
- iii. Does not hold cross-directorships or have significant links with the organisation's directors or senior employees through involvement in other organisations or their Board.

B.3.3 An organisation's Remuneration Committee should be chaired by the organisation's Senior Non-Executive Director.

B.3.4 Members of Remuneration Committees should be appointed for a term of 3 years, and may be re-appointed for one further 3 year term.

B.3.5 A Remuneration Committee should have sufficient expertise to undertake a rigorous assessment of executive posts and labour markets in order to make informed decisions on executive remuneration;

B.3.5.1 At least one member of each Remuneration Committee should have expertise in the field of remuneration.

B.3.6 Each Remuneration Committee should include one representative of the organisation's workforce.

B.4. Remuneration committee disclosure

B.4.1 Each year, Remuneration Committees should publish their Terms of Reference.

B.4.2 Remuneration Committees should each year disclose:

- i. Remuneration Committee membership,
- ii. Appointment procedures,
- iii. The number and dates of their meetings in the previous year, and members' attendance,
- iv. Remuneration of Committee members, and
- v. Any use of consultants, and details of any other relationship of the consultants with the

organisation.

B.5 Public bodies where executive pay is under direct political control

B.5.1 In organisations where executive remuneration is decided by elected politicians, those politicians should receive independent, expert advice prior to making decisions.

B.5.2 Independent Pay Review Bodies, where they operate, provide the independent expert advice that is required;

B.5.2.1 Where Pay Review Bodies are asked to advise on senior pay, they must, as now, invite representations from citizens and from workforces prior to making their recommendations, and must report publicly, and in their reports must disclose the Pay Review Body's membership, its Terms of Reference, and a summary of the evidence upon which the Pay Review Body reached its recommendations.

B.5.3 Where public bodies' remuneration frameworks are subject to approval by elected politicians, these frameworks should specify formal escalation procedures in case organisations exceptionally need to offer remuneration outside the bounds of that framework;

B.5.3.1 The process for requesting clearance for exceptional remuneration must be thoroughly documented by organisations' Remuneration Committees, including a full reasoned statement of the rationale for seeking to offer exceptional remuneration;

B.5.3.2 Where public bodies' remuneration frameworks are subject to approval by elected politicians, any decision to offer remuneration outside the bounds of that framework must receive formal Ministerial approval from the organisation's sponsoring department.

B.5.4 Organisations where senior remuneration is decided by elected politicians but which are not covered by independent Pay Review Bodies (e.g. Local Authorities) should establish advisory Remuneration Committees to advise politicians on senior pay prior to pay decisions being made;

B.5.4.1 Advisory Remuneration Committees should be independent of the executives on whose pay they are advising, and should include at least one member with remuneration experience, and one employee representative, as described in sections B.3.5 and B.3.6 above;

B.5.4.2 Advisory Remuneration Committees should publish their recommendations, disclosing at the same time their Terms of Reference, membership, appointment procedures, meetings and attendance, members' remuneration and details of any use of remuneration consultants, as described in section B.4 above.



Implementation options

Central government influence over senior pay in public services

C.1 As noted in the Interim Report, public services are currently delivered by a diverse range of different organisations, and the level of Ministerial control over senior pay varies substantially across public services, as shown in the diagram below:

Spectrum of Central Government control over senior pay		
Central Control vs. Autonomy	Example Populations	Summary of Pay-Setting Process
Strong Central Government Control	<i>Civil Service, Judiciary, Military</i>	Ministers decide on all elements of senior pay, advised by independent Pay Review Bodies (e.g. SSRB)
	<i>Maintained School Head Teachers, NHS VSMSs, Police</i>	Ministers decide salary, advised by independent Pay Review Bodies; Local autonomy over extra payments (e.g. RRP)
	<i>Chief Executives of NDPBs and Public Corporations</i>	Ministerial approval required for pay set by organisation Board; Ministers appoint Board members and Chair
	<i>Other Executives of NDPBs and Public Corporations</i>	Pay set by organisation Board, usually no requirement for Ministerial approval; Ministers appoint Board members
	<i>Local Authority Chief Executives and other LA senior staff</i>	Elected Local Authorities set pay, autonomously of central Government, advised by Local Government Employers (LGE)
Complete Autonomy of Government	<i>FE Colleges, Universities, Academy Schools, NHS Foundation Trusts</i>	Individual organisations have complete autonomy over senior pay

C.2 Central Government cannot, simply impose the Fair Pay Code recommended by this Review evenly across all public services. This is especially true given the Coalition Government’s twin commitments both to encouraging greater diversity in public service provision and to devolving greater control from the centre to individual organisations.

C.3 Implementation of the Fair Pay Code would therefore need to come through a variety of different channels for different areas of public services. Possible avenues are outlined below:

Sector	Implementation channel
Government departments, agencies and regulators	The Code could be adopted by government departments and agencies, co-ordinated by the Cabinet Office; Senior Civil Service pay is set by Ministers, on the advice of the Senior Salaries Review Body. The role of remuneration committees in departments would therefore be in reviewing top civil servants’ objectives and performance, and deciding on variable pay.
Non-Departmental Public Bodies	Cabinet Office are the lead policy department on NDPBs and, together with HM Treasury, set the broad control and governance framework within which NDPBs operate. Cabinet Office and HM Treasury could require all executive NDPBs to adopt the Code.

Local Authorities	Individual Local Authorities have autonomy over pay governance arrangements, subject to the provisions of the Localism Bill currently before Parliament, which may give the Secretary of State for Communities and Local Government the ability to recommend guidance. The Local Government Association could also recommend the Code as best practice to Local Authorities.
NHS Foundation Trusts	NHS Foundation Trust governance is currently regulated by Monitor, which could require that existing governance arrangements be modified to align to the Code.
Universities	Higher education institutions are autonomous, but the Committee of University Chairs publishes extensive guidance on best practice in corporate governance, and could recommend adoption of the Code.
Further education colleges	The Skills Funding Agency may be able to issue guidance for Further Education Colleges incorporating the Code.
Armed Forces	Particular care will need to be taken in adopting the Code to the Armed Forces, owing to the distinct operational contexts in which they perform their duties. Senior officers' pay is currently set directly by Ministers on the advice of the Senior Salaries Review Body, providing effective safeguards against the risks of unfair pay inflation. Meanwhile the concept of pay 'at risk' seems inappropriate for military personnel. The principle of transparency over senior pay should, however, extend to the military as well as to other public services, within the constraints imposed by national security concerns.

