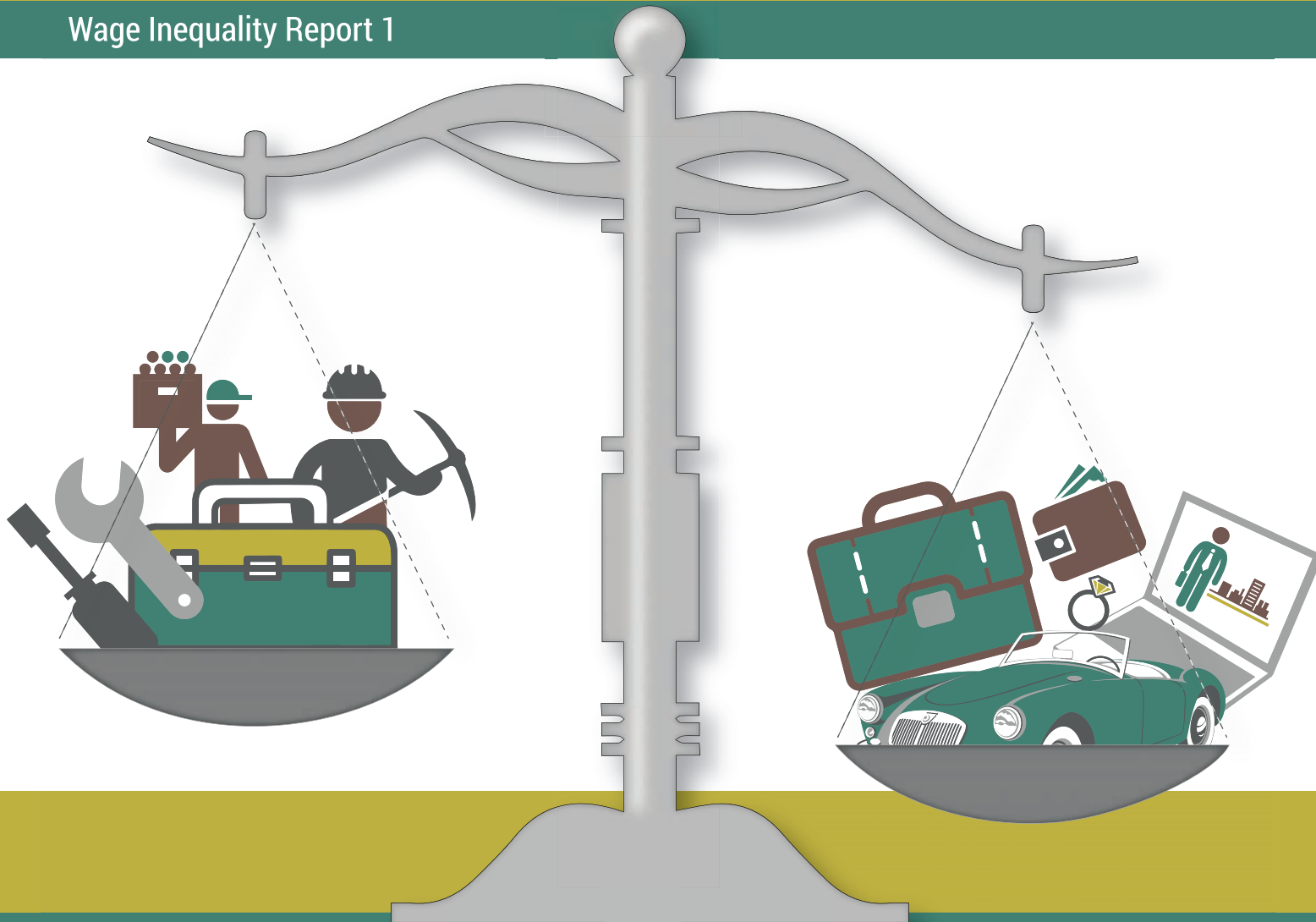




Tackling wage inequality: International experiences

Kaylan Massie | September 2017

Wage Inequality Report 1



UNIVERSITY OF THE
WITWATERSRAND,
JOHANNESBURG



NATIONAL
MINIMUM
WAGE
RESEARCH INITIATIVE

CSID – School of Economic
and Business Sciences

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Kaylan Massie

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Wage Inequality Report No. 1

www.nationalminimumwage.co.za

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The *National Minimum Wage Research Initiative* (NMW-RI) is an independent academic research project run by the Corporate Strategy and Industrial Development (CSID) Research Unit in the School of Economic and Business Sciences (SEBS) at the University of the Witwatersrand. It is undertaken in the context of a national dialogue on wage inequality and the potential introduction of a national minimum wage in South Africa. Information on the NMW-RI can be found at www.nationalminimumwage.co.za.

The NMW-RI has benefitted from the insight and expertise of our Oversight Committee made up of local and international experts, as well as labour and civil society leaders who originally suggested the research. The Oversight Committee members are:

- Basani Baloyi – SOAS, University of London
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- Professor Robert Pollin – University of Massachusetts, Amherst
- Dr Nicolas Pons-Vignon – University of the Witwatersrand
- Professor Imraan Valodia – University of the Witwatersrand
- Dr Robert van Niekerk – Rhodes University

For their ongoing support, the NMW-RI would also like to thank:

- Professor Jannie Rossouw – Head of School of the School of Economic and Business Sciences, University of the Witwatersrand
- Professor Imraan Valodia – Dean of the Faculty of Commerce, Law and Management, University of the Witwatersrand
- The staff of the School of Economic and Business Sciences, University of the Witwatersrand
- Our research team

For their edits, suggestions and comments, the author would like to thank the following people:

- Gilad Isaacs – University of the Witwatersrand
- Luis Campos – University of Lanus
- Neil Coleman – Congress of South African Trade Unions
- Allison Corkery – Center for Economic and Social Rights
- Simon Egli – UNIA
- Professor Ben Fine – SOAS, University of London
- David Francis – University of the Witwatersrand
- Dr Shane Godfrey – University of Cape Town
- Susan Hayter – International Labour Organization
- Alexane Heredia – SciencesPo
- Dr Boy Luethje – Zhongshan University SYSU
- Khwezi Mabasa – Friedrich-Ebert-Stiftung
- Jana Mudronova – University of the Witwatersrand
- Wolfgang Mueller – IG Metall Bayern
- Dr Uma Rani – International Labour Organization

We gratefully acknowledge funding for this research received from Friedrich-Ebert-Stiftung (FES). The views and opinions contained in this paper are those of the author and may not reflect the opinion of FES.

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Executive summary

In 2015, the top 10% of full-time South African employees took home, on average, 82 times more than the bottom 10%, with average earnings for white workers more than three times higher than for African workers. In 2017, CEOs at South Africa's ten largest listed companies earned between 120 and 1,332 times more than the average pay; in 2014, the JSE average of the ratio of CEO pay to average pay was 73 to 1. The gap between CEO pay and per capita GDP is even higher, at 541 times, with South Africa outpacing twenty-four other major developed economies and emerging markets studied, including the United Kingdom (with a 229:1 ratio) and the United States (with a 483:1 ratio), both countries where executive pay levels are frequently criticised.

