

ASYMMETRIC REFERENCE POINTS AND THE GROWTH OF EXECUTIVE REMUNERATIONⁱ

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Various explanations have been put forward for the recent divergence in growth rates of CEO pay and average earnings, but those which most clearly match the evidence concern power and the institutions of remuneration setting. Executive pay is characterised by 'dual asymmetric pattern bargaining', whereby firms seek to benchmark their CEO pay to higher-paying firms, and grant CEOs, with whom corporate decision makers share a social milieu, increasing benefits which also confer status benefits on the firm – in sharp contrast to the distributional pay negotiations which occur with workers. Executive remuneration rises disproportionately during boom periods, but fails to symmetrically fall during poor times. Thus 'everybody knows' that CEOs are overpaid, but firms are unwilling to do anything about it, because to do so would damage internal class relations and firm status. The different methods of pay setting for workers and CEOs reflect core differences in class power and changes in that balance of power during a period of neoliberalism.

Executive pay and termination packages have become a focus of public attention, with widespread concern about the levels of executive remuneration and termination payments for executives. Across Europe and the US, four fifths of people believe that business leaders in their countries are paid too much (Harris Interactive 2009; see also Blitz 2003). A 2004 telephone survey of 400 Australians found only 36 per cent thought bonuses and fees for executives and board members were 'fair and reasonable' (Crosby Textor 2004). A 2009 survey commissioned by *The Australian* found that: nine in 10 Australians believe that CEOs get paid too much; 79 per cent believe executive salaries should be capped; four in five believe high executive salaries do not increase company performance; and almost two-thirds of people believe high executive pay leads to higher risk taking (Ferguson 2009). This paper considers the growth in executive remuneration since the 1970s and the alleged and actual causes of the growing divergence between CEO pay and pay of ordinary employees. It draws upon existing international studies and Australian survey data, as well as a simulation of the impacts of our hypothesised remuneration determination process.

Relative growth in executive remuneration

Since the mid 1980s executive salaries have been growing faster than average wages. However, this difference in growth rates has not always existed. Australian series on executive remuneration and average earnings tracked each other fairly closely through the 1970s and early 1980s (other than in 1974, when there was a significant increase in real earnings that which established a new relativity that remained fairly stable until 1985). From 1985 the Australian series started to diverge, with major increases in real executive remuneration despite ongoing moderation in real average earnings in the context of the centralized phase of the prices and incomes Accord. The divergence continued through subsequent periods of decentralized bargaining for wage earners as well. The growth in CEO pay, of something around 470 per cent over the period 1971-2008, was nearly nine times the 54 per cent growth in real average weekly earnings over the same period (calculated from Egan 2009, Noble Lowndes Cullen Egan Dell 1994, Shields, O'Donnell & O'Brien 2003). The increase in CEO pay is a significant factor explaining the rise in the share of national income going to top income earners over the past two decades (Atkinson & Leigh 2007).

This increase in top income shares is a relatively recent phenomenon: from 1920 to the early 1980s, the share of top income earners generally declined (ibid).

Several explanations have been offered for the contemporary divergence between growth rates of CEO pay and the pay of ordinary workers (Productivity Commission 2009). Space does not permit a separate analysis of these, save to say that there is considerable evidence that growth in executive remuneration does not reflect growth in productivity or performance (Shields, O'Donnell & O'Brien 2004, 2003; Trounson 2007; West 2008; RiskMetrics Australia 2009a) nor the operation of 'global' markets for executives (Noble Lowndes Cullen Egan Dell 1994, RiskMetrics Australia 2009b). Here, we focus on an explanation that is largely ignored by those (eg Australian Chamber of Commerce and Industry 2009, Business Council of Australia 2004) with an interest in maintaining the status quo: the asymmetry in pay procedures, in particular asymmetry in reference points for pay determination. The market for executive remuneration has strong elements of 'pattern bargaining'. However, it has two key asymmetries: a 'pattern' that is asymmetric, as it is based on asymmetric reference points that seek to achieve a position *above* the mean; and 'bargaining' that is asymmetric, as there is not an effective countervailing force at the bargaining table (in contrast to wage bargaining for ordinary employees). Hence the process can more accurately be described as *dual-asymmetric pattern bargaining*.

