

Institution: University of Nottingham
Unit of Assessment: 19 Business and Management Studies
Title of case study: Informing the Design of Incentive Pay Reforms
<p>1. Summary of the impact</p> <p>Sustained research on managerial labour markets and pay determination has informed and influenced key policy-makers in determining rewards and remuneration for senior medical professionals. As an expert 'economist' member of the Doctors' and Dentists' Review Body (DDRB), Professor Steve Thompson has contributed to recommendations that have been endorsed by the UK Government and are used as an evidence base for negotiations between the British Medical Association, the Department of Health and devolved administrations within the UK.</p>
<p>2. Underpinning research</p> <p>Professor Steve Thompson's sustained research on managerial labour markets, for both quoted firms and non-profits, stems back at least to his initial appointment within Nottingham University Business School in 1994. It has drawn upon three collaborative ESRC commissioned projects and work with former colleagues carried out at the University of Nottingham between 1994 and 1998. This work has centred on attempting to determine the effective incentive element in executive remuneration. It has involved isolating the performance impact on rewards (and punishments), both of regular organisational performance and of non-routine activities such as mergers and divestments. It has also sought to evaluate the effectiveness of 20 years of corporate governance reforms, beginning with Cadbury, in linking managers' rewards more closely to their firm's performance.</p> <p>The key findings to emerge from the research showed that:</p> <ol style="list-style-type: none"> i. there is no general direct evidence of a remuneration process that rewards managers for downsizing their firms. The substantial pay-size elasticity implies the reverse. However, divestment does have a positive and significant effect in raising executive remuneration under a regime of strong corporate governance, defined in terms of the presence of a substantial blockholder (3); ii. CEO pay is not strongly related to company performance. In contrast, increases in firm size do have a significant impact. There is evidence that acquisitions offer CEOs the scope to influence their pay positively. However, CEOs engaging in 'wealth-reducing' acquisitions experience significantly lower remuneration than their counterparts whose deals meet with market approval. This result suggests that shareholder-principals have at least some success in penalizing managers for unwarranted, empire-building, mergers (4); iii. with regard to the effect that the 'Cadbury reforms' have had on the pay determination process of executives in the UK, on average, the impact has been disappointing. The relationship between pay and performance remains weak and the link to firm size has, if anything, been strengthened. However, the results suggest considerable heterogeneity in the impact of the reforms, and for those firms above median employment the link between pay and profits appears to have been reinforced (2); iv. the corollary to rewarding good performance, via higher pay, is punishing under-performance (1). Sanctions for poor performance are merely the opposite side of the coin to rewards for good performance: the probability of CEO exit is inversely related to the performance of her company. <p>Parallel work on managerial pay in non-profits, undertaken with Hilary Ingham, also revealed that size dominated performance, creating an incentive for growth (6). Further work with Nottingham colleagues Peter Wright and Sourafel Girma looked at the internationalisation of the executive labour market via the multinational enterprise, and found that having controlled for size, multinational activity – especially in the USA - raised CEO rewards among UK CEOs. (5)</p>

Key researchers:

Steve Thompson, Professor, Nottingham University Business School between January 1994 and end August 1998 and as Professor and Divisional Research Director (Economics & Finance), February 2003 to date. (Thompson was appointed as a Professor of Economics, at University of Leicester between September 1998 and January 2003.)

Peter Wright, Lecturer, Senior Lecturer, University of Nottingham from 1993 to 2009; Professor, University of Sheffield, 2009 to present.

Mike Wright, Lecturer, Reader, Professor, University of Nottingham from 1978 to 2011

Hilary Ingham, Lecturer, Senior Lecturer, University of Manchester Institute of Science and Technology, 1986-1995, Senior Lecturer, University of Lancaster, 1995 to present