As a result, South Africa is frequently termed the most unequal country in the world, with the world's highest Gini coefficient, a fact entrenched by apartheid and enhanced by the country's current growth path. Those at the bottom of the wage structure have suffered both in terms of fewer opportunities for employment and lower remuneration levels for existing jobs. Those at the top of the income scale have benefitted from relatively high pay, with South African CEOs the seventh-best remunerated in the world.

Recognising that current levels of inequality are unsustainable, the *National Development Plan* (NDP) sets a number of targets for reducing inequality and raising wages for the lowest paid. The NDP recognises the importance of higher levels of economic growth but also notes that this growth must actively reduce inequality rather than exclude large portions of the population. In light of these goals and the high levels of inequality noted, the social partners – Business, Civil Society, Organised Labour and Government – agreed to “explore ways of reducing pay differentials while maximising job creation efforts” (see NEDLAC, 2014). The first such policy programme to be discussed was the introduction of a national minimum wage with an agreement reached to introduce a national minimum wage of R20 per hour by May 2018. However, a national minimum wage, on its own, is not sufficient to reduce the large pay disparities targeted under the NDP.

This paper explores other methods of tackling wage inequality by surveying strategies adopted abroad. An extensive survey of this kind has never been conducted, and knowing what policy options are available to tackle wage inequality is an important first step in future discussions on how inequality can be reduced in the country. This paper is not designed to be an in-depth examination of the causes and levels of wage inequality in South Africa, nor is it meant to prescribe solutions for reducing inequality in the country. Instead, it provides a menu of policy options available to South Africa to adopt, adapt or reject as may be appropriate.

This paper explores seven sets of policies used internationally to address wage inequality:

- *Disclosing pay ratios.* In order to assess levels of wage inequality and chart policy interventions it is imperative to know the nature and size of wage dispersion within firms, sectors and the economy as a whole. One critical step is the disclosure of pay ratios, a policy that has been promoted in a range of countries, including as a legal obligation. Such a ratio compares the earnings of a set of employees (for instance, executives) against another set of employees

(for instance, the lowest paid). The calculation of such ratios can be followed by stipulating a target pay ratio, which is either incentivised or mandatory.

- *Implementing pay caps and ratios.* A direct strategy to curb perceived excessive levels of executive pay and reduce wage dispersion – adopted, for example, in France and Israel – is to cap executive pay either at a certain level or by mandating a maximum pay ratio which cannot be exceeded. This has the advantage of being fairly straightforward to implement although the hazards of a skills exodus and the possibility of cheating through shifting between different facets of the total remuneration package must be taken into account.
- *Reforms to corporate governance models.* Companies' formal remuneration policies and procedures, which play a significant role in wage setting, particularly for executives, can be modified to include a focus on reducing pay at the top and increasing pay at the bottom. International strategies include: placing workers on remuneration committees; providing shareholders with a binding vote on executive pay with consequences should this vote fail to pass; and placing stringent requirements on how pay levels are disclosed to the market. Unfortunately, some of these strategies have failed to reduce executive pay, as seen by continued complaints about extremely high pay levels globally. This failure can be explained in part by the dominant drive towards maximising shareholder returns, benefiting shareholders and executives and directors. Consideration should therefore be given to mandating that directors and shareholders consider the interests of a wider variety of stakeholders and social issues when deciding on remuneration practices.
- *State incentives, regulation, employment and investment strategies.* Governments – as model employers and market players – can reduce their own pay differentials or encourage companies to do so. For example, there have been proposals in the United States to give companies procurement preference on the basis of their internal pay ratios. Pay ratio criteria, or other equity-focused policies, can also be attached as conditions to government loans, subsidies or the grant of a lease on government property. As a model employer the state can publish pay differentials within its own ranks (including within state owned enterprises) and enact its own fair-pay policies that mandate pay ratios and/or maximum and minimum salaries. Minimum salaries could ensure that the state becomes a 'living wage' employer and this living wage policy can be extended to government contractors and suppliers. Finally, large public investors can leverage their position as shareholders to achieve greater equity.
- *Tax policy.* Tax incentives are another avenue to encourage companies to lower pay differentials. A tax penalty could be placed on companies with high ratios or a tax incentive could be given to those with low ratios. However, caution should be taken as tax credits often end up costing the state more in lost tax revenue than is gained in positive social benefits. When combined with a higher rate of income tax on top earners, such a double-pronged approach could discourage companies from paying excessively high salaries and reduce the benefit to employees of receiving those salaries. While high earners may complain that higher income taxes will result in emigration, studies have shown that such migration is negligible. Historically, income tax rates have been much higher in the United States and the United Kingdom than South Africa's current 45% top tax rate, and rates are currently higher in many countries including

both Sweden and Japan, countries with much lower levels of inequality than South Africa. In the wake of the global financial crisis a number of countries have increased their top income tax rate, including 21 of 35 OECD countries between 2008 and 2014.

- *The role of trade unions and collective bargaining.* Collective bargaining plays an important role worldwide in reducing pay inequity and therefore methods to strengthen the institutions of collective bargaining should be considered. Some countries have found unique ways to direct funds to unions in order to ensure that unions are able to offer benefits to their members for joining unions. In certain parts of the world, union membership is mandatory, while in others there is a duty to bargain in good faith with a recognised union, which ensures that employers are not able to ignore a union's attempts to bargain. Some governments are directly involved in the collective bargaining process, whether by negotiating pacts with the bargaining partners, extending collective agreements across industries almost automatically or imposing collective agreements on the bargaining partners when they are unable to reach an agreement. Additionally, unions have adopted collective bargaining strategies that focus on reducing wage inequality, such as the solidarity wage policy in Sweden, which reduced wage inequality by 75% and saw higher-income earners contribute to the wages of the lowest-paid. These strategies contribute to a reduction in wage inequality and are important aspects of any policy aimed at reducing inequality.
- *Labour market policies.* While measures to strengthen collective bargaining are important, other labour market policies are equally so. Minimum wages' ability to reduce wage inequality has been researched extensively in South Africa and as a result, the social partners have agreed to introduce a national minimum wage to take effect in May 2018. Many countries combine this with a system of effective enforcement and strategies to increase formalisation of employment in order to bring more employers within the net of labour regulation in order to ensure the success of the minimum wage. A complementary strategy is the calculation of a 'living wage', set at a level able to meet workers' basic needs (and those of their family), which businesses voluntarily agree to pay following worker-led living wage campaigns. Raising the incomes of the lowest paid can go a long way towards reducing inequality among wage earners.

This paper does not make firm recommendations over which of the above policy options would be appropriate to adopt in South Africa. Further research on this issue will be conducted in the future. What is clear is that there is a large and varied menu of policy options open to the country. A multi-pronged approach to tackle wage inequality might include instituting mandatory pay ratios, reforming corporate governance policies, involving employees in the remuneration-decision process, creating state incentives and tax incentives for reducing pay ratios and strengthening the country's collective bargaining institutions while ensuring that the national minimum wage legislation is effectively enforced. When combined with other strategies to reduce inequality, it is possible for South Africa to become a more equal society whose economy grows for the benefit of all its citizens and not only its higher-skilled members.