Our alternative explanation for growth in senior executive remuneration therefore focuses on institutions, in particular the existence of occupational power and the ability of that power to shape the reference points for setting executive remuneration. It focuses on the way in which CEOs hold positions of relative power, similar or related to the power that capital has in relation to labour, and that as power has shifted from labour to capital the capacity of CEOs to extract rents (Bebchuk & Fried 2004) has increased. It is based on the idea that CEOs are able to disturb relativities in CEO pay and then use their occupational power to attempt to reassert those relativities, imparting an upward bias to aggregate CEO pay unrelated to performance. For example, CEOs are able to persuade boards to attempt to pay them above the 'median' CEO salary for reasons of organizational status, and as it is mathematically impossible for most people to be paid above the median, relative CEO remuneration will rise regardless of performance. Remuneration consultants play a significant role in the 'leapfrog' explanation.

A key role in this process is played by remuneration consultants. The role of remuneration consultants in the UK was recently described disparagingly by a leading fund manager:

I would say they are a thoroughly bad influence. They are seen by fund managers as having extreme conflicts of interest: they are effectively paid by the board and are only seen to be doing their jobs if remuneration rises. In theory, remuneration consultants bring a certain level of objectivity to the task, but their existence allows companies to say they have done due diligence on pay, therefore it's not their fault when benefits and performance do not match (quoted in Wachman 2009).

The House of Commons Treasury Committee investigating the financial crisis received 'a body of evidence linking remuneration consultants to the upward ratchet of pay of senior executives in the banking sector'. (House of Commons Treasury Committee 2009:32,33).

Inflationary bias and the recognition of overpayment

It seems highly likely that there is an inflationary bias in executive remuneration. In addition to its far greater growth rates by comparison with ordinary wage and salary earners, there is also evidence of widespread perceptions that executives are overpaid – not just amongst the population at large (mentioned earlier), but amongst their own social class. A 2005 survey

co-sponsored by the Australian Institute of Company Directors showed that even a majority of directors believe that CEOs are overpaid – notwithstanding the fact that, technically, it is the job of the board of directors to set CEO pay. Indeed, over two thirds of those considered that CEOs were overpaid by between 20 per cent and 50 per cent (Buffini & Pheasant 2005). A separate study found similar results. O'Neill (2007), undertaking in-depth, semi-structured interviews with non-executive directors of Australian public companies, found that 'when the issue of "how much is too much?" arises, almost all express a level of concern', evoking comments from directors such as that CEO pay 'needs to be capped so that it doesn't become obscene' and 'I don't think any individual is worth that much' (O'Neill 2007). Even Paul Anderson, then retiring CEO of BHP Billiton, remarked:

CEO compensation is out of control, totally out of control. It's reached a point now that there's no way to justify the incredible compensation...there is just no value that can be created by a CEO that you can say that makes a lot of sense (Correy 2003).

There is a high element of status in executive pay which shapes remuneration decisions. According to the director of the Australian Institute of Company Directors:

it's quite possible that a bank CEO would do a terrific job on quite a lot less pay, but no bank board is going to want to pay its CEO substantially less than the market norm. (Ralph Evans quoted in Buffini & Pheasant 2005).

Australian data

Useful cross-sectional data on the role of institutions, including remuneration consultants, are rare. So our starting point is a survey of executive pay methods undertaken by Noble Lowndes Cullen Egan Dell (Noble Lowndes Cullen Egan Dell 1994), which showed that the most important factor influencing executive pay was 'remuneration market forces' (that is, what other corporations were paying).

