The Ethics of pay in a fair society

What do executives think?

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Who were our respondents?

PwC, along with the London School of Economics, surveyed a total of 1,123 executives around the world including 458 in Western Europe, 205 in North America, 121 in South & Central America, 170 in Asia Pacific, 89 in Middle East & Africa and 80 in Central & Eastern Europe, and the report has been prepared based on these results.

Role

Vice President	5%
C-Level exec	14%
Director	25%
Owner or partner	4%
President/CEO/Chairperson	8%
Senior Management	41%
Senior Vice President	3%

Age

Under 35	23%
35-39	22%
40-44	13%
45-49	15%
50-54	11%
55-59	8%
60-64	5%
65+	2%

Annual income

Under $150,000	40%
$150,000 – $349,999	33%
$350,000 – $724,999	14%
$725,000 – $999,000	6%
$1m or over	7%

Country

Australia	35
Brazil	74
Canada	33
China/HK	50
France	36
Germany	102
India	54
Mexico	35
Middle East	31
Netherlands	72
Poland	30
Russia	50
South Africa	41
Spain	31
Switzerland	82
UK	100
US	120
Others	147

Respondent role

50%	Executive directors
21%	Non-executive directors
29%	Neither

Gender

68%	Male
32%	Female

Industry sectors

Financial Services	21%
Manufacturing	17%
Technology	15%
Retail	7%
Healthcare	7%
Government	5%
Energy/Utilities	4%
Basic materials	3%
Communication services	2%
Real estate	1%
Hospitality and leisure	1%
Other	9%

Contents

Introduction

For some time now, societal concern about levels of executive pay has been on the rise. Executive pay has been a lightning rod for broader concerns about inequality and a 'system rigged for the elite' which has been the backdrop to a number of recent elections and referenda across the developed world. Books analysing the problem – most notably Thomas Piketty's 'Capital in the 21st Century' – have been catapulted out of academic circles to the top of best seller lists.

Since the mid 1970s, real incomes in the bottom seven deciles of the global income distribution have risen by between 20% and 80%[1]. And the proportion of the world's population living on less than the World Bank's poverty line of $2 a day has fallen from around 60% to 10%[2]. Globalisation and free trade have pulled extraordinary numbers of people out of poverty across the world but real incomes for the world's middle and working classes have stagnated or fallen, and so the greatest wealth generation mechanism ever seen in human history is being called into question.

This political context has led to a progressive tightening on the rules on executive pay. 'Say on pay' is spreading rapidly around the world, tougher rules on deferral and clawback of bonus are spreading beyond just the banking sector, and publication of pay ratios is being used as a way to encourage boards to think more fully about the question of pay fairness.

But as we showed in PwC publication *Time to listen*[3] last year, the public's concern about inequality in different countries is not correlated with the actual level of inequality, but rather with their view of their personal prospects. Making society more equal may not help reduce the public's concern if questions of security and income progression are not addressed.

Indeed a recent article in Nature set out the wide body of evidence that, in most people's minds, more fair does not necessarily mean more equal[4].

Can companies therefore ignore inequality and just get on with the business of generating wealth, leaving governments to deal with redistribution? Can they adopt the Milton Friedman stance that 'the primary social responsibility of companies is to make profit'? Or should they consider themselves as social entities in their own right, where concerns of fairness and justice hold sway?

There is a tricky balance to strike. Markets matter and companies that ignore the pay rates set by the market risk becoming uncompetitive in terms of cost or quality of talent. But at the same time, the licence to operate of companies across the developed world is being challenged, and will become more so as automation takes its course. Inaction by companies will lead to the concept of "fairness" being hijacked and equated to that of "equality" as we have already seen with recent proposals to introduce pay ratio disclosure in the US and UK.

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[1] Branko Milanovic, 'Global Inequality: A new approach', Belknap Press, 2016

[2] OurWorldInData.org/world-poverty/based on analysis by Bourguignon and Marrison, 'Inequaltiy among World Citizens, The American Economic Review, 2002 and World Bank data (Povcal Net)

[3] https://www.pwc.co.uk/services/human-resource-services/insights/time-to-listen.html

[4] Starmans, C., Sheskin, M. & Bloom, P. Why people prefer unequal societies. Nat. Hum. Behav. 1, 0082 (2017).

Moreover, the best companies know that fair treatment of employees, approached in a commercial way, is an important component in employee engagement and enhanced productivity[5]. There is a positive agenda for companies to embrace here too.