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1 Introduction

South Africa's extreme levels of wage inequality have been extensively documented. The top 10% of full-time employees in South Africa now takes home, on average, 82 times more than the bottom 10% (Isaacs, 2016). In 2017, CEOs at South Africa's ten largest listed companies earned between 120 and 1,332 times more than the average pay at those same companies (BusinessTech, 2017); in 2014, the JSE average of the ratio of CEO pay to average pay was 73 to 1 (Preston, 2014). The gap between CEO pay and per capita GDP is even higher, at 541 times, with South Africa outpacing twenty-four other major developed economies and emerging markets studied, including the United Kingdom (with a 229:1 ratio) and the United States (with a 483:1 ratio), both countries where executive pay levels are frequently criticised.

Recognising that current levels of inequality are unsustainable, the National Planning Commission's *National Development Plan: Vision for 2030* (2011) sets the target of cutting the Gini coefficient from 0.69 to 0.60,¹ raising real per capita income from R50,000 to R120,000 and increasing the income share of the bottom 40% of society from 6% to 10% by 2030. The *National Development Plan* recognises the importance of higher levels of economic growth but also notes that this growth must actively reduce inequality rather than exclude large portions of the population. This will involve a wage policy that actively works to reduce pay differentials in the country, in addition to a broader process of restructuring the economy to focus on supporting industries and sectors that provide decent and well-paid employment for those with low skill levels.

In light of these goals, the social partners – Business, Civil Society, Organised Labour and Government – jointly signed the Ekurhuleni Declaration which included a resolution to “explore ways of reducing pay differentials while maximising job creation efforts” (see NEDLAC, 2014). The process of actualising this was delegated to the National Economic Development and Labour Council (NEDLAC), which established a Wage Inequality Technical Task Team (WITTT) to explore measures to reduce wage inequality. The first such policy programme to be discussed was the introduction of a national minimum wage. The *National Minimum Wage Research Initiative* (NMW-RI) contributed extensively to this debate, and, in 2017, the social partners reached an agreement to introduce a national minimum wage of R20 per hour by May 2018 (NEDLAC, 2017).

However, a national minimum wage, on its own, is not sufficient to reduce the large pay disparities targeted under the *National Development Plan*. As a result, the NMW-RI undertook this research to explore other policies that might reduce wage disparity in South Africa, while recognising that inequality is multi-faceted with many causes and effects. This research paper comprises Part I of that project, surveying and summarising policy options implemented in other countries aimed at reducing wage inequality. This paper's focus is narrow: it is intended to serve as an overview of policy options targeted directly at limiting pay disparities.

¹ The Gini coefficient is a common measure of inequality ranging between 0 and 1 where 0 represents perfect equality and 1 perfect inequality.

² For example, a CEO to median-employee pay ratio of 20:1 means that the CEO earns twenty times the median-employee's pay (the median is the midpoint in the wage distribution, that is the wage level above which 50% of employees earn and below which the other 50% earn). Some other examples include: the ratio between the pay of the highest-paid employee and the

This report is not intended as an in-depth analysis of the causes and current levels of wage inequality in South Africa. Nor is it intended to prescribe solutions to that inequality or recommend how the various policy options could be adapted or modified to fit the local circumstances. Instead, it serves as a starting point for these discussions. Broader structural issues within the economy are not addressed and the report does not delve into how the country can restructure its economy to support industries that create decent jobs for South Africa's low-skilled unemployed population. Similarly, policies aimed at reducing forms of inequality other than wage inequality, for example, taxes on capital, inherited wealth or property, and programmes designed to reduce unemployment or expand social transfers, are beyond the scope of this report; these programmes are important and should go hand-in-hand with policies designed to reduce wage inequality. Part II of this project will build on the research contained in Part I through a series of Policy Briefs which study current levels of wage inequality in South Africa, analyse its potential causes and recommend how some of the policies surveyed in Part I could be modified to target a reduction in South African wage inequality.

The remainder of the report is organised as follows. Section 2 briefly explains why policy mechanisms to tackle wage inequality are important for South Africa, touching on the high levels of wage inequality created by the apartheid regime that persist in the modern democratic era. It discusses why a growth path that continues to support the apartheid wage regime is damaging for South Africa's future stability and to the growth of its economy.

Section 3 examines countries that require pay ratios to be disclosed, discussing how this information can be used to reduce pay differentials. Section 4 explores methods to directly tackle rising executive pay, as reducing wage inequality in South Africa is not just about raising the wages of those at the bottom end of the wage distribution. It looks specifically at how caps on executive pay, including those based on pay ratios, have been put into effect in other countries. Section 5 explores potential changes to corporate governance models and the roles that remuneration committees, remuneration policies, remuneration consultants, 'say on pay' laws and investor codes of conduct can play in reducing wage inequality.

Section 6 explores how state incentives and levers are applied nationally in order to reduce wage inequality. It studies how equity conditions can be attached to state procurement policies and state investment or funding contracts and also explores how the state can act as a model employer by reducing its own internal pay differentials. Section 7 discusses how taxation policies can play a role in reducing wage inequality. It includes a discussion of measures such as an additional tax on high incomes, tax incentives for reducing pay ratios and tax penalties for inappropriate pay policies.

Section 8 summarises the importance of collective bargaining to reducing wage inequality and how it can be strengthened. It looks at how different collective bargaining strategies have been adopted to reduce inequality in a number of countries, including Sweden and Germany. Beyond collective bargaining, Section 9 examines how other labour market policies, such as minimum wages, a living wage policy and policies to promote the formalisation of labour, have reduced wage inequality in other countries. The paper concludes, in Section 10, by summarising the measures that have the greatest potential to lessen wage inequality. This lays the foundation for Part II of this project, which will discuss how similar policies could potentially be adapted to fit South Africa's unique circumstances.

2 Why policy mechanisms to tackle inequality are important

2.1 Wage inequality in South Africa

South Africa suffers from extremely high levels of inequality. The Gini coefficient – a common measure of inequality in which 0 is perfect equality and 1 perfect inequality – has remained persistently high in South Africa, increasing marginally from 0.65 to 0.66 between 1993 and 2012 (Leibbrandt *et al.*, 2011; Finn, 2015). This Gini coefficient is the highest in the world based on the World Bank's data set (Kiersz, 2014). Earnings inequality has remained virtually constant over this period, with a Gini coefficient of 0.553 in 1993 and 0.554 in 2012 (Finn, 2015). Currently, differences in wages account for 85% to 90% of overall household income inequality in South Africa (Leibbrandt *et al.*, 2010). This wage inequality has two aspects: earnings inequality due to different wage levels among those earning an income, and earnings inequality due to the presence of those without an income (the unemployed). Leibbrandt *et al.* (2010) show that approximately one-third of South Africa's wage inequality is caused by unemployment, while the remaining two-thirds is caused by earnings differentials among the employed. It is this latter form of wage inequality that is the concern of this report and references to wage inequality or pay inequality should be understood in this manner.