D Key data from the Interim Report

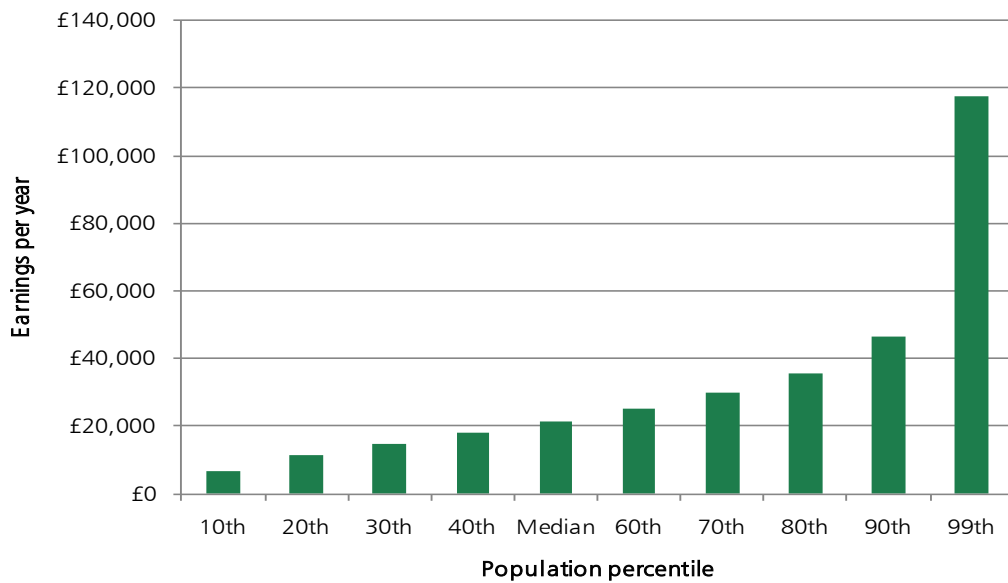
D.1 This annex aims to recapture a selection of the key data presented in the Interim Report. The charts reproduced in this Annex serve as a reminder of some of the key messages emerging from the Review's research in the following areas:

- Pay dispersion in the UK
- Median pay across English Regions and Districts
- Median and top earnings by industry
- Public sector executive pay
- Top to bottom pay multiples in the public sector
- Median earnings of UK FTSE 100 and US S&P 500 CEOs over time
- Composition of median FTSE 100 CEO earnings over time
- Median earnings for internal and external recruits to Senior Civil Service over time
- Market capitalisation and FTSE100 chief executive remuneration growth

Pay dispersion in the UK

D.2 According to the Office for National Statistics, the median salary for a full time employee in 2009 was £25,428 (£21,320 for all employees, including part-timers)¹. But **pay is unevenly distributed either side of median earnings**. The latest figures from the Office for National Statistics Annual Survey of Hours and Earnings on income distribution show that in 2009 the difference between the 90th and 99th percentiles was greater than that between the 10th and 90th percentiles (Chart A).² The top one per cent of earners number 290,000³ and earn over £117,523 a year:

Chart A: Gross annual pay for all employees by percentile, 2009



Source: Source: *Fair Pay Review Analysis of ASHE*

Note that these figures are for all employees and as such include both full and part time workers. Gross pay includes: pay before deductions for PAYE, National Insurance, pension schemes and voluntary deductions. It also includes basic, overtime, shift premium, bonus or incentive pay and any other pay

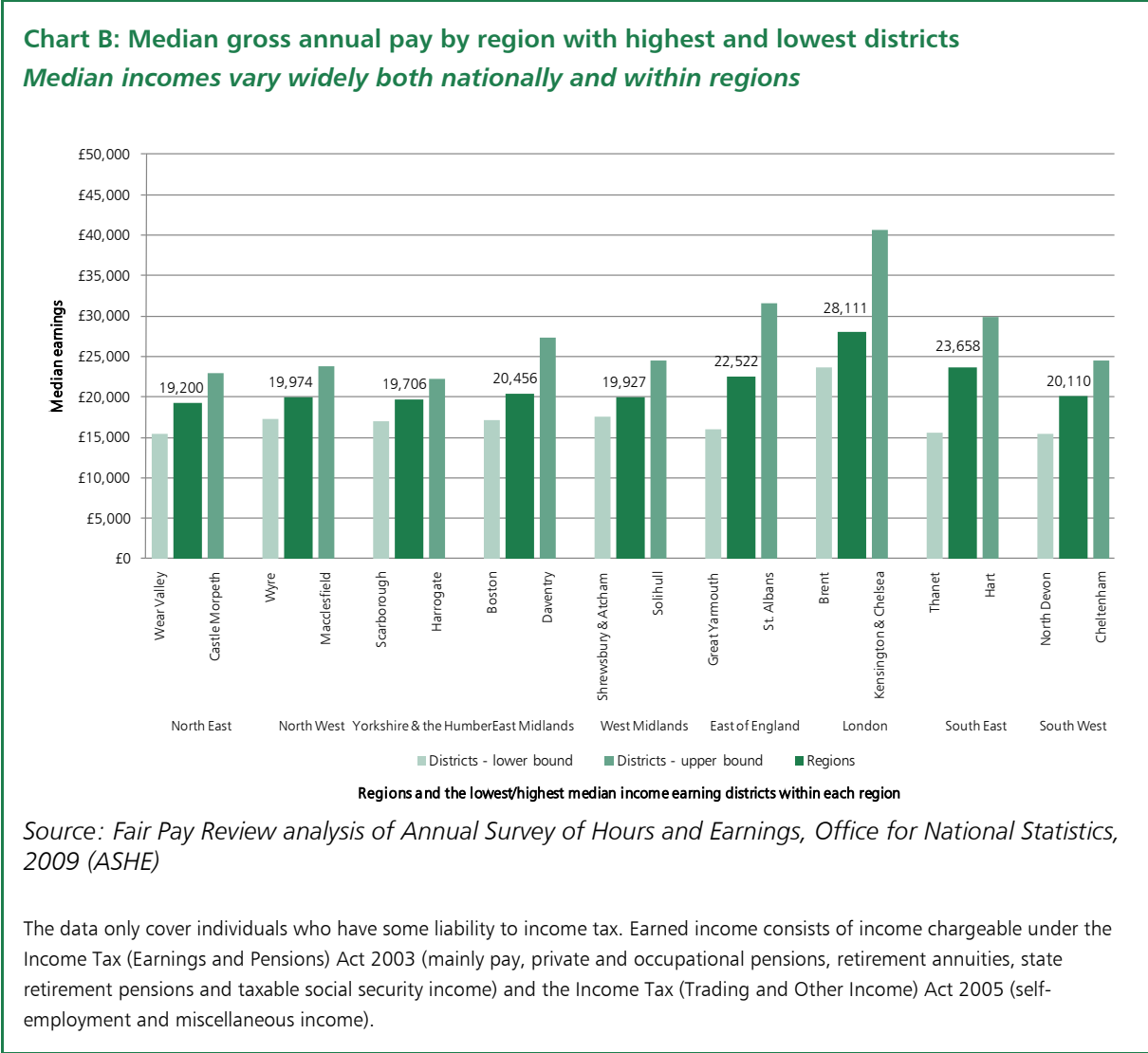
¹ Annual Survey of Hours and Earnings 2009, Office for National Statistics.

² ONS's Annual Survey of Hours and Earnings provides data for the 99th percentile is not available as a time series. Hence the following charts rely on an HMRC dataset drawn from income tax records.

³ Based on 1% of 29 million – *Labour market statistics*, October 2010, Office for National Statistics.