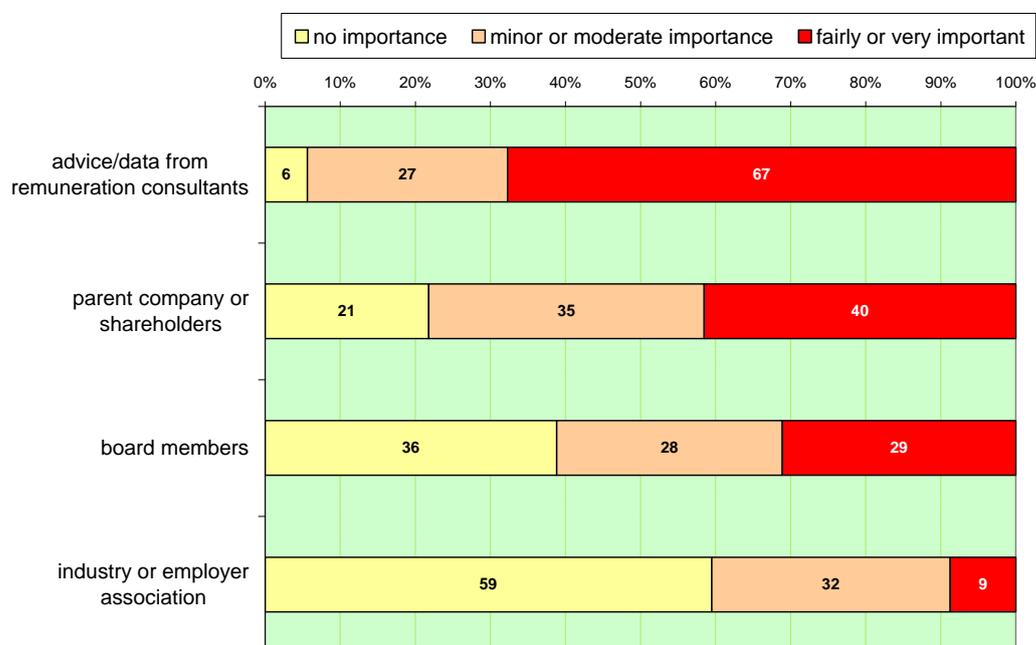


Figure (1) How important is each of the following as a source of information, advice or direction on pay levels for senior executives, Australia, 1991.

Source: Noble Lowndes Cullen Egan Dell 1994

Although the survey, commissioned by the then Department of Industrial Relations, is over a decade old, it is a crucial source of data as it provides a rare, frank insight into executive pay determination, an area that is normally shrouded in self-justification and a shortage of transparent publicly available data. Figure 1 shows the main sources of information, advice or direction on executive pay levels in that survey. It indicates that advice and data from remuneration consultants was far more important than the views of shareholders, board members or industry associations in determining executive pay.

Indications that the factors driving the relative size of executive pay have not significantly changed since then came from a recent 'web poll' by Egan Associates, using quite different questions. This indicated that the three factors 'with the most significant influence on executive pay' were 'company remuneration policies/ competitive positioning', 'market rates' and 'remuneration consultant data'. Although the results should be treated cautiously because of web-based sampling, it was clear that 'remuneration consultant data' was over twice as likely as 'shareholder views' to be rated significant, while 'shareholder views' were at least three times more likely than 'remuneration consultant data' to be rated the 'least significant influence' on executive pay (Egan 2009).

The NLCED survey also asked about the 'comparative remuneration market' for their senior executives. Some seven tenths of companies benchmarked their senior executives pay by reference to the industry in which they operated. Smaller proportions referred to occupational labour markets, firms of similar size or the Australian private sector in general.

Most relevant, however, was the question on how companies sought to pitch or 'position' their senior executives' pay. Results are shown in Figure 2. Nearly two thirds of companies had a policy of 'positioning' their executives' pay above the median and 92 per cent claimed to set them around or above the median. The 65 per cent who pitch their executive pay above the median comprised 35 per cent who pitched between the median and the 75th percentile and 31 per cent who pitched at or above the 75th percentile. Only 2 per cent aimed to position their pay below the median. Of course, it is mathematically impossible for all companies to achieve the position they are seeking. By definition, 50 per cent of firms will be paying below the median, not 2 per cent. As virtually all firms attempt to position themselves at or above the median, senior executive remuneration will increase even in an environment of zero inflation and zero productivity gains. A similar pattern was seen in the USA at that time (Crystal 1991).

Respondents were also asked the time frame they used when estimating pay comparators for senior executives. Some 31 per cent did not just rely on the current rates but attempted to anticipate where the median would be any time up to twelve months into the future.

In June 2009, Hewitt CSi, a management consulting firm, 53 medium-large respondent corporations were asked to indicate where they positioned their CEO and Senior Executives in the market for three different components of executive remuneration. The sample was around a quarter of that in the NLCED survey, but it provides a useful comparison and confirmation of asymmetry in executive pay-setting. For fixed term remuneration, only 6 per cent pitched CEO pay below the median, while 54 per cent pitched at the median and 40 per cent pitched above the median (comprising 20 per cent in the upper quartile, 14 per cent in the third quartile and 6 per cent who pitched at the 'average', which is somewhat above the median). For short-term CEO incentives, the skew was higher, with none pitching below the median, only 47 per cent at the median and 53 per cent above the median (comprising 20 per cent in the upper quartile, 14 per cent in the third quartile and 6 per cent who pitched at the 'average', which is somewhat above the median). The distribution of long-term CEO incentives was also skewed in a pattern in between these two distributions (Hewitt CSi 2009).