If companies are to play a role in ensuring pay fairness and a just distribution of income, they will need to figure out what these concepts actually mean in tangible terms. 'Fair' is a morally and politically loaded term, which must be handled with care in a corporate context. It does not mean pushing companies towards some socialist utopia. But if more fair is not more equal, what is it? To better understand this question, we need to get to grips with some of the moral principles which underlie the concept.

Fortunately, philosophers have been debating these questions for centuries and provide much material to draw on. So over the last year, in collaboration with Dr Alexander Pepper, Professor of Management Practice at the London School of Economics and Political Science (LSE), and Dr Susanne Buri, Assistant Professor in the Department of Philosophy, Logic, and Scientific Method, PwC conducted a series of thought experiments with over 1,000 senior executives within large, multinational organisations on distributive justice: the principles by which institutions and governments distribute income among their constituents.

PwC chose senior executives as its target audience for two reasons. First, most research on attitudes to fairness focus on the general population. PwC wanted to see if business leaders have a fundamentally different view. But second, senior executives play a critical role in determining the culture of their business and its sense of purpose. Understanding their views on fairness is therefore central to understanding what can realistically be achieved within companies in this area.

The approach builds on a PwC study of a few years ago into the Psychology of Incentives, which, as well as this report, was also carried out with LSE[6]. That study gave great insight to how executive pay should be designed to motivate executives. PwC hope that this study will play a part in helping companies develop a motivating reward strategy for the whole company.

The research explores the attitudes to fairness and distributive justice in companies and society. As well as shedding light on current attitudes to fairness, our findings will help companies develop a new language to explore what they mean by 'fair'. This will help them to engage with their employees as they build remuneration structures that are fair, just and meet employee as well as wider societal expectations.

Developed economies face nothing less than a challenge to capitalism as we know it. To respond to this challenge, companies need to know what they mean by fair. We hope this research helps them to figure this out.

> "The top positions are the think heads for any organization. It is very important that they are properly recruited and optimally paid."
>
> Senior Manager, financial services business, India

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[5] Edmans, A. (2012), 'The Link between Job Satisfaction and Firm Value, with Implications for Corporate Social Responsibility', Academy of Management Perspectives 26, 1-1

[6] Making Executive Pay Work, The Psychology of Incentives, http://www.pwc.com/gx/en/services/people-organisation/publications/making-executive-pay-work-the-psychology-of-incentives.html

Principles of distributive justice

There is a great wealth of literature in the field of political philosophy dealing with the matter of distributive justice. PwC drew on this literature to structure the thought experiments for participants around six key principles of distributive justice, shown opposite. These represent the span of theories, although they are not comprehensive. To simplify the survey, we did not include some of the most extreme theories – for example complete equality of outcome.

Survey respondents were taken through a series of thought experiments to evaluate their attitudes to, and prioritisation of, these principles of distributive justice in relation to their company and society; as it is, and as they would wish it to be.

> "Without falling into a socialist ideology, all the employees of a company contribute actively to its success, so too great a disparity in wages is unjust and counterproductive."
>
> Director, Manufacturing, Switzerland

Entitlement

All voluntary transactions are just

With the late Robert Nozick as its most famous exponent, this theory turns the approach to distributive justice on its head: rather than asking, how can we justify a transfer of money from A to B, it instead asks, how can we justify interfering with this transfer in the first place? Any transfer between willing agents is just.

Just desert

People who achieve more deserve more

The basis of desert theory is that there ought to be a like-for-like relationship between one's work contribution and the reward one gets in return: what you put in is equal to what you get out. Moreover, those who are more productive but work less hard deserve more than those who work hard but are less productive.

Sufficiency

Guarantee a minimum standard of living for all

Sufficiency has as its ethos the idea that any state or system whose constituents are not able to lead a dignified life is fundamentally immoral. Once this minimum quality of life is guaranteed for all, however, society has fulfilled is obligations towards distributive justice.

Efficiency

The income distribution should lead to an efficient allocation of labour

This theory ostensibly has no distributive principle, but its real one is this: that efficiency is to be put before any other distributive consideration. What the market decides is what is right, as this will create the greatest wealth for the greatest number.

Equal opportunity

Outcomes are fair provided the starting point is

This theory sees market competition as fair game, so long as there is a level playing field. Certain advantages which arise out of luck, such as what postcode someone was born in, or the school they went to, should have as little to do with their future economic opportunities as possible.

Maximin

Distribute income to make the worst off in society as well-off as possible

The brainchild of political Philosopher John Rawls, maximin states that inequality should only exist to the extent it makes the worse-off in society better off: a strong test. This is achieved by harnessing the productive capacity of the better off, through the preservation of some level of monetary incentive.