Median pay across English Regions and Districts

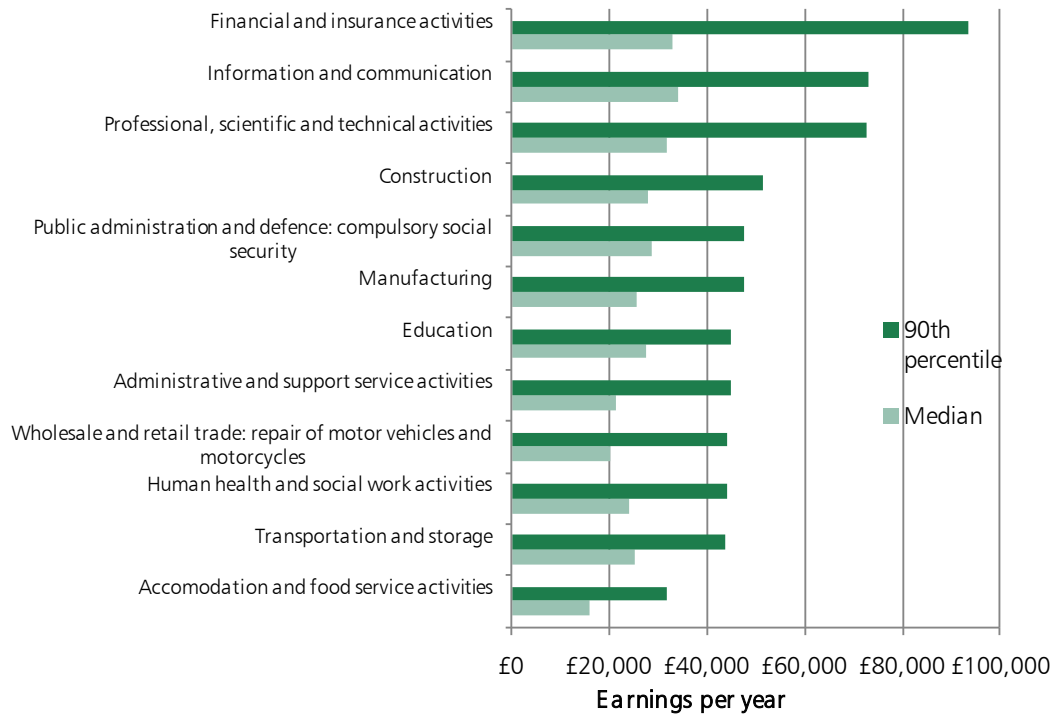
D.3 Median incomes vary dramatically between local authority, ranging from £12,300 in Penwith, in the South West, to £53,100 in the City of London:



Median and top earnings by industry

D.4 Median income also varies by employment sector. Because of the nature of the people they employ, the median in the information and communications sector is £34,194; in the catering industry ('accommodation and food service activities') it is £15,940:

Chart C: Median and 90th percentile gross annual pay for full time employees by industry
What constitutes a 'high earner' differs from sector to sector



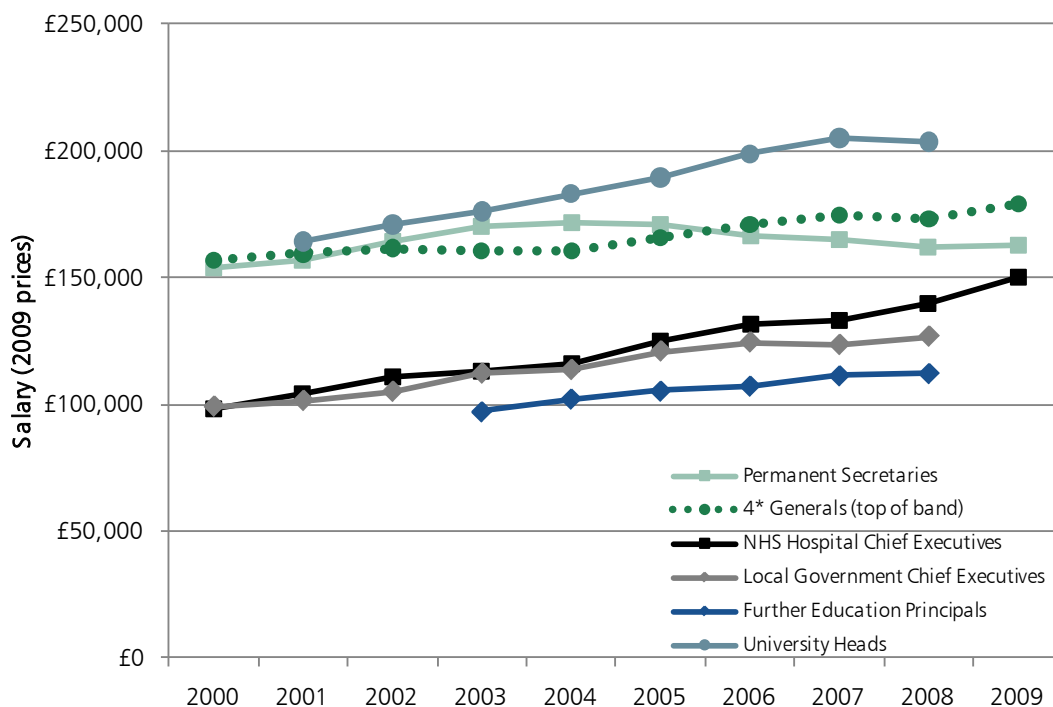
Source: Fair Pay Review analysis of ASHE, Analysis by Industry: 4 digit SIC 2007.

Data is not available for all industries. Industries shown here represent 62% of UK total workforce.

Public sector executive pay

D.5 Data from the Interim Report showed that across a range of sectors, median top executive pay has seen steady increases in real terms over recent years (Chart D). The exception to this is the civil service where the median pay of permanent secretaries has declined in real terms between 2005 and 2009:

Chart D: Real average salaries of top public sector managers 1999-2009 (2009 prices)



Source: Fair Pay Review analysis of various sources (see below). GDP figures from HM Treasury.

Local Government: Top = Average of local authority chief executives provide by LGA, Bottom = Bottom of LGE spinal point. Please note that some authorities may pay more than the bottom of the LGS spinal point as a minimum and that therefore ratios will vary between authorities

Civil Service: Top = 2000 – 2002 is an estimated median of Permanent Secretary pay derived from SSRB reports, 2003+ is for the median of Permanent Secretaries salaries as provided by Cabinet Office Bottom = the minimum pay of a clerical assistant in DSS in inner London for 2000 and for a clerical assistant in DWP in inner London for 2001 onwards taken from IDS's Pay in the Public Services. Please note that DWP are not the lowest paying department and exact ratios vary between Departments. DWP has been used as it is the most consistent time series that we could obtain.

Health: Top = Median salary of chief executives of hospital trusts provided by IDS, Bottom = 1999 – 2004 Starting point of administrative and clerical staff salary provided by NHS Advance Letters provided by the Department of Health and from 2005 onwards the starting point of Band 1 on the Agenda for Change pay scale has been used. Please note that prior to Agenda for Change ancillary staff may have been the lowest paid. Administrative staff have been used to provide a consistent time series.