Results are summarised in Figure 3. The greater likelihood of pitching incentives, particularly short-term incentives, compared to fixed remuneration at the upper part of the distribution may help explain why short-term incentives became a larger component of CEO remuneration over the last decade. While asymmetry in the distribution of pitches is evident in both the Hewitt 2009 survey and the NLCED 1992 survey, the extent of the asymmetry differs. We return to this later.

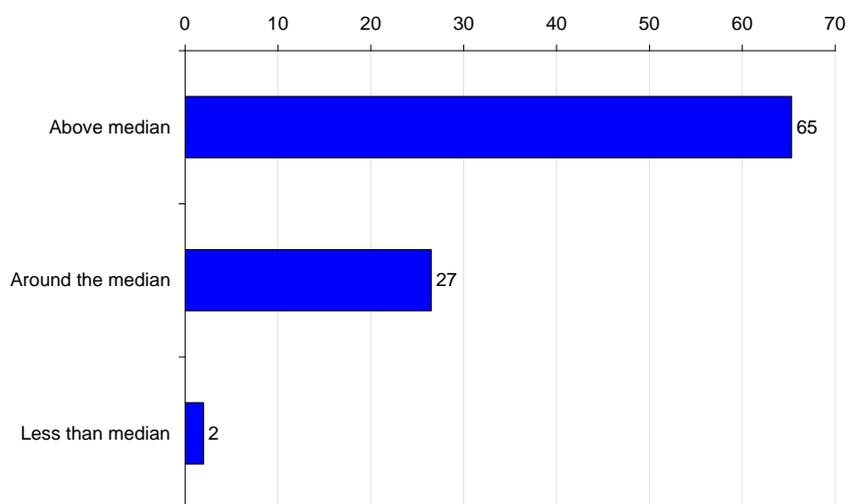


Figure (2) In relation to this comparative market, where do you generally aim to position your senior executives' pay?

Source: Noble Lowndes Cullen Egan Dell 1994

Data were also collected in the pitching of senior executives' remuneration. This followed a similar pattern to that for CEO pitching, though there was a slightly lesser tendency to pitch for the upper quartile for senior executive pay and incentives than in CEO pay and incentives. For example, 28 per cent of senior executives' short term incentives were pitched at the upper quartile, compared to 33 per cent for CEOs (Figure 4).

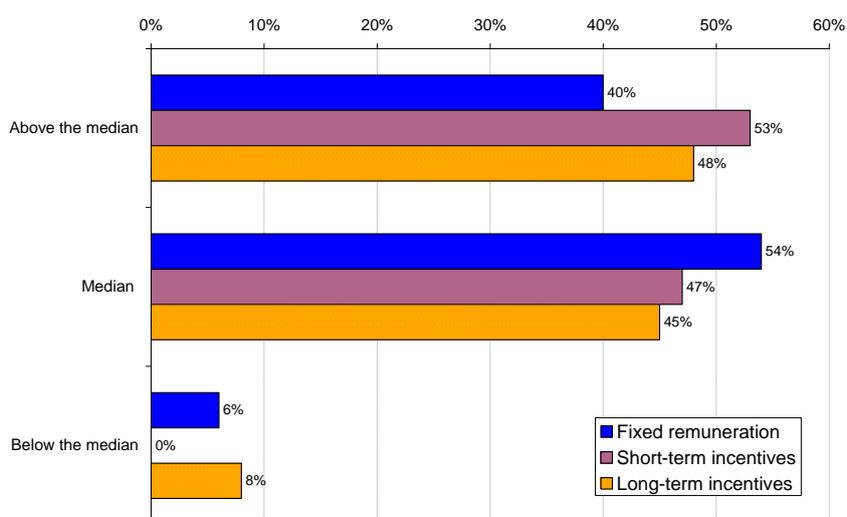


Figure (3) Positioning of components of CEO pay

Source: Hewitt CSi 2009

Social capital in executive remuneration

There is also strong evidence from US studies that this process continues. In the US, Faulkender & Yang (2007) found that, when selecting comparators for determining CEO pay, firms forego lower paid potential peers in their same industry in favor of higher paid peers outside of their industry when constructing the peer groups.

