CENTRE *for* ECONOMIC PERFORMANCE

ELECTION ANALYSIS

Bankers' Bonuses

- Over the decade from 1998, the top 10% of workers in the UK saw their share of total annual wages rise from 27% to 30%. The majority of this went to the top 1% and can be mainly accounted for by bonuses to financial sector workers. By 2008, the increased share that bankers were taking amounted to an extra £12 billion per year in wages alone.

- The size of these bonuses and their structure may have been a contributing factor to the financial crisis. Bankers paid large cash bonuses on the basis of short-term returns often unadjusted for risk have incentives to take on excessive risk.

- All the parties have attacked bankers' bonuses – the Liberal Democrats have said that they would ban all bonuses to board members and force all bonuses above £2,500 to be paid in shares.

- It is unclear why shifting away from cash toward equity-based compensation would alter any perverse risk incentives since unlike a CEO (chief executive officer), an individual banker typically has only a small effect on the share price.

- Another proposal is to 'claw back' bonuses if performance is sub-standard in the future. Unlike simply deferring bonuses, this in principle could improve incentives.

- The government has increased the marginal tax rate to 50% for those earning over £150,000 and introduced a one-off 50% tax on bankers' bonuses over £25,000 for the 2009/10 pay period. The Conservatives do not pledge to reverse the first policy and the second will theoretically have been completed by the time of the election.

- There is very little evidence whether such tax rises will cause a significant number of firms and workers to leave Britain. In any case, highly paid workers are likely to change their behaviour to minimise the impact of the tax rises and so reduce the expected revenue gains to the Exchequer.

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Introduction

During the campaign, all major parties have attacked bankers with the Liberal Democrats referring to them as 'Scargills in pinstripes'. The size of bonuses in the financial sector has exploded in the last decade and has been highlighted as one of the contributing factors to the financial crisis. In the UK, the vast majority of the gains at the top of the income distribution have come from 'bankers' bonuses', that is, bonuses paid to workers in financial services.

The focus on the remuneration of bankers is a consequence of the broader issue surrounding the 'moral hazard' that arises as a result of bailouts. Major financial institutions (and the market) have an expectation that the taxpayer will bail out bondholders (and possibly even shareholders) if major losses occur that threaten financial stability. This expectation encourages excessive risk-taking since the upside accrues entirely to the employees and shareholders of the bank while the downside is limited by the taxpayer.

This problem of moral hazard suggests that while bankers' pay will continue to receive substantial focus from politicians and regulators, it is only one of the many fronts that must be tackled from the perspective of financial stability. This Election Analysis addresses four questions:

- Why bonuses may encourage excessive risk-taking by bank employees?
- Are there are changes that could be made to mitigate these effects while still providing incentives to workers?
- What role can the tax system play in charging banks for the guarantees and subsidies provided by the taxpayer?
- Will financial talent be driven offshore by recent tax changes?

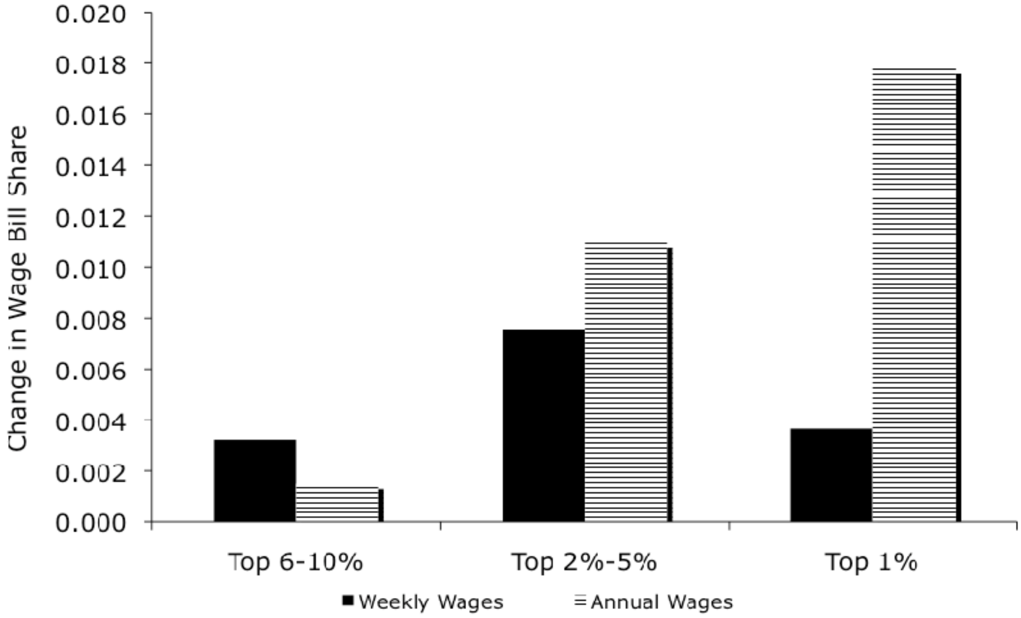
The size of bonuses and the gains to bankers

The sheer scale of the income gains that the best paid workers, and particularly financial sector workers, experienced over the course of the last decade is almost unprecedented. Figure 1 shows the total gains (as a share of the aggregate wage bill) going to the top groups within the wage distribution between 1998 and 2008.