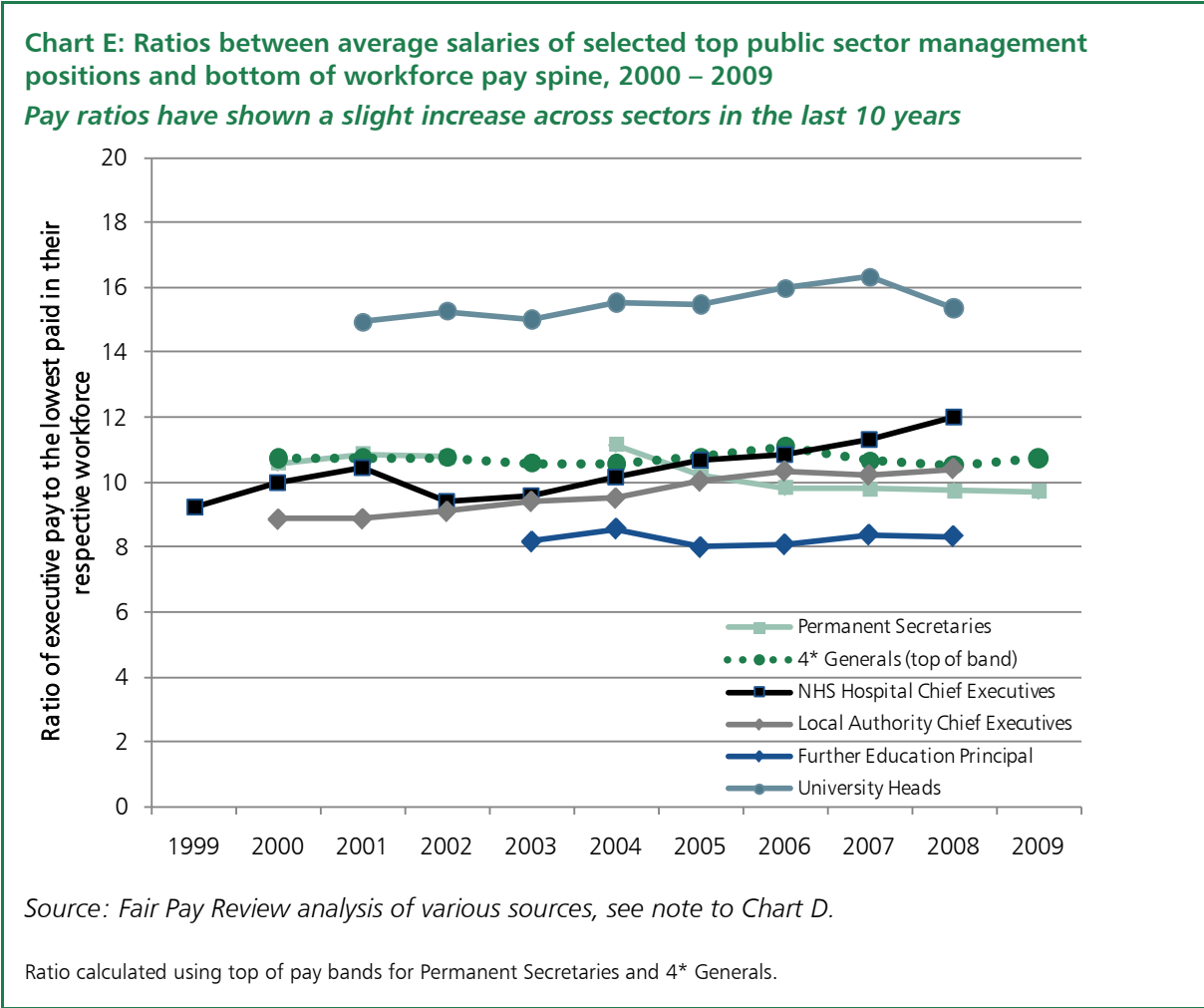
Further Education: Top = Average salary of Further Education principals provide by the Association of Colleges (AOC). Bottom = the start of the AoC national recommend pay spine. Please note that the AOC pay spine is voluntary and that actual starting pay could vary.

Higher Education: Top = Median Vice Chancellor salaries provided by the Universities and Colleges Employers Association (UCEA), data based on the total remuneration package (excluding pension contributions and excluding payments made to compensate for a pension cap) as declared in institutions' published annual accounts. Data are not from constant sample but the whole emolument time series data used below are constructed using the same methodology for previous years and the number of institutions for which data are available is high as a proportion of total institutions. Bottom = Starting point of UCEA single pay spine provided by UCEA. Note that UCEA pay spine is voluntary and that actual starting pay could vary.

Military: Top = Highest point of 4* General pay scale take from Senior Salary Review Board reports, Bottom = for 2000 the lowest rate for Private III, for 2001 onwards lowest point of Range 1. Please note that Range 1 includes the starting ranks for services. Figures apply to all three military services.

Top to bottom pay multiples in the Public sector

D.6 Pay multiples have increased to some degree in all these workforces except the civil service. The highest ratio was in higher education where the median vice-chancellor’s salary was 15.35 times the bottom of the Universities and Colleges Employers Association pay spine for university staff. The lowest was in Further Education where the average ratio of Further Education College Principals to the bottom of the pay spine was 8.3:1. In general, the ratios have only increased gradually although there have been more significant increases in local authorities and hospital trusts:

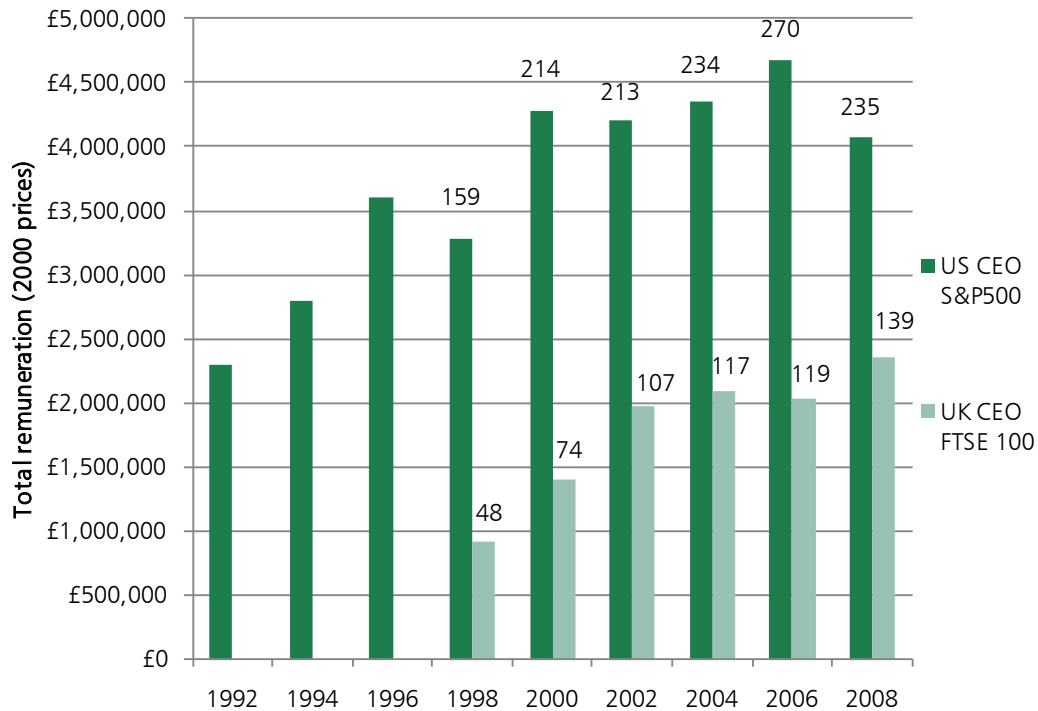


Median earnings of UK FTSE 100 and US S&P 500 CEOs over time

D.7 Data from the Interim Report showed the median FTSE100 CEO earnings following the trend set by the US S&P500 CEO, albeit at a far lower level. The large rise in the size of the ratio of top to median pay illustrates the gulf in the rate of growth of earnings at the top, compared to the median earnings, with the ratio more than doubling over the 10 years from 1998 to 2008:

Chart F: Median total remuneration of chief executives of S&P 500 and FTSE 100 firms (in 2000 Sterling), with ratios to US and UK median earnings overlaid

Chief executive remuneration at large UK firms is catching up with that at large US firms