Results

All principles secured at least some support from half the respondents, although some were more favoured than others. Entitlement, which gives companies the freedom to pay their employees as they please, and imposes no obligation on society to intervene in wealth outcomes, is least supported. In the same bracket is Maximin, which argues for allowing inequality only to the extent that it maximises the welfare of the least well-off. Doing nothing to help the least well-off is as unfavoured an idea as doing everything to help the least well-off.

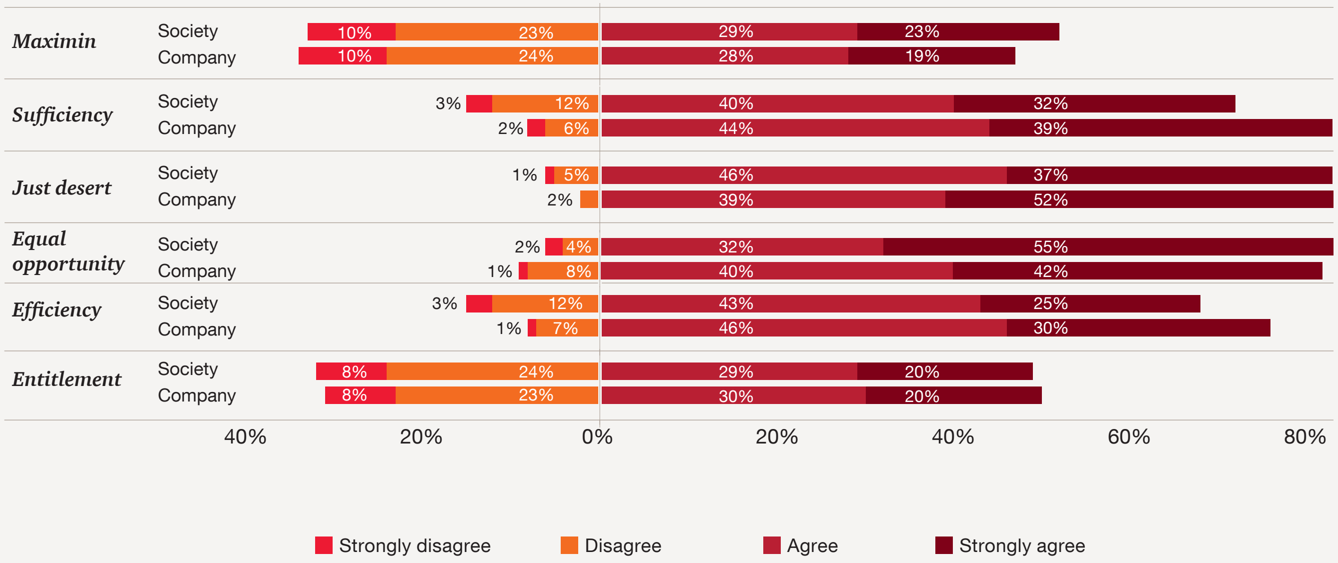
The four more moderate principles of Efficiency, Just Desert, Equal Opportunity, and Sufficiency, were the most favoured by a considerable margin. Respondents typically favoured three or more principles.

Respondents supported multiple principles simultaneously, even though, on the face of it, many of the principles are in conflict. This shows that attitudes to fairness are complex and multidimensional. A single principle cannot describe the richness of human attitudes in this area. Hence more fair does not mean more equal. To develop an outcome that is seen as just requires subtle trade-offs across many dimensions.

Attitudes to fairness in companies and societies were strikingly similar. The idea that companies create wealth and societies distribute it did not seem to hold water even amongst this senior population. Companies are viewed as social entities in their own right, a microcosm of the distributional challenges faced at the level of society.

Results for principles that were viewed as just in the context of a participant's ideal company or society are shown below:

Proportion of respondents agreeing that a principle is important in their company or society



> "It's fine to compensate executives at a very high level as long as they create value for all stakeholders."
>
> Director, Education Business, USA