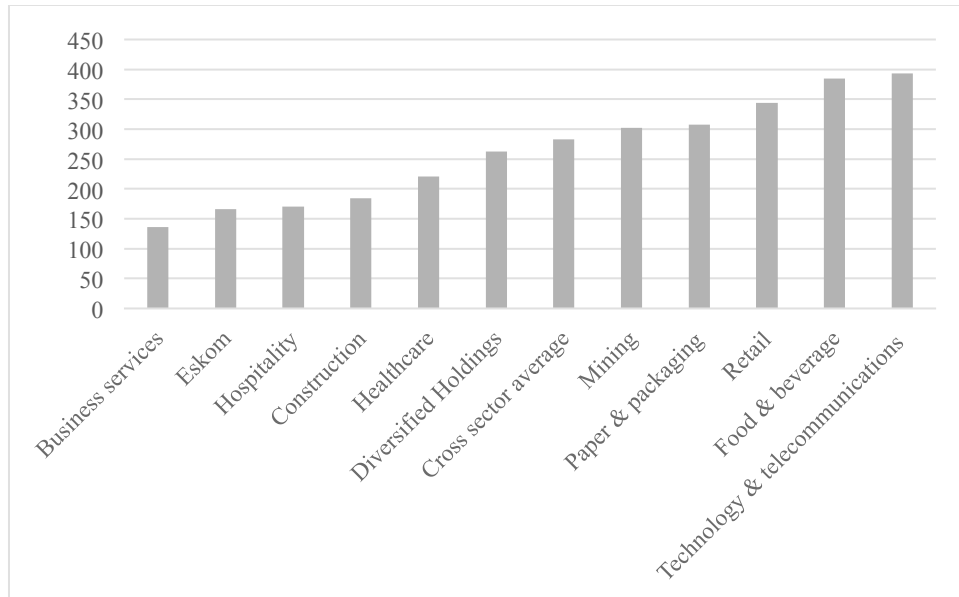
Despite the fall of apartheid, wage inequality across ethnic lines continues to persist. Although non-whites now comprise a higher proportion of those earning at the top end of the wage spectrum than under (and before) apartheid, and therefore inter-race inequality has declined somewhat, whites still remain disproportionately represented among high-income earners (Leibbrandt *et al.*, 2011). In 2011, wages for white workers were on average three times higher than for African workers, while the 2014 mean monthly earnings (in 2015 rands) for black African workers was R6,671, compared to R19,209 for white workers (Finn, 2015).

Another way of measuring wage inequality is through pay ratios – calculated as the difference between what one employee (or group of employees) and another employee (or group of employees) earns – providing information on how pay is distributed across a workforce.²

² For example, a CEO to median-employee pay ratio of 20:1 means that the CEO earns twenty times the median-employee's pay (the median is the midpoint in the wage distribution, that is the wage level above which 50% of employees earn and below which the other 50% earn). Some other examples include: the ratio between the pay of the highest-paid employee and the lowest-paid employee; the ratio of the top 5% of earners to the bottom 5% of earners; the inter-decile income share ratio, or s_{90}/s_{10} (where 's' stands for share), which measures the share of income received by the top 10% divided by the share of income received by the bottom 10%; the p_{90}/p_{10} ratio (where 'p' stands for percentile, a particular point on the income distribution between 0 and 100), which measures the ratio of income of the 90th percentile to that of the 10th percentile; the ratio between different categories of workers, for example, the ratio of pay between skilled and unskilled workers or managerial and non-managerial workers; or the ratio between the CEO's total guaranteed package and the average income of the lowest-paid band of workers (PwC, 2013). Pay ratio calculations can include or exclude pensions, share incentives, health benefits and other perks. They can also include or exclude interns, part-time workers, temporary workers, contractors and foreign and overseas workers. The Hutton Review – an analysis of pay practices in the United Kingdom – suggests that pension contributions should not be included in calculating a pay ratio because these figures are incredibly difficult to collect,

Figure 1 shows the top-to-bottom pay ratios in South Africa’s major industries (based on a sample of 33 JSE-listed companies) in 2012.

Figure 1. Ratio of average CEO pay to lowest-paid worker (2012)



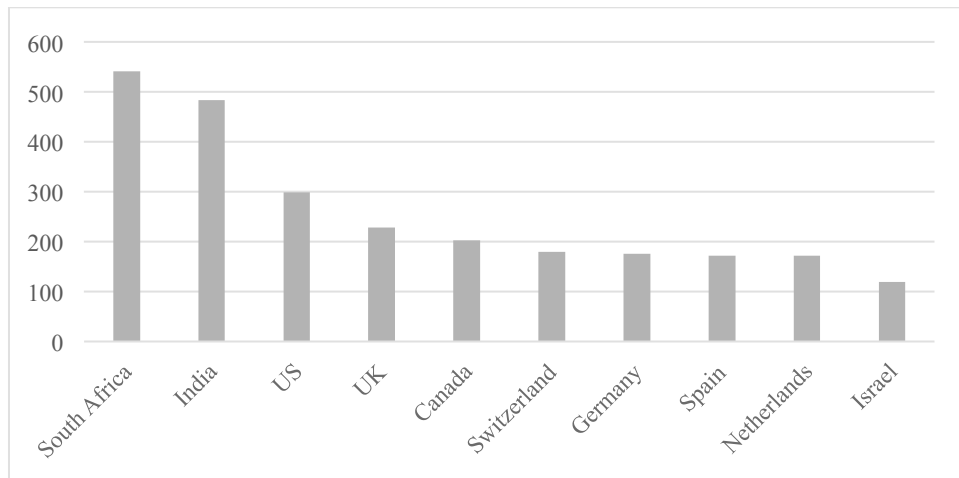
Source: Elsley (2013)

As an example, average CEO pay in the publicly-listed business services sector was 136 times the lowest-paid worker, while average CEO pay in the publicly-listed technology and telecommunications sector was 393 times the lowest-paid worker. In another study, Preston (2014) analysed pay ratios in JSE-listed companies for 2013, comparing the gap between the CEO and the average salary per employee. The highest pay ratio was 725:1 between Shoprite’s CEO and its average employee. The study found that across the JSE, the ratio of a company’s average CEO compensation to the average wage is 73:1. Globally, Lu and Melin (2016) show that South Africa has the highest ratio of CEO pay to average GDP per capita and the seventh highest level of average CEO compensation in the world.

Figure 2 provides ratios of CEO pay to average GDP per capita on a purchasing-power-parity basis, which gives a rough indication of the level of inequality in a country.

usually requiring the employer to purchase the data for each individual from the pension scheme.

Figure 2. Ratio of CEO pay to average GDP per capita adjusted to purchasing power (2015-2016)



Source: Lu and Melin (2016) using data from Bloomberg.

South African GDP per capita is just over \$13,000 USD (adjusted for purchasing power) while the average CEO made 541 times this, for a total over \$7 million USD. The South African ratio is much higher than the 229:1 ratio seen in the United Kingdom and even the 483:1 ratio seen in the United States, both countries where executive pay levels are frequently criticised.