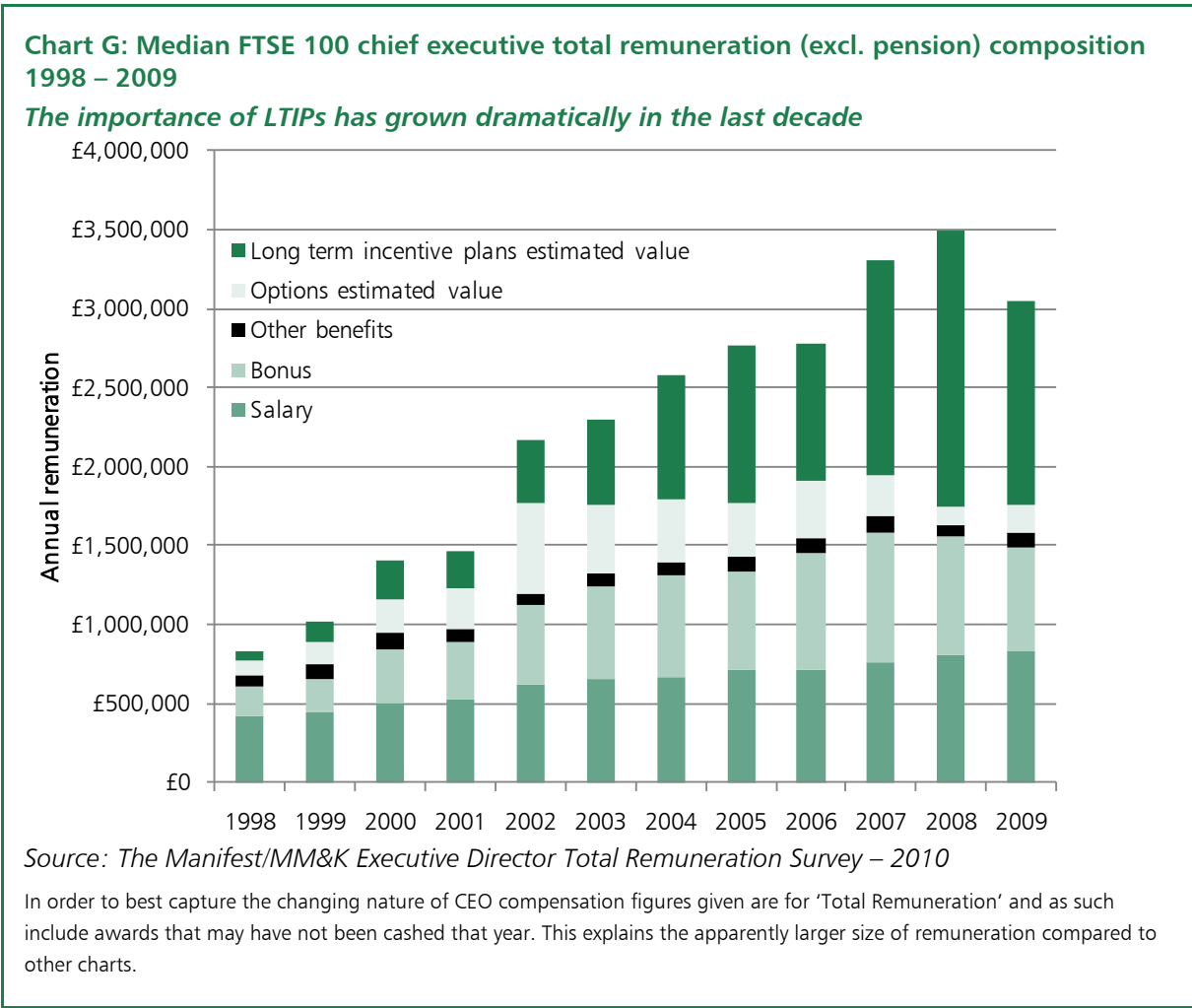


Sources: FPR analysis of data taken from C. Fyrdman and D. Jenter, *CEO Compensation, 2010*, Bureau of Labour Statistics, *The Manifest/MM&K Executive Director Total Remuneration Survey – 2010*, *Annual Survey of Hourly Earnings, ONS*, *HM Treasury GDP figures*

US data depicts total compensation and its main components: salaries, bonuses and payouts from long-term incentive plans, the grant-date values of option grants (calculated using Black-Scholes), the grant-date values of restricted stock grants, and miscellaneous other compensation (perquisites, contributions to benefit plans, discounts on stock purchases, etc.) Conversion to Sterling is at the exchange rate as of June 2000. UK chief executive data is also for 'total' remuneration and includes an estimated yearly value of long term bonuses awarded, but not necessarily cashed, in a given year.

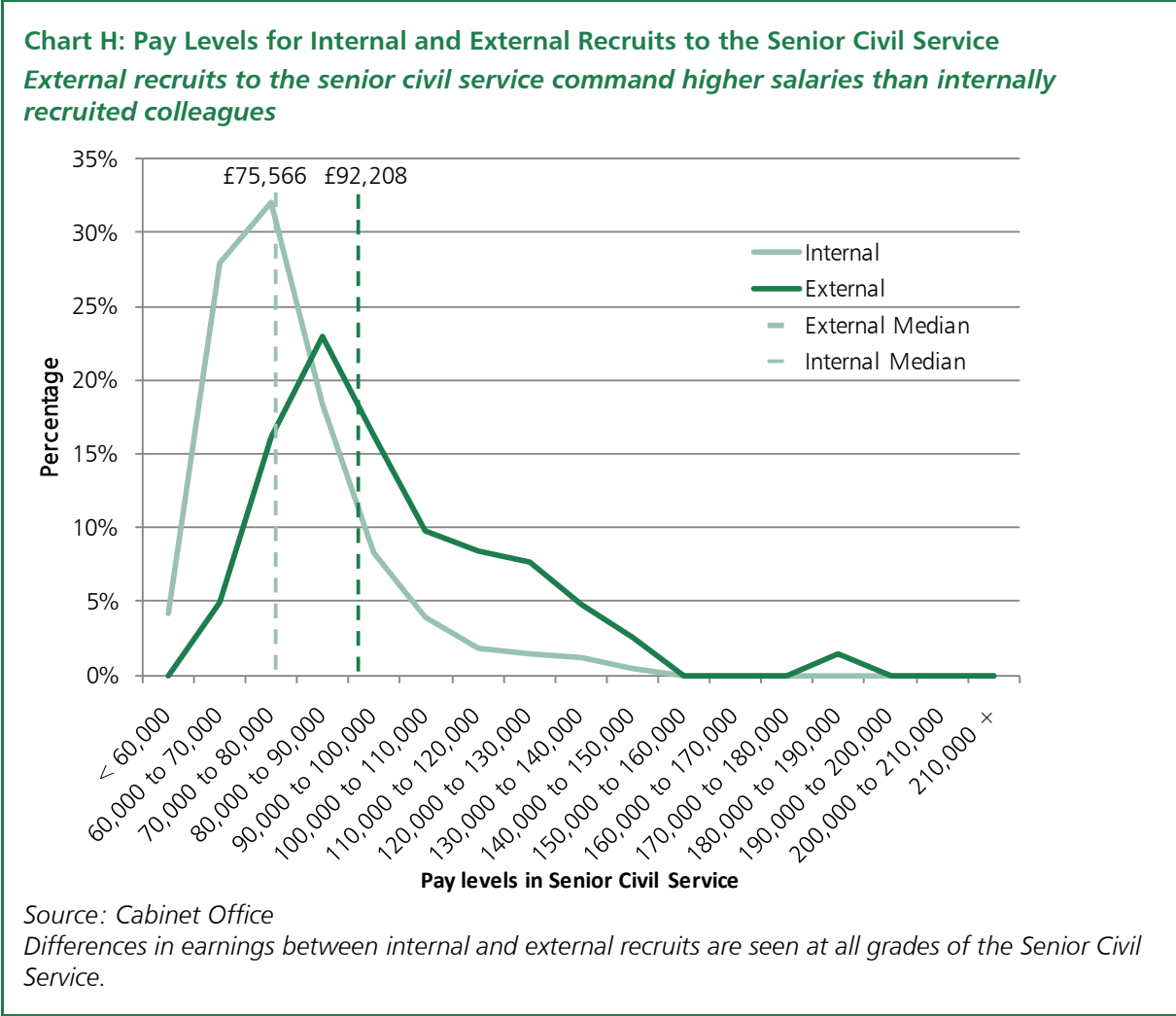
Composition of median FTSE 100 CEO earnings over time