Workers in the top 10% gained an extra three percentage points of the wage bill over this period. The majority of these gains went to the top 1% of workers, and finance workers accounted for almost three quarters of these gains. In contrast to previous decades, this expansion of inequality at the very top of the distribution was not matched by rising inequality at lower levels.

The increased share that bankers were taking amounted to an extra £12 billion per year by 2008, and almost all the gains accrued as a result of bonuses rather than increases in basic pay.[1] Even these figures underestimate the gains since we have no reliable data on bonuses paid in restricted stock and stock options. Accounting for these would certainly make the gains at the top even more extreme.

Figure 1: The change in share of all income going to the top 1%, 2-5% and 6-10%



Source: Bell and Van Reenen (2010)
Notes: Figures are computed from the Annual Survey of Hours and Earnings, ONS

Why should bonuses have contributed to the financial crisis?

Bonuses are generally thought to improve incentives for workers since, in theory, they aim to link pay more closely with performance. In a classic piece-rate scheme such as those used on production lines, there is accurate monitoring of individual or group output and bonuses are paid for past output. Workers in these environments cannot in any sense produce negative output going forward.

Bonuses for traders in financial markets encourage risk-taking since such risk-taking is instrumental in producing high returns. Risk-taking is desirable in the financial sector; indeed, it is a key reason to encourage performance-related pay. The downside, however, is that traders paid bonuses on the basis of the annual profits of their book have an incentive to search for short-term profits and to maximise the risk they can take at the expense of the long-term interests of the firm.

These effects become magnified during a period in which the low policy interest rates of the major central banks encourage risk-taking and leverage. This is particularly so for traders who make money in aggregate only by luck and have no ability to outperform the

[1] See Bell and Van Reenen (2010) for a full accounting and discussion of the role of financial bonuses in the wage distribution over the last decade.

market in the long run.[2] The worst that can happen to such traders is that they lose their jobs but keep the bonuses they had previously received.

All this suggests that to mitigate the excess risk-taking that bonuses can induce, bonuses in the sector need to be based on risk-adjusted performance and either to be based on long-run performance or to be subject to 'clawback' if future performance declines.

Altering the mix of bonus compensation

The mix of cash and equity in bonus compensation has been highlighted as an important area for reform and regulation. It should be recognised, however, that many investment banks have historically paid bonuses in a combination of cash and restricted equity.

A fairly typical example might be a trader receiving a £500,000 bonus composed of perhaps £250,000 cash and £250,000 in equity. The equity would need to be held over a three-year period, with a third allowed to be sold at the end of each subsequent year. The proportion paid in cash versus equity tended to fall as the size of the bonus rose.

The motivation for such a bonus structure was to tie top performing workers into the firm by raising the costs to the worker of changing firms. Workers who had such a bonus payment and decided to leave the firm before the full three-year 'vesting' period would lose any remaining unvested equity.

The renewed focus on equity-based compensation focuses on the potential to align workers' incentives more closely with the long-run interests of the firm rather than their lock-in properties. Economists have long argued that incentives for chief executive officers (CEOs) are more in line with those of shareholders if a substantial proportion of their remuneration is in the form of restricted stock and stock options.

The basic intuition is simple. The CEO takes actions that affect the value of the firm but shareholders do not clearly observe these actions. To ensure that the CEO takes the actions that maximise shareholder value, it is necessary for shareholders to link CEO remuneration directly to the value of the firm. But crucial to this argument is that the CEO's actions have at least some effect on the share price – if not, shareholders should have no interest in sharing the value of the firm with the CEO.

But this is not obviously true for other employees, whose activities almost certainly result in at most only a small change in the bottom line for their employer. So it is unclear why a worker would alter their risk-taking behaviour only as a result of receiving more remuneration in equity than cash. While workers are subject to the same type of 'principal-agent' problems that afflict top management, simply copying the remuneration strategies from one to the other is unlikely to be effective.

[2] There were a number of reports of trading desks that made substantial profits for many years and received large bonuses on such profits only to incur huge losses (sometimes as large as the total cumulated profit of the preceding years) in the crisis but obviously not to repay the bonuses they had received.

Clawback agreements in bonuses

Clawback agreements allow for bonus payments to be recovered from the employee if future performance falls below pre-specified standards. These are likely to be particular useful in the financial sector because the existence and size of 'alpha' (that is, investment returns due to the worker's true ability) is surely only observable in the long run.[3] As Rajan points out, 'compensation structures that reward managers annually for profits, but do not claw these rewards back when losses materialise, encourage the creation of fake alpha'.