All of this is in a context where average wages in South Africa do not accurately reflect the extent of low pay and the scope of wage inequality as they are pulled up by high wages at the upper end despite low wages for the majority. The World Bank found that high wages in South Africa “appear to mainly be due to high wages for managers and professionals – not high wages at the bottom of the income distribution” (Clarke *et al.*, 2004, p. 10). Even by international standards, South African top-end pay is high. The 2016 Bloomberg Global CEO Pay Index ranked CEO pay in South African JSE Top 40 firms seventh highest in the world, above those in all other emerging markets and more than in Australia, France, Finland and Japan (Lu and Melin, 2016). On a sectoral level, Barnes *et al.* (2015), for example, compared 2009 labour costs in the Thai and South African automobile industries. The authors found that management and production workers are almost three times more expensive in South Africa than in Thailand, while professionals are six and artisans twelve times more expensive.

In addition to this personal distribution of income, distributional questions can also be approached on the basis of the functional distribution of income – the distinction between the division of income paid to labour as wages (the ‘labour share’) and that paid to the owners of capital as profits (the ‘profit share’). Both distributions contribute to inequality levels and the rate of economic growth (Dabla-Norris *et al.*, 2015; ILO and OECD, 2015; Carvalho and Rezai, 2014). The wage share in South Africa has fallen since 1990 and is approximately five percentage points below the average of other emerging market economies (Strauss and Isaacs, 2016) This exacerbates the unequal personal distribution of income as wages tend to be somewhat more equally distributed than gains from capital. There is, therefore, room to shift the functional distribution of income from capital to labour.

2.2 Greater equity is good for the economy

A growing body of research, including by international institutions such as the International Monetary Fund (IMF), shows that inequality is harmful to economic growth. Dabla-Norris *et al.* (2015), for example, found that increasing the income share of the top 20% by 1% is associated with a 0.08% decrease in economic growth for the following five years, while a 1% increase in income for the bottom 20% was associated with a 0.38% increase in growth. The UNDP (2014, p. 6) has also linked high rates of income inequality to lower levels of economic growth:

...poverty, unemployment and inequality interact in complex ways, with evidence that high levels of social and economic inequality can constrain the scope for growth – and in particular, for the kinds of inclusive growth necessary to create jobs and reduce poverty. In contexts of high inequality, growth often reproduces existing patterns of distribution.

One way in which a more equal distribution of income benefits the economy is by raising aggregate economic demand because households with lower income levels tend to consume a higher proportion of their income than those with high incomes, which tend to save more of their income (Stiglitz, 2015; Godar *et al.*, 2015. See also Berg and Ostry, 2011). As stated by Prasch (2003, p. 20): “each firm’s wages represent, when spent by employees, the revenue of some other firms. Low or falling wages are a threat to these revenues and the high wage economy that a substantial revenue stream can support”. An increase in consumption by poor households generated by higher incomes can therefore lead to an increase in production and employment, spurring economic growth (Godar *et al.*, 2015).

This highlights that rising wages will not necessarily negatively impact employment. Wages, unlike the prices of many commodities, are not derived solely through the creation of an equilibrium between labour demand and labour supply. Wage levels and wage inequality have multiple causes and effects which are difficult to isolate. In particular, wages are, to a very large extent, structurally determined – based on the structure of the economy and balance of power between different groups – and depend on a far greater range of factors than individual contracting between employers and employees. This is evidenced by the systematic differences in pay across regions, races and genders in South Africa. Given the multiple factors at play, raising wages at the bottom of the wage scale will not necessarily lead to reduced demand for labour as classic theories of supply and demand predict. As the research in Section 9 shows, firms respond in many ways to rising wages at the bottom, including reducing profits (shifting the functional distribution of income away from capital towards labour), reducing upper-end wages, becoming more productive or raising prices.

Beyond increasing aggregate demand, reducing income inequality benefits the economy in other ways. Stiglitz (2015) states that greater levels of equality can increase productivity because the poor are more likely to obtain an education when they are able to afford educational expenses and the opportunity cost of delaying entry into the workforce. Increased productivity is good for businesses, contributing to rising profits and firm expansion and thus increased employment levels. Stiglitz (2015) and Dabla-Norris *et al.* (2015) also demonstrate that high levels of income inequality tend to cause the overextension of credit to lower income households, contributing to financial crises and economic instability. These financial crises affect everyone, not just the poor, and

contribute to unemployment, reduced growth and increased inequality. The risk of credit overextension in South Africa is highlighted by a World Bank report that South African adults take out the greatest number of loans compared to adults in the rest of the world, with 86% of adults taking out loans during the 2013-2014 year, and that 11 million credit-active South Africans were over-indebted (Staff Writer, 2015a). Finally, Landman (2013) links inequality to fractious labour relations, noting a link between inequality and rising strike activity in South Africa. The country lost 10.3 million workdays due to strikes in 2014 alone, costing the economy R6.1 billion (Staff Writer, 2015b).

2.3 Greater equality is good for society

A high level of income inequality has social as well as economic consequences and can negatively affect all members of society, not just those at the bottom of the income scale. According to Sitglitz (2015), there is a substantial link between violence and economic inequality that is divided on racial, religious or regional grounds. Wilkinson and Pickett (2010) also note a link between high levels of income inequality and the widespread use of drugs and alcohol, high levels of crime and higher levels of mental illness, depression, anxiety and obesity, all of which contribute towards lower life expectancy. England (2016) reports that more than 50 people are killed daily in South Africa, with over 142 *reported* sexual offences every day, earning the country the title of rape capital of the world. While inequality harms the poor the most, mental illness, depression, obesity and other negative social effects linked to inequality do not discriminate between the rich and the poor. Crime and social tensions, likewise, undermine the quality of life of all.

2.4 Greater equality can be good for business

Greater equity can also be good for businesses. Beyond future productivity increases associated with greater skills accumulation discussed above, two competing theories explain how pay equality affects the productivity of existing employees. On the one hand, pay dispersion is argued to motivate performance because if an individual performs well, he or she knows this can be rewarded with promotions and higher pay (the tournament theory). On the other hand, the behavioural or equity theory holds that employees compare their pay, job responsibilities and effort to other employees and if workers feel they are being underpaid, they react negatively, exhibiting less loyalty and commitment (Shin *et al.*, 2015). The latter is associated with poor workplace climate, morale and job satisfaction as well as lower productivity and cooperation levels. Under this conception, more equal pay distributions foster a spirit of fairness and cooperation and hence enhance firm performance and product quality while reducing rates of absenteeism (Bloom, 1999).

The empirical evidence regarding which of these theories holds true is contested.³ Alexopoulos and Cohen (2004) and Hibbs and Locking (2000) find that both effects may occur depending on the firm and economic context. Alexopoulos and Cohen

³ For a summary, see Shin *et al.*, 2015. In support of the tournament theory see: Faleye *et al.*, 2013; Main *et al.*, 1993; Heyman, 2005; Kale *et al.*, 2009; Lallemand *et al.*, 2009. Note that Crawford *et al.*, 2016 criticise the method used in Faleye *et al.*, 2013. In support of the equity theory see: Hutton, 2011; Martins, 2008; Bloom, 1999; Shaw *et al.*, 2002; Yang and Klaas, 2011; Pfeffer and Langton, 1993; Cowherd and Levine, 1992; Shin *et al.*, 2015; and Torre *et al.*, 2015.