Four philosophical tribes

Clustering the data

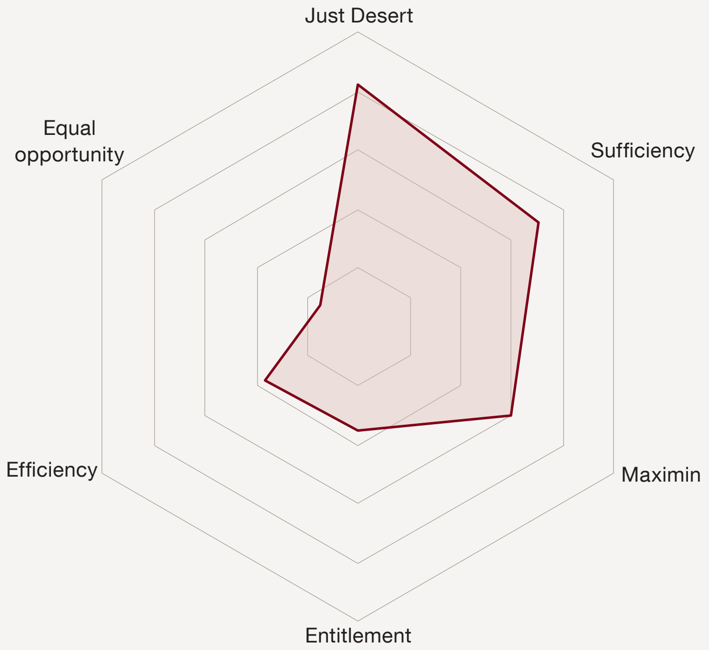
The statistical analysis allows us to identify clusters in the data where groups of like minded people take a similar perspective on the different dimensions of fairness shown above. The data broke into four clear and broadly equally-sized clusters.

There are overlaps between the attitudes to distributive justice set out in these clusters. But they reflect four distinct views of what people expect from their company and society.

The charts show, for each tribe, the importance of each principle, with values closer to the centre of the spider diagram representing less important principles and values closer to the outer edge representing more important principles.

Idealist

Distribution of wealth should lead to moral outcomes. Individuals should receive rewards based on their contribution, but all members of a community should have an income that is sufficient for them to lead a dignified life. Inequality should be accepted but as a means to making the worst-off as well-off as possible. Efficiency is not an important criterion by which outcomes should be judged.



Communitarian

All members of a community should have an income that is sufficient for them to lead a dignified life. Equal opportunities are important – nobody should be at a disadvantage because of the circumstances of their birth. An efficient outcome for the community overall matters. Individual talent and contribution is not an important criterion for allocating economic benefits.

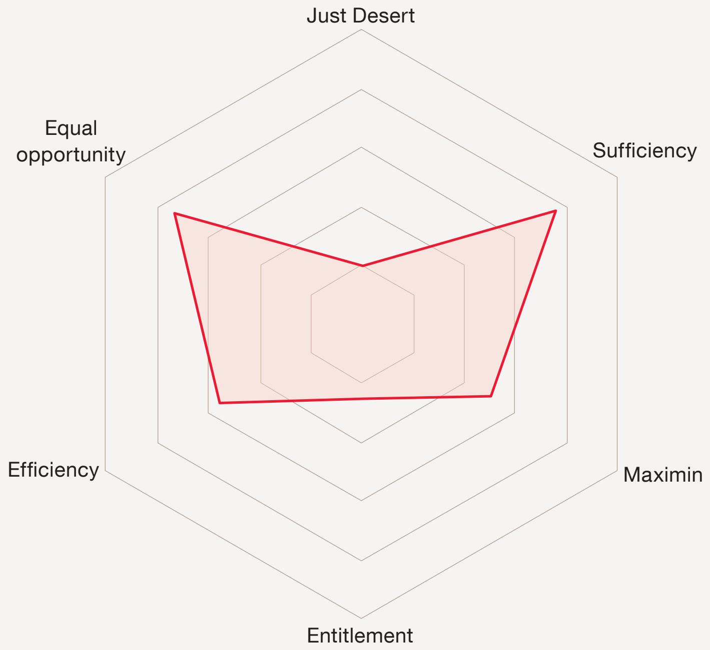
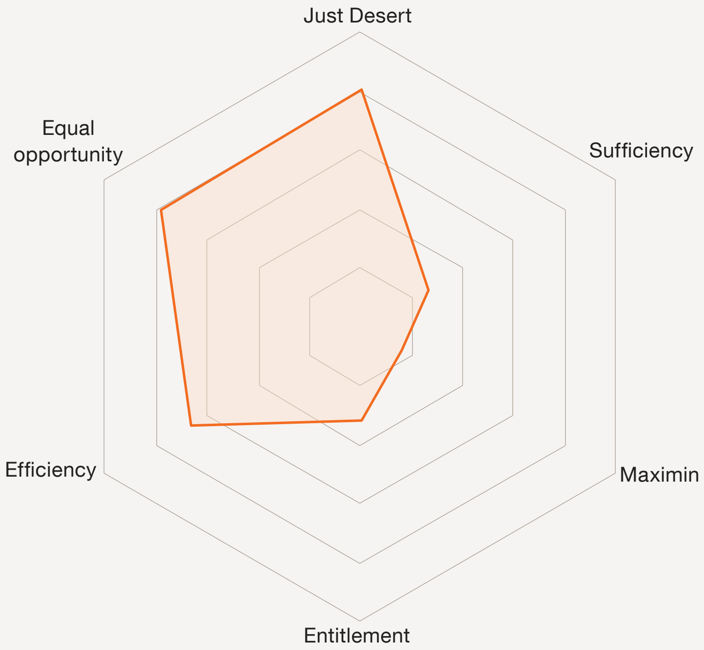