D.8 The Review’s research highlighted a trend of long term incentive plans representing ever large proportions of total remuneration packages for the median FTSE 100 chief executive. The growth in base salary has not been as fast growth of total remuneration, so base salary as a proportion of total remuneration has actually decreased over time:



Median earnings for internal and external recruits to Senior Civil Service over time

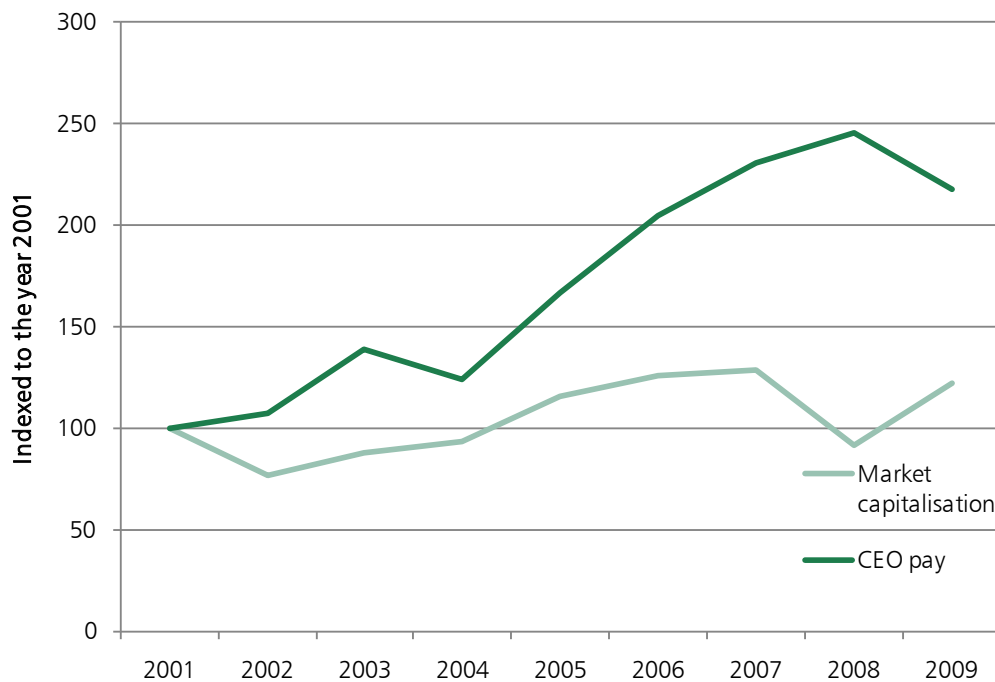
D.9 In the civil service there is clear evidence that external recruits do command higher salaries than internally-recruited colleagues:



Market capitalisation and FTSE100 chief executive remuneration growth

D.10 A firm that is double the size will not necessarily have double the strategic decisions to make. So some of the growth in chief executive pay may be their due desert for managing larger and more complex firms, but not all. Indeed, the average size of firm in the FTSE 100 in terms of market capitalisations is not much changed from ten years ago, yet chief executive remuneration has continued to rise:

Chart I: Remuneration of chief executives at FTSE 100 firms compared to firms' market capitalisation (indexed, 2001=100)
FTSE 100 chief executives' remuneration has grown even as firms' market capitalisation has remained largely constant



Source: Fair Pay Review analysis of data from Incomes Data Services and Bloomberg

E

Notes on the data used by the Review

E.1 This Review has not sought to be a definitive pay survey. It has sought to highlight indicative trends. With that in mind the following provides more detailed information on the background and definitions of the data used to describe the overall economy, public and private sectors. The information aims to allow a more detailed understanding of our data sources than was feasible to include in the main text whilst still allowing ease of reading. However what follows includes important caveats on the conclusions that can be drawn from charts within the review.

A note on chronology

E.2 Due to the different sources of data used and the need to make comparisons between them, compromises have needed to be made when describing the year in which the data is from. As a general rule if data was given for financial years this has been converted to calendar years so 2008-09 has become 2008. In addition certain data points were given for specific times of year. In these examples the year in which the data is provided.

Data used to describe the economy as a whole

- The definition of 'gross income' used in the Review's analysis of ASHE data includes pay before deductions for PAYE, National Insurance, pension schemes and voluntary deductions. It also include basic, overtime, shift premium, bonus or incentive pay and any other pay The data only includes employees on adult rates who have been in the same job for more than a year.
- Where data refers to full time or all employees, this has been noted.
- In order to accommodate methodological changes in ASHE the Review has used the 2004 data set (e.g. not excluding the additional information) and 2006 that is consistent with 2007 methodology.
- The Review's calculations using Gross Domestic Product were taken directly from the HM Treasury website and do not reflect HM Treasury analysis.
- GDP per worker was calculated using money GDP figures divided by an annual average of the seasonally adjusted monthly data based on three month rolling averages for all people in employment taken from the Office for National Statistics.

Data describing public sector workforces

Median earnings

Median data has been taken from Standard Industry Classifications (SIC) codes as defined in the Annual Survey of Hours and Earnings (ASHE), conducted by the Office for National Statistics (ONS). This dataset can generally be found on the ASHE subset Table 16. The Review also used 1999-2003 Collective Agreement tables from the ASHE data series as the base for the Review's calculations of median earnings for Local Government. These tables are generally found on ASHE subset Table 19, but please note this series ends after 2003.

The proportion of workforces made up by part-time workers varies greatly across public sector organisations. Using a median earnings figure including part-time workers would distort the true figure, so the Review opted instead to use full-time earnings only.

Median earnings were also taken from Civil Service Statistics tables, collected by the ONS. The catalogue of this data allowed the presentation of full-time equivalent median earnings in a time

series for the entire Civil Service. The latest edition of this data also provided median full-time equivalent earnings for individual civil service departments and agencies.

Higher Education

Lead Executives:

- Provided by the Universities and Colleges Employers Association (UCEA).
- The data refer to emolument figures based on the total remuneration package (excluding pension contributions and excluding payments made to compensate for a pension cap) as declared in institutions' published annual accounts. This data is compiled yearly as part of UCEA's Remuneration Survey, which collects data from institutions on the pay of heads of institution, senior and middle staff in UK HE Institutions.
- Please note that the time series data has been constructed using the same methodology for previous years and are not a constant sample. This means that the composition of individuals and institutions for each year are potentially different. However, the number of institutions for which data are available is high as a proportion of total institutions and the figure provided is the median so this should reduce possible problems of using a non-constant sample.

Median Earnings: To gather median earnings time series for Higher Education, the Review used the classification 'Higher Education' in ASHE. The latest code for this classification is 854 while in ASHE series before 2007, the higher education SIC code is 803.

Further Education

Lead Executives:

- Provided by the Association of Colleges (AoC)
- The data refers to the average salary for college principals taken from the management pay scale data provided to AoC by the Skills Funding Agency. This data is for England only.

Median Earnings: To gather median earnings time series for Further Education, the Review used the classification 'Higher Education' in ASHE. The latest code for this classification is 854 while in ASHE series before 2007, the Higher Education SIC code is 803.