3. References to the research

1. Gregory-Smith, I.; Thompson, S.; Wright, P. (2009), "Fired or Retired? A Competing Risks Analysis of Chief Executive Turnover" *Economic Journal*, 119, March 2009, pp. 463-482. **(4*)**. DOI: 10.1111/j.1468-0297.2008.02243.x. <http://onlinelibrary.wiley.com/doi/10.1111/j.1468-0297.2008.02243.x/pdf>
2. Girma, S.; Thompson, S.; Wright, P. (2007), "Corporate Governance and Executive Compensation Determination" *The Manchester School*, 75, pp. 65-81. **(3*)**. DOI: 10.1111/j.1467-9957.2007.01003.x <http://onlinelibrary.wiley.com/doi/10.1111/j.1467-9957.2007.01003.x/pdf>
3. Haynes, M.; Thompson, S.; Wright, M. (2007), "Executive Remuneration and Corporate Divestment: Motivating Managers to Make Unpalatable Decisions" *Journal of Business Finance and Accounting*, 34, pp.792-818. **(3*)**. DOI: 10.1111/j.1468-5957.2007.02008.x. <http://onlinelibrary.wiley.com/doi/10.1111/j.1468-5957.2007.02008.x/pdf>
4. Thompson, S.; Girma, S.; Wright, P. (2006), "The Impact of Merger Activity on Executive Pay in the UK", *Economica*, 73, pp.321-339. **(3*)**. DOI: 10.1111/j.1648-0335.2006.00513.x <http://onlinelibrary.wiley.com/doi/10.1111/j.1648-0335.2006.00513.x/pdf>
5. Girma, S., Thompson, S. and Wright, P. (2002) "Multinational Activity and CEO Compensation", *Weltwirtschaftliches Archiv*, 138, 680-693 **(2*)**. DOI: 10.1007/BF02707657. <http://link.springer.com/content/pdf/10.1007%2FBF02707657.pdf>
6. Ingham, H. and Thompson, S. (1995), "Mutuality, Performance and Executive Compensation", *Oxford Bulletin of Economics and Statistics*, 57, 295-308 **(3*)**. DOI: 10.1111/j.1468-0084.1995.mp57003002.x. (Publication available on request).

Journal quality by ABS (2010) rating is given in parentheses.

Grant Awards:

ESRC *Mergers and Employment in UK Firms*, 1994-6, £35k with Peter Wright

ESRC *Mergers and Wages in UK Firms*, 1995-7, £35k , with Peter Wright

ESRC Corporate Refocusing in the UK, 1994-6, £55k with Mike Wright

4. Details of the impact

In recognition of his research on managerial labour markets and pay determination, the Doctors' and Dentists (Pay) Review Body (DDRB) appointed Thompson as their expert 'economist' member in 2008. The Body's purpose is to collect and analyse information from original sources and interested parties on the recruitment, retention and morale of all grades of NHS doctors and dentists. This analysis of the relevant labour market characteristics, together with an assessment of affordability, is then used to recommend annual pay uplift for the respective groups or, in the case of general dental practitioners contracted to the NHS, adjustments to the relevant fee scales to achieve comparable pay outcomes. Its objective is to provide employers and medical unions

with an independent and unbiased evidence-base for agreement.

Within DDRB, Thompson has been responsible for evaluating the economic evidence presented by the various parties. He has co-authored DDRB annual reports on recruitment, retention and morale of NHS doctors and dentists since 2008 and recommendations have been accepted in full by medical/dental employers and professional associations (i.e. unions) in most years (although only partially in 2009). The 2013-14 recommendations were implemented as suggested (A).

In 2011-12, the DDRB undertook two commissioned enquiries. First, the Secretary of State for Health instructed the Body to review incentives and pay for hospital consultants, triggered by widespread criticisms of the current operation of the consultants' Clinical Excellence Award (CEA) scheme. Thompson co-authored the major report (B), which was delivered to the Department of Health and devolved governments in July 2011, and published in December 2012. It called for a radical overhaul of the incentive schemes, with bonuses more closely linked to recent performance, stringent renewal reviews and for long, largely automatic incremental scales to be replaced by fewer performance-related increments. It also recommended the introduction of a 'senior consultant' grade, to be restricted to 10% of the headcount, to recognise outstanding achievements and to incentivise mid-career consultants. The report's recommendations would introduce more flexibility to reward consultants for excellent local performance.

The report's recommendations for CEAs suggested they use available of funds to recognise and encourage new manifestations of clinical excellence rather than focusing on past achievements. Subject to strict limits on the number of new awards per year, the report suggested fixed duration rather than permanent CEAs, to enable recycling and rewarding excellence on a greater scale.

The report also argued that the removal of certain anomalies did not breach 'pay protection for accrued rights' conceded by UK governments for health reorganisations. These included the anomaly of continuing financial benefit for those who have had their awards withdrawn – currently those demoted from 'excellent' retain their merit payments – and those who retire and keep their awards in any part-time return, restricting award recycling.

In response, UK and Welsh governments consulted with stakeholders to canvass opinion on whether the removal of such obvious anomalies did breach that principle (F). It was concluded that there was no breach and the BMJ reported in August 2013 that pay protection will be removed from consultants who lose or surrender their rewards from October 2014 (I).

The Secretary of State for Health accepted the report's principal recommendations in December 2012 (C) and negotiations on the implementation of new arrangements were underway between the Department of Health (and devolved governments) and the British Medical Association (as of October 2013). The latter has indicated a willingness to negotiate directly on CEAs and does support some reforms to the CEA system, particularly to instil greater transparency (J). Many of the Review's recommendations, perhaps excluding the non-pensionable nature of awards, are expected to be adopted and some have already been endorsed (retire and return payments and loss of award following poor performance (D, E)).