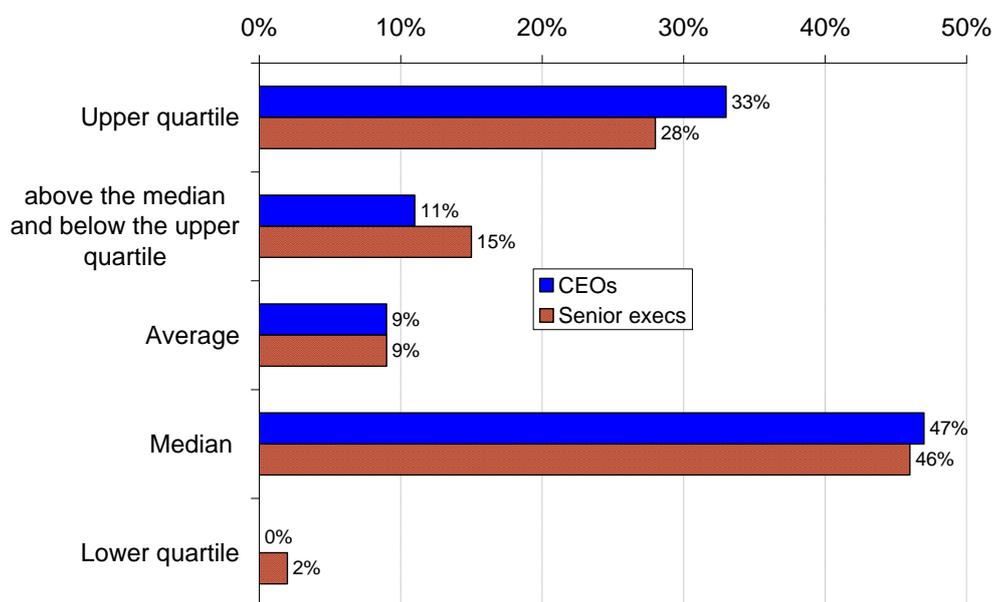


Figure 4 Positioning of short-term incentives for CEOs and senior executives

Source: Hewitt CSi 2009

This effect persisted when controlling for industry and size. Indeed comparative pay of peers was far more important in determining CEO pay than industry or size. They concluded that the selection of relatively highly paid (above median) peers to justify CEO compensation was more common where the CEO was chairman of the board, when the firm had greater market share, poorer governance and where a particular remuneration consultant was used by the firm (Faulkender & Yang 2007). The role of remuneration consultants in the UK was recently described disparagingly by a leading fund manager (quoted in Wachman 2009) and by the House of Commons Treasury Committee (2009:33), reporting on the global financial crisis in the UK.

Notably, Ang, Nagle and Yang (2007) showed the role of social capital, demonstrating that CEO compensation includes a 'social circle premium', in excess of what could be justified by firm performance. They found that channels of social interactions that shaped these social circle premiums included 'golfing in the same exclusive club, sharing directors who understand the local pay norm and displaying luxury mansions' (Ang, et al. 2007). Rather than having opposing interests to executives, the board members or others who set their pay are from the same social milieu with broadly comparable interests, and often they see status or reputation costs and benefits associated with executive remuneration. In other words, the market is distorted by the absence of genuine opposition of interests that exists elsewhere in the labour market and the high degree of power possessed by CEOs, arising from the resources and information that they have access to within the corporation, their connections or networks with other CEOs and directors, the norms or attitudes that permeate the executive

'market' and their collective social identity as a class, things that all set aside 'arms length bargaining' in executive remuneration (Bebchuk & Fried 2004, Yablon 2008).

For ordinary workers, leapfrogging is prevented by the existence of countervailing forces at the bargaining table. Management has a clear interest in resisting employee attempts to raise wages through leapfrogging. In the past, tribunals also effectively placed a break on asymmetric pattern bargaining in the public sector once its disutility became apparent in an environment of generalized wage restraint. More recently, the Workplace Relations Act and Fair Work Act have prohibited something referred to as pattern bargaining by employees.