Diagram Sources: PwC Survey – The Ethics of pay in a fair society' November 2017

> “Organisations where the gap between the highest paid and the lowest paid employees is too high create frustration and mistrust and are de-motivating.”
>
> Director, Public sector organisation, Switzerland

Free Marketeer

Provided there are equal opportunities for all, talented people deserve to receive income in line with their contribution. Market efficiency is important in determining how income should be allocated. No one is automatically entitled to income or wealth. The economic system does not owe anyone a living, nor need it improve the lot of the least well off in the community, provided it is efficient overall.



Meritocrat

Provided all members of the community have an income that is sufficient for them to lead a dignified life, individuals are entitled to receive economic benefits because of their efforts and contribution. Equal opportunities are important – nobody should be at a disadvantage because of the circumstances of their birth. Efficiency is not an important criterion by which outcomes are judged, and the distribution of wealth need not be to the benefit of the least well off in the community.

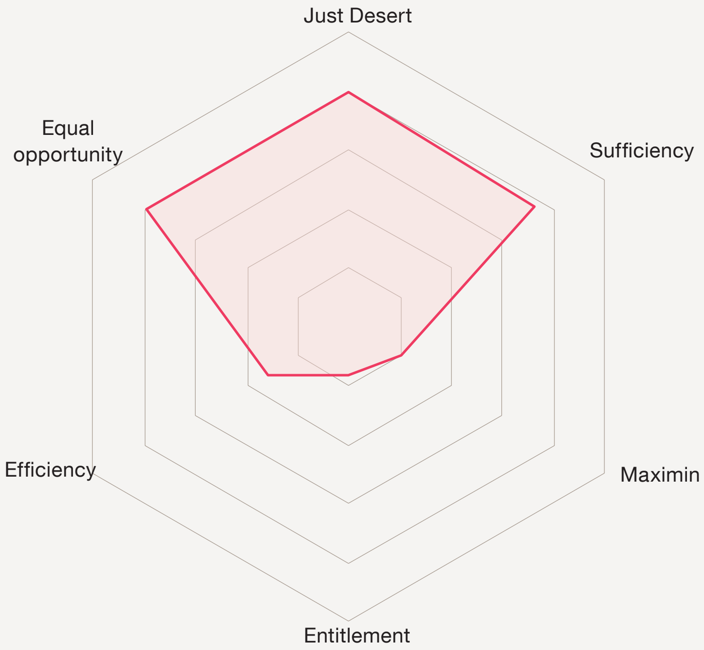


Diagram Sources: PwC Survey – The Ethics of pay in a fair society’ November 2017

Do demographics matter?

Universalism reigns

Analysis shows that the data is remarkably consistent across a range of demographic dimensions. There were no significant differences by:

- Gender
- Territory
- Earnings level

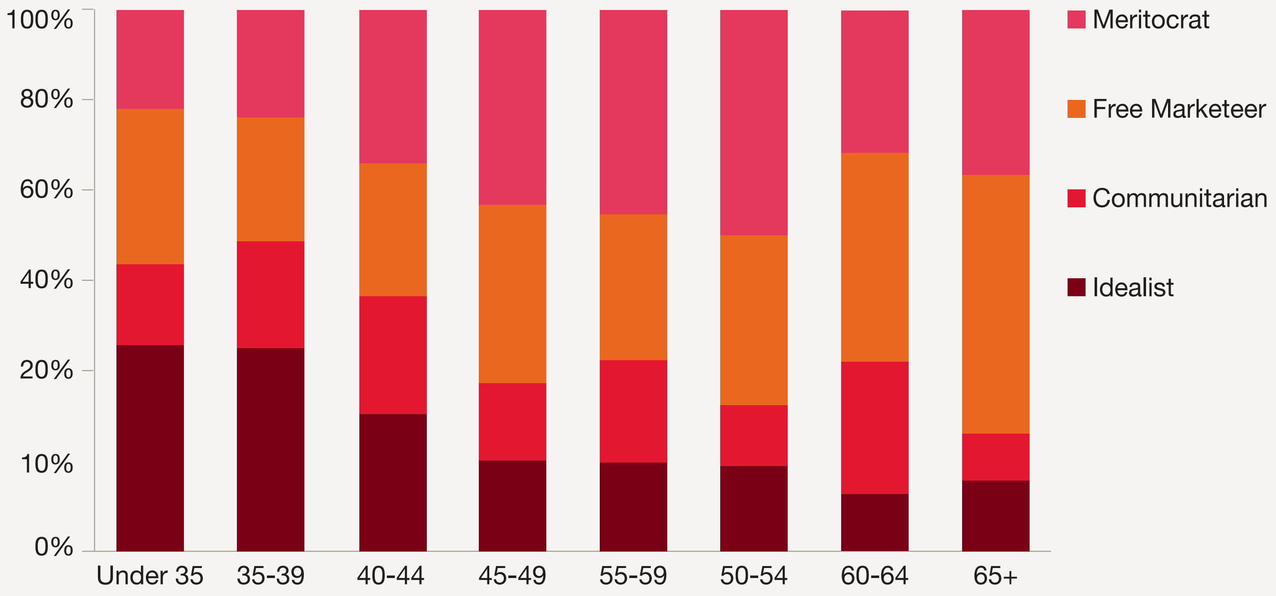
This does suggests that the dimensions of fairness and the desired balance between them hold universal appeal.

However, there was one significant demographic predictor of which philosophy of fairness was most favoured: Age. The under 40s were far more likely to be Idealists than any other age group and the over 50s were far more likely to be Free Marketeers.

This is significant in the current debate about intergenerational fairness between Gen X and Y and the baby boomers. Ideas about distributive justice differ markedly, with the younger population significantly more circumspect about trusting the market to produce a morally desirable result, and wanting stronger protection for the less well-off. By contrast the older generation are more likely to put more faith on the effectiveness of market outcomes.

Almost 50% of over-65s identified themselves most strongly with pro-market principles, while less than a third of under 35s did the same. The further we go down the age groups of respondents, the more likely they are to distribute away from market outcomes and towards more socially orientated outcomes.

Proportion of each age bracket in the different philosophical tribes



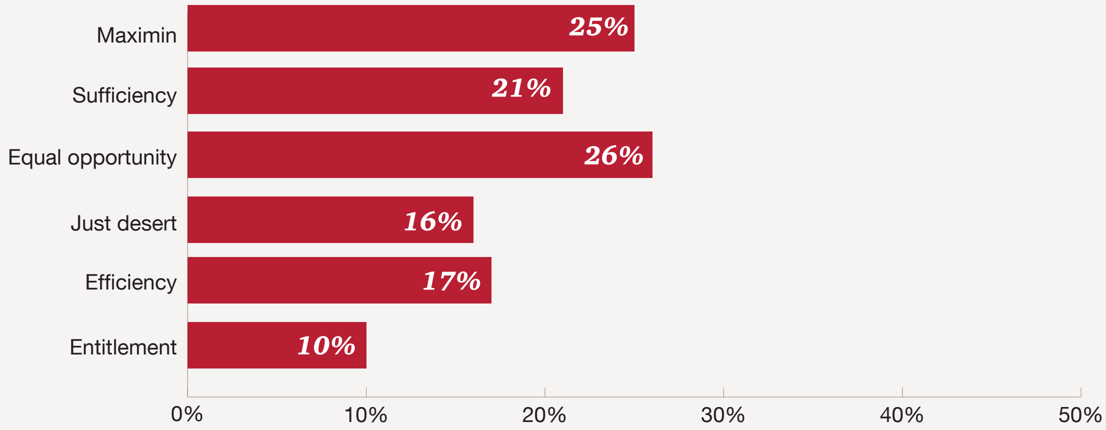
> “The workers do all the work and the CEO receives all the rewards. Look after your workers and they will look after your company as if it is their own.”
>
> Senior Manager, Retail, South Africa