At the request of the Deputy First Minister of Scotland, the DDRB also conducted a review of compensation for Scottish dentists in 2012, following concerns of serious flaws in the data used to compute inflation uplift payments for self-employed dentists, not least by conflating principals' costs and associates' earnings. In 2012. The DDRB's technical study of costs, of which Thompson is a co-author, was published by the Office of Manpower Economics as an attachment to the DDRB's Annual Report (G). It suggested a simplified means of calculating the cost inflation adjustment to uplift which avoided the potential double counting issue and suggested a rule-of-thumb expenses/income ratio of 50%.

The study was immediately acknowledged by the Deputy First Minister, who commented: "I welcome the DDRB's observations and will ensure that your comments are carefully considered and acted upon, as appropriate. My officials will work with you and the other parties to take forward the issues highlighted in your report and any progress will be relayed to you in our evidence for the next round." (H). A follow-up letter to the chair DDRB (April 2012) acknowledged the report to

have: “identified elements that we had not previously considered... leading to a consideration of the implementation of its recommendations.” However, disagreements remain between the Scottish government and the DDRB on the inadmissibility of contractual efficiency savings (D, ch.4 p.50).

Thompson’s work on managerial labour markets and remuneration has attracted further interest from policy-makers. In February 2012 he was invited to Number 11 Downing Street to participate in a seminar considering the feasibility of introducing ‘market-facing’ (i.e. regional) pay in the public sector, attended by the Chancellor of the Exchequer and Chief Secretary to the Treasury. The meeting considered the costs and benefits of departing from national pay scales and making pay responsive to local labour market conditions. Despite support from HM Treasury, the ‘market-facing’ pay initiative faces challenges such as public sector employers’ reluctance to adopt local pay bargaining. In January 2010, Thompson presented a review paper to government economists at the Office of Manpower Economics as part of a Senior Salaries Review Body investigation of higher public sector rewards. This paper summarised recent research findings on corporate governance reforms and changes in executive reward determination in the private sector and its relevance for public sector pay reform.

5. Sources to corroborate the impact

- A. BMJ Careers. Doctors are awarded a 1% pay rise for 2013-14. 18 March 2013. Available from: <http://careers.bmj.com/careers/advice/view-article.html?id=20011283> (accessed 15/10/13).
- B. Review Body on Doctors’ and Dentists’ Remuneration: *Review of Compensation Levels, Incentives, and the Clinical Excellence and Distinction Award Schemes for NHS Consultants*, Cm8518, 170pp, Dec. 2012.
- C. UK Government Press Release: “Doctors’ Contracts fit for the 21st Century”, at: <https://www.gov.uk/government/news/doctors-contracts-fit-for-the-21st-century>., accessed on 17/7/13
- D. Review Body on Doctors’ and Dentists’ Remuneration: *Forty-first Annual Report, 2013*, Cm8577, 168pp, especially chapter 7.
- E. Rt Hon Jeremy Hunt MP Written Ministerial Statement on: ‘Review of Rewards for NHS Consultants and Publication of Report on Junior Doctors’ Contracts’, at: http://www.parliament.uk/documents/commons-vote-office/December_2012/17-12-12/8.HEALTH-Review-awards-NHS-consultants.pdf, accessed on 17/7/13
- F. Department of Health and Welsh Government: ‘Proposal to Discontinue Two Anomalous Features of the Clinical Excellence and Distinction Schemes’, March 2013, 12pp at: <http://www.nhsemployers.org/SiteCollectionDocuments/Proposal%20to%20Discontinue%20Two%20Anomalous%20Features%20of%20the%20CEA.pdf> accessed on 17/7/13
- G. Review Body on Doctors’ and Dentists’ Remuneration, *Fortieth Annual Report, 2012*, Cm 8301, accessed at: <http://www.official-documents.gov.uk/document/cm83/8301/8301.pdf>
- H. Letter from Nicola Sturgeon MSP, Minister for Health & Wellbeing, Scottish Government, 8th March 2012
- I. Helen Jacques Pay protection to end for consultants who no longer hold clinical excellence awards, *British Medical Journal*, 13th August 2013, at: <http://careers.bmj.com/careers/advice/view-article.html?id=20013982>
- J. British Medical Association Consultants to enter contract negotiations, 18th September 2013, at: <http://bma.org.uk/working-for-change/negotiating-for-the-profession/bma-consultants-committee/consultant-contract>