The breakdown in labour/CEO relativities

Why then the breakdown of CEO/AWE relativities in the 1980s? First, 'today's universal practice of setting CEO pay relative to peers was not common in the 1970s... the 1970s were marked by relatively little compensation consultant activity and scarce objective pay information' (Nagel 2007).

Second, in part as a result of changing economic policies, the 1980s marked a shift in power between labour and capital. The share of national income going to profits relative to that going to labour increased, and continued to rise through the 1990s and 2000s (Australian Bureau of Statistics 5204.0). Income inequality – particularly between very high income earners and the rest of the population – also began to increase at this time (Atkinson & Leigh 2007). Rents that previously were shared between labour and capital have increasingly been appropriated by capital. Although at law CEOs are employees, and their income counts towards labour's share of national product (thereby understating the shift in income from labour to capital), in substance their income, like their social context, has much more in common with that of capital than of labour. As their relative power has grown, so has their relative income. The high rate of CEO remuneration in the US reflects not the greater size of US companies (they are no larger than the largest European corporations), but the greater power in the US of capital in general, and CEOs in particular, by comparison with labour.

The dual asymmetries

There are two key asymmetries in the market in which executive remuneration is determined. First, the 'pattern' is asymmetric – it is not based on bringing the typical participant up to a common mean (as in traditional pattern bargaining), but to asymmetric reference points that indicate a position *above* the mean in a leapfrog pattern. Second, the 'bargaining' is asymmetric, as there is not an effective countervailing force at the bargaining table, as there is with wage bargaining for ordinary employees. Hence the process can more accurately be described as *dual-asymmetric pattern bargaining*.

The most recent Australian data might suggest that the nature of positioning may vary according to the stage of the business cycle. While the Australian data from both the 1992 NLCED survey and the 2009 Hewitt survey show evidence for dual asymmetric pattern bargaining, the upward bias appears to be stronger in the 1992 data than in the 2009 data. It appears that the 'aggressiveness' of asymmetric pay pitching strategies (Ryan 2009) may be related to economic and social conditions facing the corporation. Losses or sometimes major falls in profits may lead to firms temporarily freezing, but rarely cutting executive remuneration, offsetting losses through incentive payments with increases in other components of remuneration. Conversely, boom times for corporations appear to facilitate more 'aggressive' pitching under the guise of linking pay to performance. An Australian study found that CEO pay was only correlated with company performance during boom periods; during soft landing and flat recovery periods there was 'no relationship between corporate performance and executive remuneration', and during recession on one measure there was a negative relationship (Matolcsy 2000). An American study found that CEO pay

was related to what was euphemistically called 'talent' (enterprise income, after an adjustment for incentives) but that this relationship does not hold for periods when enterprise returns are negative; rewards are substantial when enterprise income rises but there are no substantial penalties when enterprise income falls (Sung & Swan 2009, pp5-6). It appears that there may be a ratcheting effect, whereby bonuses boost pay during good times, but base levels are then boosted (or bonuses restructured) to offset the loss of value of bonuses or options schemes in bad times (eg Schwab 2009, West 2008). The ratcheting effect is given support by a finding that asset volatility ('risk') is positively related to CEO pay (Sung & Swan 2009): a CEO benefiting from a rapid short term movement in share prices, and whose overall remuneration is then protected against share price decline by offsetting increases in other components of pay, will experience greater medium term remuneration gains than a similar CEO in a firm with stable share prices. Sung and Swan, it should be noted, find no upward trend over 1995-2007 in mean 'talent', but that volatility and real CEO pay both trend upwards, in the latter case by 4.4 per cent per year.