Unmet aspirations

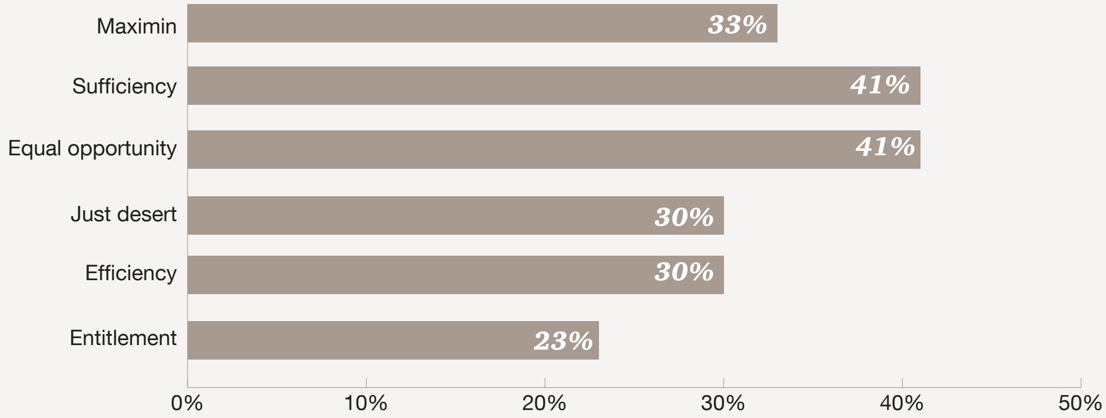
What people want; what companies and societies do
Companies, as well as societies, are not always living up to people's hopes of them. Typically a quarter to a third of people feel that companies are not delivering principles of fairness that they deem to be important.

The same is true for societies to an equal if not greater extent. This all suggests that citizens have strong expectations of fairness from both companies and societies, that are not always being met. In both companies and society, equal opportunity was the principle where there was the biggest gap between aspiration and reality. Fully 40% of respondents that consider equal opportunity to be important did not consider the principle to be implemented in their society. The corresponding proportion for companies was little over 25%. Other principles with a sizable gap between aspiration and reality were Sufficiency and Maximin. Market-based principles of distribution were felt to be more effectively implemented.

Proportion of people who think that their company is not delivering on a principle of fairness they think is just

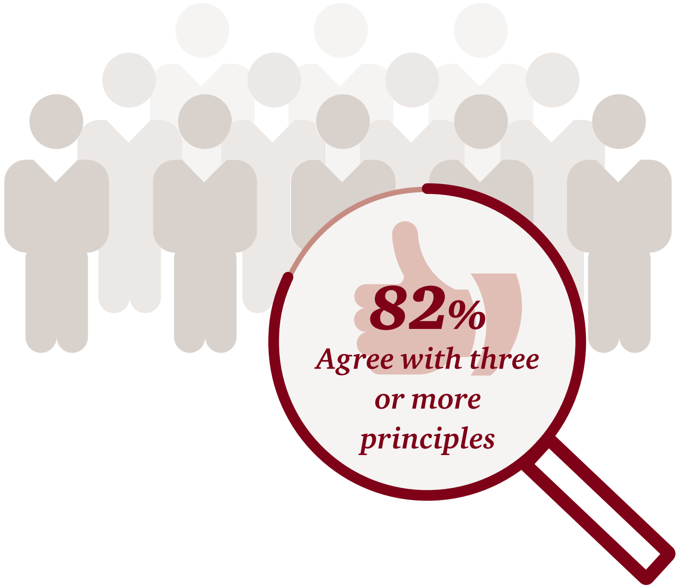


Proportion of people who think that their society is not delivering on a principle of fairness they think is just



> "I believe in pay for performance (for contribution, effort, expertise, etc.). Those that don't want to work hard, make sacrifices and take advantage of opportunities shouldn't be rewarded at the same level as those that are willing to do more."
>
> C-suite exec, Manufacturing, USA

Key conclusions



Fairness is multi-dimensional

The findings demonstrate that as far as the survey respondents were concerned, there is no single catch-all principle of distribution. For instance, for questions related to Society, the majority of the respondents (93%) agree with more than one principle, with 82% agreeing with three or more.

Views of distributive justice are multidimensional and complex. There is much more to fairness than equality. Yet the debate on fairness is at risk of being hijacked by a one-dimensional view based on pay ratios. It is in companies' interests to develop a much fuller narrative on what they mean by fairness and how they are delivering on that for employees.

There are four fairness tribes

Participants cluster into four distinct tribes when it comes to their perceptions of what is fair:

Idealist: Distribution of wealth should lead to moral outcomes. Individuals should receive rewards based on their contribution, but all members of a community should have an income that is sufficient for them to lead a dignified life. Inequality should be accepted but as a means to making the worst-off as well-off as possible. Efficiency is not an important criterion by which outcomes should be judged.