Such clawback arrangements are envisaged in the remuneration code recently implemented by the Financial Services Authority (FSA),[4] though the teeth of such regulations are an open question. The code proposes that a significant proportion of any bonus should be deferred for at least three years *and* a significant proportion of this deferred bonus should be 'linked to the future performance of the firm' and 'the business undertaken by the employee'.

An example of such a bonus system is that now operated by UBS.[5] Senior bankers were allocated a bonus pool of 900 million Swiss francs, which would pay out in equal parts in 2010, 2011 and 2012 provided explicit profit targets were met. Following a loss for the 2009 fiscal year, UBS clawed back 300 million from the pool.

For clawback contracts to be practical, they must be based on explicit formulae of readily observable and verifiable measures of performance since more arbitrary clawback would be liable to challenge in the courts. It remains unclear whether such contracts can be successfully written for traders based on individual risk-adjusted performance rather than simply the overall performance of the firm.

Taxing the gains from guarantees and subsidies

One argument in favour of a tax directed explicitly at bankers is to recover the profits that primarily occur as a result of both the explicit guarantees (such as deposit insurance) and implicit guarantees (for example, 'too big to fail') that the sector enjoys from the taxpayer and the implicit subsidy provided by central bank liquidity policy.

Ideally, we would like to estimate the benefit of these guarantees and subsidies to individual institutions and charge them appropriately – presumably at some rate going forward as capital is replenished.[6] This may be unrealistic, in which case a strong argument can be made to use the tax system to recover these gains.

It is, however, unclear why it makes sense to tax bonuses rather than impose a windfall tax or subsidy charge on the sector. This second option is essentially what the Obama

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[3] Rajan (2008)
[4] Financial Services Authority (2009)
[5] http://www.bloomberg.com/apps/news?pid=20601085&sid=aXPA95YPD4.0
[6] We do not here consider the alternative approach of dealing with the 'too big to fail' problem – namely regulating to make sure they are not too big in the first place.

administration has proposed with the Financial Crisis Responsibility Fee, imposing a levy based on the size of the balance sheet of large financial firms.

Increasing taxes on high earners?

In addition to regulating the mix, deferral and clawback of bonuses, there has also been a more general focus on the issue of raising marginal tax rates on higher earners – either in general or directly focused on bonuses. Such a focus is hardly surprising given both the fiscal outlook and the dramatic gains that have accrued in recent years to those at the very top of the wage distribution.

The government has moved on both the general front and on bonuses in particular. The 2009 Budget introduced a new 50p marginal tax rate on those earning over £150,000 (roughly the top 1% of wage earners) and tapering the tax relief on pension contributions for these workers to the basic tax rate. In the November 2009 Pre-Budget Report, the government imposed a 50% tax rate on *employers* for any bonus paid to an employee in excess of £25,000 for the current tax year only. The Conservatives do not propose to reverse the first tax increase and the second will already be completed before the election.

There are two common arguments against raising marginal tax rates on bankers (or indeed more generally on high-skilled high-earners). First, it is suggested that the behavioural responses of labour supply and effort, changes in the form in which compensation is taken and reduced compliance will result in the tax yield being significantly lower than expected. Evidence suggests that such responses are larger for highly paid workers facing higher marginal tax rates.[7]

Second, such workers are alleged to be highly mobile and would rapidly relocate to lower tax jurisdictions.[8] There has been much anecdotal reporting of London-based hedge funds scouring Switzerland for suitable premises.

There is, however, very little robust empirical evidence on international mobility and income tax differentials. One notable recent analysis[9] suggests that the location choice of football superstars in Europe responded strongly to marginal tax rates – though it is a matter of some debate as to how workers in London investment banks and hedge funds truly correspond to soccer stars. More generally, policy-makers must decide whether such potential flows out of London are a price worth paying.

[7] Gruber and Saez (2002) suggest that the overall elasticity of taxable income with respect to marginal tax rates lies between 0.4 and 0.6, with higher elasticities for the highest earners.
[8] Separately, it is argued that tighter financial regulation will encourage firms to relocate to countries with looser regulation.
[9] Kleven et al (2009)

Conclusions

The financial crisis raised awareness of the sheer size of bankers' bonuses over the last decade. This group of workers have been the biggest gainers in the labour market, and they have significantly increased their presence at the top of the income distribution.

The structure of bonuses has come in for sustained criticism as it allegedly increased risk-taking in the financial sector to dangerous levels and contributed to the unravelling in 2007/8. The evidence suggests that simply changing the cash/equity split of such payments will not solve these problems nor will deferral if not associated with clawbacks.

The sharp rebound in bonuses during 2009/10 is likely to increase the popularity of higher marginal tax rates – or special bonus taxes – in spite of the potential negative effects from international mobility of workers and firms.

April 2010

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