(2004) studied Swedish wage compression, finding that while wage compression can have positive benefits on productivity and morale, 'excessive' wage compression may cause lower effort on the part of better-paid workers, leading to reductions in productivity and profits. As Silverman (2004) explains, it is also possible for other forms of reward to take the place of monetary incentives: formal recognition from the employer, public appreciation or rewards such as parking spaces and meal vouchers can all form elements of compensation that do not give rise to pay inequity while still allowing an employer to recognise employees for a job well done. Given the extreme levels of inequality in South Africa, it is highly plausible that equity-enhancing policies can have positive firm-level effects, although this requires further empirical investigation.

2.5 The moral case for intervening in the labour market

Discussions on pay regulation are sometimes met with the assertion that the labour market, like any commodity market, should be left to its own devices and that optimal outcomes will ensue. We have already highlighted above how the labour market is not equivalent to other commodity markets and how pay regulations can be positive for the economy; there is no evidence that an unregulated labour market leads to optimal economic or social outcomes.

The labour market is already extensively regulated, and for good reason. As a society we have decided that certain interventions are necessary to build the society in which we wish to live – the prohibition of child labour, introduction of health and safety regulations, and limits on the number of hours that can be worked, are all such examples. These are ethical decisions that we make as a polity, and measures to reduce inequality should also be seen in a similar light. Luckily, reducing inequality can also be good for the economy and so these facts together present a compelling case for inequality-reducing labour market intervention.

2.6 Conclusion

Any attempt to achieve greater economic growth and reduce poverty in South Africa must address the issue of reducing the extremely high level of wage inequality present. Studies show that economic growth is boosted when incomes are distributed more equally. While inequality hampers economic growth, it is also connected to a variety of social ills, including crime and drug use. Beyond this, a greater level of wage equality can be associated with greater productivity, firm value and product quality. Reducing wage inequality in South Africa is an important goal that can lead to positive economic and social effects. Intervening in the labour market can therefore achieve a host of socially beneficial outcomes. The next sections will examine policies adopted internationally that have helped countries achieve greater levels of wage equality.

3 Disclosing pay ratios

A key metric for measuring wage inequality, as noted above, is the ratio between higher-paid and lower-paid or average workers. The first step in tackling this is accurate information on the scope of these disparities.

Knowing the extent of such wage inequality allows diverse role players in the economy to compare this to what they consider feasible or ideal. Kiatpongsan and Norton (2014), from Harvard University, recently examined data from 40 countries, including South Africa, to compare individuals' estimates of current wage disparities to what they believe to be an ideal pay gap. Of the 3305 survey participants in South Africa (a sample representative of the population), participants estimated that the pay ratio between a CEO and an unskilled worker in 2009 was 17:1 and believed the ideal ratio to be 8:1.⁴ Across the 40 countries studied in the survey, the estimated ratio of CEO pay to an unskilled worker's pay was 10:1, while the ideal was approximately 5:1. Somewhat above this level, the oft-quoted management-guru Peter Drucker argues that a ratio of 15:1, 20:1 or 25:1 was the maximum optimal ratio (dependent on firm size) to prevent resentment and falling employee morale (Drucker Institute, 2011). Clearly, these 'ideal' ratios are far from the South African reality shown above.

It is only in the past few years that some countries have begun requiring companies to disclose pay ratios. Even before regulation was implemented, however, a few companies voluntarily set pay ratios in order to improve employee morale and productivity, acting as leaders on the issue. For instance, Whole Foods, an American supermarket chain, has a corporate policy that limits the cash compensation paid to any employee to 19 times the average annual wage and bonus of all full-time employees (Mackey, 2006).⁵ There are also some South African examples. Most notably, PPC Ltd CEO Ketso Gordhan took a R1 million salary cut and convinced a number of managers to agree to a pay freeze in order to reduce pay ratios in the company, achieving a top-to-bottom pay ratio of 40:1 in 2014 (Klein and Masote, 2014; PPC Ltd., 2014). However, these examples are few and far between and have not been sufficient to reduce pay ratios across the economy. Thus, more than a voluntary system is needed if pay ratios are to be actively reduced in South Africa.

Requiring disclosure of pay ratios is an important step towards reducing them. As stated by Caulkin (2015, p. 17):

By definition, a company that doesn't measure pay multiples already, doesn't consider them important enough to manage. There's no mystery about the widespread failure to explain internal pay relationship under present guidelines – for most companies they simply don't enter into the calculation.

Requiring the disclosure of company pay ratios encourages boards to consider how to justify executive pay in comparison to other levels of pay within the company, provides

⁴ In line with this, Wagemark, a non-profit organisation based in Canada, certifies companies internationally that have an 8:1 pay ratio between their highest-paid employee and the bottom decile of earners (The Wagemark Foundation, 2016).

⁵ Other notable ratios include the John Lewis Partnership's 75:1 limit between CEO pay and the average non-management partner (Burgess, 2015), an accounting firm's cap on CEO remuneration at 20 times the average employee's pay (Bentham, 2015) and Ben & Jerry's former cap on CEO pay at 5 times the lowest-paid worker (Weiss, 2013).

important information on the level of pay inequality in society, allows for comparison of pay differentials across companies, and is a starting point for reducing those differentials. Beyond contributing to the goal of pay equity, mandatory pay ratio disclosure can also be beneficial to investors. Kelly and Seow (2016), conducting a survey of individuals, found that if a company's pay ratio between the CEO and median employee is higher than the industry average, this has a significant negative effect on the company's perceived investment potential. Crawford *et al.* (2016) found that banks with very wide pay disparities receive 5 to 9% more negative say on pay (SOP) votes⁶ than banks with smaller pay disparities, demonstrating that shareholders are concerned with the compensation structure of the entire workforce.

Beyond requiring disclosure of pay ratios, there is also the possibility of requiring shareholders to vote to approve pay ratios or to vote to approve pay levels above a certain ratio set by the government (see for example US Government, 2009a). However, as will be discussed in Section 4, because the institutional investors voting on these types of issues on behalf of beneficial shareholders have a personal interest in maintaining high pay structures, this policy may lead to the legitimisation of high pay ratios rather than to their reduction. Thus, this policy should be considered with caution, and the possibility of expanding this vote to include other stakeholders such as employees could possibly be considered if this avenue is pursued.

In addition to requiring the publication of pay ratios, it is possible to require boards to disclose the annual pay increase for each category of employee. Harrop (2014) explains that this would see boards being required to justify why pay growth at the top may be greater than that at the bottom. Given the large number of workers that earn wages below the poverty line in South Africa, companies could also be required to disclose the number of working poor that they employ. Requiring such disclosure alongside executive pay levels and pay ratios could prompt a consideration of how much executive salaries would need to be reduced in order to bring all of a company's workers above the poverty line.