Communitarian: All members of a community should have an income that is sufficient for them to lead a dignified life. Equal opportunities are important – nobody should be at a disadvantage because of the circumstances of their birth. An efficient outcome for the community overall matters. Individual talent and contribution is not an important criterion for allocating economic benefits.

Free Marketeer: Provided there are equal opportunities for all, talented people deserve to receive income in line with their contribution. Market efficiency is important in determining how income should be allocated. No one is automatically entitled to income or wealth. The economic system does not owe anyone a living, nor need it improve the lot of the least well off in the community, provided it is efficient overall.

Meritocrat: Provided all members of the community have an income that is sufficient for them to lead a dignified life, individuals are entitled to receive economic benefits because of their efforts and contribution. Equal opportunities are important – nobody should be at a disadvantage because of the circumstances of their birth. Efficiency is not an important criterion by which outcomes are judged, and the distribution of wealth need not be to the benefit of the least well off in the community.

> "A CEO takes all the corporate risk – why would they take a job that could see them in prison for little or no pay? "

Senior Manager, Defence company, UK

The generations view fairness very differently

Demographic factors generally do not predict attitudes to fairness. We found remarkable statistical consistency by territory, gender, level of earnings. This suggests some universal principles apply. The major exception to this is age, which was the only demographic factor that provided statistically significant indication of the philosophy of fairness to which an individual would subscribe.

Perhaps unsurprisingly, the young are much more likely to be Idealists, with the prevalence of free-marketeers increasing with age. This provides a challenge to companies seeking to develop an approach that works for three generations in one workforce.

Principles of fairness apply to companies

Survey participants didn't subscribe to the view that the role of companies is to make money and of the state to redistribute it. Instead, respondents think companies have a broadly equal responsibility in providing a fair pay structure among their employees. Companies are seen not to live outside of, but to be very much a part of, society and are expected to act justly.

38%
of under 35s were clustered as Idealist

8%
of over 65s were clustered as Communitarian

48%
of over 65s were clustered as Free Marketeer

> "Placing an arbitrary limit on executive pay is sadly necessary. A Board of Directors is at serious risk of operating in a moral vacuum. It rarely if ever has sufficient time or the experienced intellectual talents to resist the mutual flattery that lies behind excessive pay packages."
>
> Senior vice president, Natural Resources Business, US

How should companies respond?

'Fairness' is a morally and politically loaded term and means different things to different people. It is a concept that is easily high-jacked by special interests and one-dimensional views, as we've seen recently with the pay ratio proposals in the US and UK.

But questions about fairness, and the role companies have to play in this, are not going away any time soon. Fairness matters, and executives expect companies to play a role in distributional justice and fairness rather than just leaving it to governments. Responding to this instinct is an important part of rebuilding trust in business. But beyond this, there is an opportunity to create a more engaged workforce with benefits for long-term value and productivity. So what should companies wanting to address this issue do? We see four key steps.

1. Develop fairness principles

Boards need to translate the key principles of fairness into their own business, and decide which is relevant to them given their business, workforce, and culture. Different businesses will place different weights on the dimensions, which should be tailored to each company's purpose, culture, and strategy.

2. Translate into tangible people policies

Fairness principles will come alive through their expression in tangible people policies such as living wage adoption, pay-for-performance, worker security, equal pay and so on. Companies should identify the concrete policies that support their board-approved fairness principles.

3. Measure and monitor

Develop metrics that enable progress towards fairness to be measured and monitored. This can include objective outcomes such as equal pay statistics, social mobility in the organisation, pay ratios, market positioning, and so on. Developing a 'fairness dashboard' can help with accountability and reporting.

4. Engage with employees

We have identified four common philosophies of fairness that people hold. The most appropriate fairness principles for the company will depend on employee attitudes and culture. Engage with employees to find out what fairness means to them and use the insight to refine company fairness principles.

PwC will share more detail in coming publications on how these four steps can be brought to life in practice. This is a difficult area and there will be some who argue it is a debate that has no place in a commercial business context. But we would argue that the public and political debate on fairness is here to stay, and will influence public policy relating to the corporate sector. Companies should therefore consider their perspectives on this debate. The first step for each company is to figure out exactly what fairness means for them.

> "It is too difficult to say what people should or should not make, it has to decided by the job, the performance and what the business is worth."
>
> Director, Healthcare Business, USA

Start a conversation

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