Magnitudes

How inflationary can dual-asymmetric pattern bargaining be? A simple simulation can give us an indication of the orders of magnitude involved. The NLCED (1992) survey mentioned earlier contained a distribution of executive remuneration with a 92 per cent response rate.¹ We can undertake a simulation based on the following assumptions: (1) the distribution of executive remuneration by income band reflects that in the NLCED report, such that within income bands, remuneration is evenly distributed, while in the highest and lowest income bands the income gap between percentiles matches that in the adjoining bands; (2) the lowest 8 per cent of firms pitch their pay between the 1st and 45th percentiles,² with pitches evenly distributed within those ranges; (3) the next 27 per cent pitch between the 45th and 55th percentiles, with pitches evenly distributed within those ranges; (4) the next 15 per cent³ pitch between the 55th and 75th percentiles, with pitches evenly distributed within those ranges; (5) above-median firms aim to maintain their prior percentage differential with the median. On these assumptions, the simulation suggests that within one remuneration cycle (one year), average executive remuneration would rise by 16.4 per cent. In some respects, the assumptions of this model are quite cautious. The model makes no allowance for the disturbance to relativities caused by firms successfully changing their rank (it assumes they attempt to change their ranking, but fail to do so), perhaps due to above-average growth in productivity or profits or just above-average generosity by the board, and downplays leapfrogging by firms already above the median. Nor does it allow for second round effects whereby higher ranked firms aim to offset any compression of relativities that has occurred.

However, its assumptions may be unduly harsh in one major respect, because the reference groups for executive pay are more commonly industry than national, and so would occupy a smaller income range than the national range. We can adjust for this in our model by dividing this simulated economy into three industries, one occupying the highest third of the income range, one the middle, and one the lowest. (While there are obviously more than three industries in a real economy, the idea that the range of executive pay in each industry would encompass no less than a third of the total income range is probably conservative.) Under these assumptions, our simulation produces a more realistic increase in average remuneration of 5.1 per cent in a year. This is in an environment with zero growth in productivity and zero inflation in prices or wages. It is, in other words, an indication, albeit simple, of the order of magnitude of the pure inflationary impact of the institutions of setting executive remuneration. Interestingly, over the quarter century since 1983, growth in our index of real CEO pay has exceeded growth in national productivity by just under 5 per cent per annum. Thus while it is not possible to precisely estimate the inflationary impact of the

dual-asymmetric pattern bargaining effect, it is certainly plausible for it to explain the inflation in executive remuneration over the past quarter century.

Conclusions

Although growth in executive remuneration maintained parity with average earnings until the mid 1980s, thereafter it has grown at a rate far exceeding that of average earnings or national productivity. The inflation of executive remuneration is fundamentally a phenomenon of class. It reflects the asymmetries of power between labour and the agents of capital. While labour negotiates with capital over the determination of wages, capital actively resisting labour's efforts to raise real wages, there is no such 'arms length' symmetry in the determination of executive remuneration. Agents of capital negotiate with agents of capital, perhaps members of the same golf club or occupants of neighbouring mansions, over what percentile in the executive pay distribution they should occupy. Executive pay is characterised by 'asymmetric pattern bargaining, whereby firms seek to benchmark their CEO pay to higher-paying firms, and grant CEOs, with whom corporate decision makers share a social milieu, increasing benefits which also confer status benefits on the firm – in sharp contrast to the distributional pay negotiations which occur with workers. Thus 'asymmetric' refers not just to the targeting of percentile bands in the executive pay process, but the lack of similarity between the pay setting procedures for CEOs and for workers. The asymmetry also occurs over time: executive remuneration ratchets up disproportionately when corporate profits rise, but fails to fall by anything near an equivalent amount when profits fall, cushioned by changes in the structure of executive remuneration.

As a result of dual-asymmetrical pattern bargaining, CEOs obtain gains in remuneration well above any growth in productivity they engender, absorbing an ever increasing share of the 'rents' that are available for distribution, at the expense of workers. As a consequence, that CEOs are overpaid is something, as Leonard Cohen would say, 'everybody knows', including the directors who decide what they should be paid. Yet firms are unwilling to do anything about it, because to do so would damage internal class relations and firm status. The different methods of pay setting for workers and CEOs reflect core differences in power and changes in that balance of power through a period characterised by the growth 'neoliberal' policies and practices.

Notes

¹ In this survey 22 per cent of firms had remuneration below \$100,000 per year (in 1991 terms), 45 per cent between \$100,000 and \$149,999, 20 per cent between \$150,000 and \$199,999, and 9 per cent at \$200,000 or above, while 5 per cent did not respond (NLCED 1992).

² This comprises the 2 per cent of companies in Figure 2 who pitched below the median, and 6 per cent who did not answer.

³ This comprises the remaining firms who are below the median at the start of the period (50 per cent minus 8 per cent minus 27 per cent).

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ⁱ This paper has been peer reviewed by two anonymous referees.