There are only a few countries that require companies to disclose information related to pay ratios. Since 2015, public companies in India have been required to disclose the ratio of the remuneration of each director to that of the median employee's remuneration as well as the average increase in employee remuneration compared to that of key management personnel, and explain the difference (InGovern Research Services, 2015). The United Kingdom requires companies to compare and disclose the percent change in CEO pay to that of employees of the company (UK Government, 2013b). This calculation does not include equity-based pay and companies are permitted to choose their employee comparator group. However, Petroff (2016) reports that Theresa May has suggested that she will enact rules to recommend that companies disclose CEO-to-worker pay ratios. In South Korea, annual reports are required to provide information on average employee pay and the pay of top executives, giving enough information to allow for the calculation of pay ratios (Shin *et al.*, 2015). Starting in 2018, public companies in the United States will be required to publish the ratio of the total annual compensation of the CEO to the median compensation of all the firm's employees (SEC, 2015). Companies may select their own reasonable method for choosing the median employee and calculating that employee's compensation. Kumar (2015) suggests that instead of using median employee pay, American companies should have been required to use a weighted average which would take into account

⁶ Say on pay votes allow shareholders to vote on executive remuneration.

not only how much each worker got paid, but how many workers were paid each amount.

Business frequently criticises government regulation despite the fact that the regulation may be in society's best interest, and pay ratio disclosure regulations are no different. There are three main criticisms raised by companies over requiring pay ratio disclosure. However, each of these can be overcome. One argument is that the calculation is an expensive and time-consuming process (Caulkin, 2015). For instance, CEO pay is complex and difficult to compute and a company's employees may be spread out across the globe and be employed by a variety of subsidiaries that encompass a number of different payroll processes. However, publicly-listed companies are already required to compute and disclose the level of CEO pay. In South Africa, companies with more than 50 employees are required to collect and report local employee remuneration information on their EEA4 forms. Even if such a practice does require some effort, the equity-enhancing benefits for society (and possibly for the firm itself as outlined in Section 2) of such a policy have the potential to outweigh any additional cost to the company in collecting the data.

Another criticism is that companies are able to manipulate the pay ratio reported by outsourcing the lowest-paid jobs or turning low-paid workers into contractors or part-time workers. This could be overcome by mandating the inclusion of such workers in pay ratio calculations even if they are outsourced in these ways. This would admittedly add to the expense and complexity of calculating pay ratios, but would provide valuable protection to the most vulnerable workers and ensure companies are not able to manipulate the figures.

A final criticism is that ratios may not be comparable across companies, industries or countries. Similar companies might engage in different calculation processes, resulting in completely different figures. To be meaningful, clear methodological approaches must be defined, for example regarding which employees are to be compared and what parts of their pay must be included. For telling comparisons, all elements of remuneration should be taken into account – not just cash payments. Even if this is done, comparisons between companies should be treated with care, for instance, small companies will likely have lower multiples than large companies. Similarly, pay ratios in a company which has a majority of low-skilled workers, such as domestic cleaning company, will be very different to a company with a highly-skilled workforce, such as a technology development company. Any concerns a company has in this regard can be outlined in explanatory text alongside the pay ratio, while those concerned with pay ratios are surely able to understand any contextual differences when making comparisons.

Mandatory disclosure could be accompanied by the stipulation of a target pay ratio (using society's perceptions of what would be appropriate – perhaps somewhere between 8:1 and 25:1). If companies fail to achieve these targets over time, the government can enact incentives for achieving these ratios, such as favourable procurement policies or tax incentives, policies which will be discussed in Sections 6 and 7. Finally, should companies' voluntary compliance be deemed insufficient, mandatory regulations setting a pay ratio could be instituted. This policy option will be discussed in the next section.

4 Implementing mandatory pay caps and ratios

A more stringent form of regulation would be to cap pay or mandate a maximum pay ratio or level. Failure to comply with such *mandatory* caps and ratios could result in fines or criminal proceedings, or legislation could require companies to obtain certification proving that they comply. This is often seen as a means to reduce perceived excessive levels of executive pay – as discussed in this section. Pay ratios have also been used as a means to increase lower-end wages, as discussed further below.

4.1 Academic literature on pay caps

Bebchuk and Fried (2006) demonstrate that executive pay is largely determined by strong managers with the power to dominate the board and set their own pay levels. The authors show that compensation levels are not linked to long-term company performance (PwC, 2016, reports the same in South Africa). Instead, compensation structures reward executives for market-wide and short-term spikes and create perverse incentives for executives to misreport results, engage in strategies that are not transparent and take excessive risks (see also Bebchuk and Spamann, 2009). Clearly, regulation is needed to rein in levels of executive pay, including amendments to corporate governance legislation discussed in Section 5 and the mandatory disclosure of pay ratios discussed in Section 3. Should these strategies fail to rein in executive excess, another option is to simply cap executive salaries.

Opponents of salary caps point to a potential skills exodus and the inability to recruit talented employees. However, there are many reasons why an employee would choose to remain with a company despite a salary cap. For example, employees may be unwilling to give up severance benefits or lose unvested stock options, they may value job security more than the chance of earning a higher salary elsewhere, they may have a high level of relevant experience and be reluctant to leave for another industry or position, or they may have a high level of job satisfaction. A founding executive at a major publicly-listed company with a personal interest in the company's success and his or her reputation as its leader may decide to remain with the company despite a pay cap.

The academic literature on the impact of total compensation caps is limited except in the case of professional sports, which is not considered relevant here.⁷ Llense (2010) argues that pay caps will lead to a misallocation of executive talent – as smaller less profitable firms are now able to compete for top executives – with a negative impact on production. However, this effect may be overstated and generally the magnitude of pay differences between executives does not reflect equivalent differences in skill. Gabaix and Landier (2008, p. 50), studying CEO pay in the United States, found that:

If we rank CEOs by talent and replace the CEO number 250 by the number one CEO, the value of his firm will increase by only 0.016%. These very small differences in talent translate into considerable compensation differentials, as they are magnified by firm size. Indeed, the same calibration delivers that CEO number 1 is paid over 500% more than CEO number 250.

⁷ Professional athletes are especially mobile due to the nature of their careers. Their compensation structure is often based on team-wide caps rather than individual salary caps.

Dittmann *et al.* (2011) looked at the effect of a pay cap or tax on extreme levels of total realised compensation. They found that companies would simply shift their compensation structure so that over time, executives would be provided with the same or higher level of incentives as without a cap because pay during periods of mediocre performance would be better rewarded than they would be without the cap. In addition, the study found that an *ex ante* cap on total compensation (including a pay ratio limit) will cause firms to choose between offering performance incentives and attracting CEOs that are perceived to be the most talented, who will likely be able to command a fixed salary at the level of the cap, leaving no room for performance incentives. However, as Gabaix and Landier (2008) point out, this effect may be overstated as the most valuable CEOs do not necessarily have a large impact on firm value. Finally, Dittmann *et al.* (2011) point out that a pay cap may reduce beneficial risk-taking behaviour: just as the overuse of share incentives can lead to excessive risk-taking, the underuse of incentives can lead to suboptimal levels of this behaviour. Therefore, any cap must be sufficiently high to ensure companies are able to offer appropriate incentives while also being sufficiently low to have a meaningful impact on compensation levels.