The NHS

Lead Executives:

- Provided by Incomes Data Services (IDS).
- The data refer to Chief Executives of NHS Hospital Trusts in England. The data was originally harvested from annual accounts. Please note that the Chief Executive is not always the highest paid executive.

Median Earnings: To gather median earnings time series for the NHS, the Review used the classification 'Hospital Activities' in ASHE. The latest code for this classification is 861 while in ASHE series before 2007, the hospital activities SIC code is 8511.

The Civil Service

Lead Executives:

- 2003 onwards provide by the Cabinet Office.
- The data refer to an estimated median of Permanent Secretaries salaries created by taking the midpoint of the pay band for the median group of permanent secretaries from Senior Salaries Review Body reports. For 2003 onwards the Review used the median base pay of Permanent Secretaries provided by the Cabinet Office.

Median Earnings: To gather median earnings time series for the Civil Service, the Review used the Civil Service median earnings data published by the ONS. These figures are full-time equivalent.

The Military

Lead Executives:

- Taken from Senior Salaries Review Body reports.
- The data refer to the top of the pay band for 4 star generals – between 2000 and 2002 this was the maximum of range 7 and for 2003 onwards it is Scale Point 6. Please note that although the term ‘4 star generals’ has been used for ease of understanding the pay ranges also apply across the services and so also to Admirals and Air Chief Marshals.

Median Earnings: To gather median earnings time series for the Military, the Review used the classification ‘Defence Activities’ in ASHE. The latest code for this classification is 8422 while in ASHE series before 2007, the hospital activities SIC code is 7522.

Local Government

Lead Executives:

- Data provided by the Local Government Association. Data for 2009 represents Fair Pay Review analysis of annual accounts.
- The data refer to the average salary of chief executives of Local Authorities across England and Wales. Please also note that the 2007 figures do not include national pay awards as these were agreed after the survey and that the 2008 figures include the 2007 national pay award but not 2008 as this was agreed after the survey was taken. 2008 and 2009 pay awards are both captured in the 2009 data and so there is an exaggerated increase in 2009.
- Also please note that the exact relationship in individual councils is likely to be different than the overall ratio suggested in the charts. This is because the councils with the highest chief executive salaries will be in areas that are less likely to use the lowest pay point listed by the Review. Additionally, due to the number of reorganisations that have taken place in Local Government, the overall trend of increase may be exaggerated.

Median Earnings: To gather median earnings time series for Local Government, the Review used the 1999-2003 Collective Agreements classification ‘Local authority single status national agreement’. This series gives full-time median earnings to 2003. To complete the data series to 2009, this series has been updated using growth rates calculated from data on ASHE Classifications ‘Education’, ‘Provision of services to the community as a whole’ and ‘Social work activities without accommodation’ up to 2009. This was done by weighting each classification by headcount (using ASHE data for employee numbers) and calculating the growth rate from year to year of the aggregate of all three classifications, then applying this growth rate to the local authority single status national agreement classification.

The ASHE code for the classification ‘local authority single status national agreement’ is 448. The latest code for the classification ‘education’ is 85 while in ASHE series before 2007, the SIC code is 80. The latest code for the classification ‘provision of services to the community as a whole’ is 842 while in ASHE series before 2007, the SIC code is 752. The latest code for the classification ‘social work activities without accommodation’ is 88 while in ASHE series before 2007, the SIC code is 8532.

A note on the Panorama data set

E.3 The Review as used the data obtained by the BBC Panorama investigation into top pay in the public sector as it is the best source of data on individual remuneration that is currently available, and it would not have been appropriate to replicate existing research. To validate these data, the Review has conducted a number of checks back to original sources (primarily annual accounts).

E.4 A full description of the Panorama investigation's methodology is available at <http://www.bbc.co.uk/news/uk-11369278>

E.5 Additional attempts have been made to 'clean' the data for the Review's purposes for specific workforces:

- Higher Education: Excludes those listed as academic, clinical, non-clinical, staff, employee, professor, research or left blank;
- NHS: Excludes those listed as consultant, GP, with specific medical, technical or scientific roles, other, unknown or blank;
- Central Government and QUANGOs: Bodies listed as Central Government but that could reasonably be described as arms length bodies have been merged with those classed as QUANGOs and the whole group reclassified as Arms Length Bodies;
- Every attempts has been made to delete duplicate entries, however as some entries in the Panorama dataset do not include individuals' names, the Review cannot guarantee that all duplicates have been eliminated;
- Finally, please note that no attempt was made to differentiate between 2008/09 data and 2009/10 data.

A note on the data describing the private sector

E.6 Calculating the exact total of chief executive remuneration is a contentious issue as shown by the recent debate in the Financial Times <http://www.ft.com/cms/s/0/1490a046-e6e8-11df-8894-00144feab49a.html#axzz16OSipxjO>. The main question is around whether to count the value of options as they are awarded or when they are become redeemable or 'vested'. The Review has noted clearly when each valuation of options has been used. In order to clarify the data further the Review has used, below is a summary of what is included within the two main data sets from IDS and Manifest/MM&K.

E.7 Charts using IDS data represent 'actual total earnings'. This represents the total amount earned by an individual during the year, excluding company pension contributions. It includes:

- 13 Total cash representing contractual annual remuneration for management services plus bonus payments received by an individual during the company's financial year. More specifically it includes:
 - basic salary: this is not necessarily the figure set at the individual's salary review, but the amount received during the year. It may also include any fees paid and, where it is not possible to separate, a salary supplement relating to pensions;
 - benefits-in-kind. These are the estimated money value of any benefits, excluding company pension contributions, received by the individual concerned. Where a cash alternative to a company car is paid, it is included under benefits. This figure also includes, in some cases, a cash payment pension supplement where this is not given separately;
 - annual bonus: this is often a cash payment but may include the cash value of any (deferred) shares awarded as part or all of the award. It may also include profit sharing and profit-related pay.
- 14 The cash value of any long-term incentive plan (LTIP) and/or matching share scheme shares vesting, but not the value of any conditional share awards that may vest at some time in the future;
- 15 The notional/actual gains on the exercise of SAYE and executive share options: The profit or notional gain on share options has been calculated by multiplying the number of shares exercised by the difference between the exercise price at grant and the market price for a share on the day the options were exercised. It should be remembered that

unless the individual has sold the shares, none of this 'profit' will necessarily have been realised in cash. Further, if shares have been sold subsequent to exercise, they may not have been sold at the same market price as was in effect at exercise.

- 16 Any miscellaneous payments. These include special payments for pensions, housing assistance, one-off bonuses for particular projects and profit share.
- 17 Pension provision is not included in any of the data (aside from occasional special payments for pensions outlined above and included in miscellaneous payments in total earnings.)

E.8 Charts using the Manifest/MM&K data show both realised and total earnings. Below are extracts from the *The Manifest/MM&K Executive Director Total Remuneration Survey 2010* definitions of its collection process:

- Salary: The amount paid in the year as shown in the annual accounts, not the current salary.
- Benefits: The taxable value of benefits as reported in the table of emoluments in the annual report. It excludes the value of pension, but includes compensation for loss of office.
- Cash Bonus: This is the figure shown in the emoluments table for annual bonus, less any bonus which is deferred. This produces a lower bonus figure than some other surveys. However, we take the view that only bonus that has actually been received should be counted. The amount that was deferred in respect of the previous year's bonus will be included in the long term incentive awards, plus the value of any potential matching awards. It should be noted that the amount of bonus deferred for the latest year will (usually) not show in our survey until the next year, if it made as a share plan award, or until vesting if it is a deferred cash award. When the deferred bonus vests (e.g. in three years' time), the amount plus any bonus matching shares is recorded in the long term incentive "realised" and Total Remuneration "realised" part of the survey.
- Long Term Incentives: We survey both the amount of long term incentive awarded in the latest year and the amounts "realised" in the year, from previous years' awards.
- Awards In The Year: "Fair Value", i.e. expected value of awards, is rarely disclosed in the annual report. We adopted the simple approach of using the Fair Value of options as 30% of the face value of grant in the latest year. For LTIPs and bonus matching, when performance linked, 60% of the face value is used. This may be over simplistic for some companies with complex plans but, if we have overestimated some and underestimated others, it balances out to give a fair estimate of the market place. We do not apply a discount for the possibility of forfeiture on leaving as the executive, if successful and recruited elsewhere, will be able to negotiate an equivalent or better incentive.
- Amounts "Realised": This is the value of shares that vest under LTIPs, deferred bonus plans and any other share plans plus the gains from options exercised in the year plus any cash payments received from any cash long term incentive plans.
- Total Remuneration Awarded: The sum of salary, pension, benefits, cash bonus and the fair value of share options and other long term incentives awarded.
- Total Remuneration "Realised": The sum of salary, benefits, cash bonuses and the amount of long term incentives "paid out", i.e. notional gains from options exercised in the year calculated at the date of exercise of each option, plus the value of other share schemes that vested in the year, at the date of vesting.

Median earnings: To calculate top to median ratios for FTSE100 chief executives, the Review used the median full-time earnings for the UK workforce from ASHE. .

F

Illustrative example of executive disclosure

F.1 The following provides an illustrative example of the kinds of executive disclosures, with explanations, that might feature in remuneration reports, in accordance with the Fair Pay Code and recommendations made by the Review.

Summary Table

Executive Title	Name	Total Available Basic Pay (less earn back)	Earned back received (total available)	Additional pay	Benefits in kind	Recruitment and retention premiums	Other	Total	Previous Year's total
Chief Executive	John Hebiton	£180,000 (£150,000)	£10,000 (£30,000)	£nil	£374	£5,000	£nil	£165,374	£150,122
Finance Director	Sheila Shah	£167,500 (£142,500)	£nil (£25,000)	£nil	£263	£nil	£nil	£145,163	£148,078
Other Executive	...	...	...	...	...	...	...	...	...
Other Executive	...	...	...	...	...	...	...	...	...
Other Executive	...	...	...	...	...	...	...	...	...

Individual role and performance statement

Executive Title	Name	Total Available Basic Pay (less earn back)	Earned back received (total available)	Additional pay	Benefits in kind	Recruitment and retention premiums	Other	Total	Previous Year's total
Chief Executive	John Hebiton	£180,000 (£150,000)	£10,000 (£30,000)	£nil	£374	£5,000	£nil	£165,374	£150,122
Key responsibilities					Performance				
<ul style="list-style-type: none"> • Be responsible for delivery of all Russetshire CC statutory functions, retain confidence of Council Leader & Members; • Successfully manage contracts and commissioning for outsourced services, including refuse collection; • Reduce Russetshire CC total operating costs by 15%; • Implement restructuring of Children's and Social Services, in line with 'Vision 2014' strategy; • Design and implement new contingency plans for winter weather, including grit supplies and road clearance. 					<ul style="list-style-type: none"> • Statutory responsibilities successfully discharged, resulting in 'good' rating in 2015 Council Assessment; • Refuse collection with PropreUK successfully renewed on improved terms, new library management contract negotiated with Bingham Trust libraries charity; • Total operating costs reduced by only 8.6%, necessitating 3% increase in Council Tax to balance budgets. • Children's and Social Services successfully restructured, implementing new 24/7 helpline; • Road grit stockpiles established, with 20 day capacity. 				

Multiple statement

	2015	2014	% change
Lead Executive total earnings	£165,374	£150,122	9.22%
Median total earnings	£20,121	£21,358	-6.15%
Ratio	8.22	7.03	14.48%

Justification

This has been a demanding year for Russetshire County Council, with the completion of the final merger with Garston District Council to form a Unitary Authority, alongside ongoing implementation of (delayed) 'Vision 2014' reforms, involving substantial restructuring of a range of Council services, this year focussing on Children's and Social Services, and involving contracting out of a significant proportion of social workers.

Russetshire CC's pay multiple has increased this year, driven by higher Chief Executive pay and a drop in median pay following workforce changes (outsourcing of 50% of highly-qualified social workers).

CEO total available pay (including earn back) was increased by 12.5% (in addition to a cost of living increase of 3.2%) to reflect increased CEO responsibilities following merger with Garston District Council: for example this year street cleaning and kerbside refuse collection have become Russetshire CC responsibilities.

However, as Mr Hebiton failed to meet his agreed target of reducing total operating costs by 15%, Russetshire CC decided to award him only £10,000 of earn back pay, of a maximum available £30,000, and not to award him any additional performance award.



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On 19 July the Review issued a call for evidence, inviting views from all interested parties on issues around fairness in pay. A summary of the responses can be found at:

http://www.hm-treasury.gov.uk/indreview_willhutton_fairpay.htm

We received submissions from a range of individuals (academics, human resources specialists and members of the public), as well as the following organisations:

Association of Colleges
Association of Local Authority Chief Executives
Association of Managers in Education
Association of Teachers and Lecturers
British Association of Journalists
Citizens UK
Committee of University Chairs
Confederation of British Industry
Educational Institute of Scotland
Equality and Human Rights Commission
First Division Association
Gatenby Sanderson Ltd
Gateshead Council
GLA Economics
Hay Group
The Higher Education Funding Council for England
The Institute for Employment Studies
John Lewis Partnership
Kent County Council
Local Government Employers
Managers in Partnership
NASUWT
National Union of Teachers
New Economics Foundation

Nottingham City Homes
One Society
Other TaxPayers' Alliance
Prospect
Public and Commercial Services Union
Royal College of Midwives
Royal College of Nursing
Senior Salaries Review Body
Shepway District Council
Society of London Treasurers
South East Employers
Towers Watson
Trades Union Congress
Trust for London
Unison
Unite the Union
The University and College Union
West Sussex County Council
Zacchaeus 2000 Trust

We are also grateful to the representatives of the following bodies who have met with us to help develop our understanding of particular sectors and workforces:

Association of Colleges
Association of Local Authority Chief Executives
Association of Teachers and Lecturers
Audit Commission
Cabinet Office
Chartered Society of Physiotherapy
Committee of University Chairs
Department for Business and Skills
Department for Communities and Local Government
Department of Education
Department of Health
FDA union
Fire Brigades Union
GMB union
Higher Education Funding Council for England
HM Treasury

Managers in Partnership
NASUWT The Teacher's Union
National Union of Teachers
NHS Employers
Local Government Association
Local Government Employers
Home Office
Managers in Partnership
Ministry of Defence
Ministry of Justice
NASUWT
National Audit Office
National Offender Management Service
NHS Employers
Odgers Berndtson
Office of Manpower Economics
Prospect
Public and Commercial Services Union
Shareholder Executive
Society of Radiographers
Towers Watson
Trades Union Congress
Treasury Board of Canada Secretariat
Unite the Union
Universities UK
University and Colleges Employers Association

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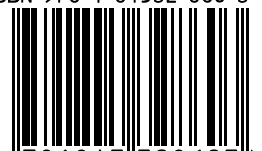
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