4.2 Mandatory pay caps or pay ratios

There are a number of examples of countries capping executive pay or establishing a pay ratio limit. South Korea, Egypt, Israel, France, Venezuela, China and Poland have all established a form of executive pay cap, some based on a pay ratio. Teevs (2013) reports that in 2013, Switzerland held an unsuccessful referendum over a constitutional amendment stipulating a firm cannot pay its top executives more than 12 times the wage of the lowest paid worker in the firm, or around €400,000. Additionally, firms receiving funds under the financial bailout regulations in the United States and Germany had limits placed on their compensation. Unfortunately, many of these examples are in non-English-speaking countries which restricts the availability of both academic articles and other information, and many apply only to a particular sector of the economy.

In South Korea, laws require shareholders to set a salary cap for all executives and directors at publicly-listed companies unless a cap exists under the company's corporate charter. Garner and Kim (2010) found that the Korean salary cap is only effective at limiting pay at firms that are externally monitored by shareholders, such as those with large holdings by foreigners or institutional investors. Other firms set a high cap beyond actual pay levels, which is effectively meaningless. This highlights the importance of corporate governance and strong shareholder representation in enforcing such caps, making methods to empower stakeholders and encourage them to vote (as discussed in Section 5) even more important.

In July 2012, the French government limited salaries at state-owned enterprises (SOEs) to €450,000, equivalent to twenty times the average salary of the lowest paid 10% of workers (Ministère de l'Économie et des Finances, 2012; French Government, 2017). By 2014, the Agence des Participations de l'État (2014-15) reported that all publicly-owned companies in France complied with the pay-cap decree, demonstrating how a salary cap using a pay ratio can be imposed successfully across many companies as a result of the government leveraging its position as shareholder. The cap applies to 20 French CEOs.⁸ Efforts to limit salaries in the private sector at a cap of 100 times the

⁸ Confirmed by email to the author from Alexane Heredia dated 9 March 2017.

minimum were rejected by 1 vote in the Assemblée Nationale while a similar attempt to cap pay at 50 times the minimum wage was rejected by 3 votes (Rousseau, 2016).

Egypt's 2014 Constitution permits "setting a maximum wage in state agencies for whoever works for a wage as per the law," which in 2014 was set at 35 times the minimum wage (Saied, 2015). By the end of 2014, 140 officials in Egypt's public banks had resigned in protest at the cap, and some executive level positions in public telecommunications enterprises remained vacant (Aggour, 2016; El-Din, 2015). Like Egypt, executive pay in Chinese SOEs is capped at either 12 or 30 times average employee pay for the firm and plans to cut executive pay in SOEs by 50% were introduced in 2015 (Li *et al.*, 2013; Yuzhe, 2014; Leutert, 2016). Chinese officials stated that these policies were unlikely to result in attrition because executives in China obtain job stability and professional development opportunities they would not get elsewhere. However, Hewitt (2015) reported that several top executives in China's banks had already quit as a result of salaries declining by up to 50%. A similar cap exists in Venezuela, which has a law setting the highest wage for public officials at 12 times the minimum wage (Pearson, 2011). However, evidence of how these caps are applied in practice and their effects on wage inequality, recruitment and retention are not readily available in English.

In 2016, Abudy and Shust reported that the Israeli government passed a law that provides that executive compensation greater than 2.5 million NIS (\$650,000 USD) "cannot be granted by a financial corporation if it is more than 35 times the lowest salary paid by the corporation" thus relating a pay cap to a wage ratio. This cap applies to all compensation and requires the pay of contractors and their employees to be included in determining the lowest salary, removing the incentive to terminate or outsource low-paid positions. Any compensation in excess of 2.5 million NIS is subject to a tax penalty and must be approved by the directors and shareholders, while no salary over 2.5 million NIS can exceed the pay ratio of 35:1 (Abudy and Shust, 2016). According to lawmakers, the "modest peg makes it far more likely that executives will actually choose to raise the salaries at the bottom of the corporate hierarchy" in order for executives to be able to increase their pay as well (Times of Israel, 2016). Abudy and Shust (2016) found that following the announcement and passage of the law, investors responded favourably, with returns on shares being abnormally positive. However, critics of the law point to the oft-used arguments of a skills exodus (Benmeleh, 2016; Lipkin, 2016). The effects of this law are yet to be seen due to its recent implementation.

Polish legislation caps pay in local government, and in companies where the state holds a majority stake, at 6 times the average monthly remuneration in the private sector plus a bonus of 3 times the average monthly remuneration (The European Institute of Public Administration, 2015). The policy also applies to foundations that obtain more than 25% of their annual income from the government. The Prime Minister has the authority to raise the maximum by 50% in the case of special importance to the state. The European Institute of Public Administration (2015) suggests that the evidence indicates that this rule resulted in a number of managers quitting due to wide disparity between remuneration in the public and private markets and problems with hiring qualified managers at State Treasury companies. The pay cap also had other unintended consequences. Cienski (2008) found that executives began creating subsidiaries with the sole purpose of gaining more board seats in order to increase their pay beyond the cap, resulting in a huge cost burden to the state which was reportedly more expensive than if the cap had not been imposed at all. Other companies resorted

to using management contracts to ensure that the CEO was not an employee, but a service provider, and thus not subject to the cap (The European Institute of Public Administration, 2015). Janicka *et al.* (2016) state that Poland amended this law in 2016 so that in any company in which the state owns shares, the state must vote for a resolution that limits fixed salary to no more than 15 times the average monthly salary in the private sector and limits bonuses to no more than 50% to 100% of fixed salary depending on the size of the company. The new law also closed the loophole that allowed managers to earn extra income by holding posts in subsidiaries or being hired as a contractor. This example, and the mixed results described above, indicate that such caps (or pay ratios) should be carefully implemented to limit loopholes and reduce inequality in a manner that does not undermine firm performance.

The 2008 financial crisis and subsequent bank bail-outs resulted in governments imposing strict regulations on compensation within recipient firms. For example, the binding European Union Council Directive (2013/36/EU) came into effect in 2014, placing a cap on senior banker bonuses at 100% of fixed remuneration, which may be increased to 200% upon a shareholder vote. Schäfer (2013) found that 79% of European banks surveyed stated that they were going to raise the base pay of employees covered by the cap in order to counteract the impact of the bonus regulations, with more than 50% of banks intending to keep overall pay levels completely unchanged. Arnold (2016) reports that the European Banking Authority found that the most senior bank executives saw the doubling of their fixed pay in 2014 while their variable pay fell by 28%, resulting in no change to their overall pay packages. As a consequence of the higher salaries paid to senior bankers, banks have lost the flexibility to cut their pay in times of poor performance. A study by Klymenova and Tuna (2016) finds that following the introduction of this bonus regulation, the likelihood of CEO turnover increased as CEOs left the financial industry for other non-regulated activities, retirement or to start their own businesses. These effects point to the importance of regulation applying across all sectors of the economy and not just one sector in order to counteract the effects of turnover. Additionally, any cap needs to apply to all forms of pay rather than just a portion of it.

The United States placed a salary cap of \$500,000 USD on senior executive officers and capped bonuses of top earners at one-third of total compensation in institutions that received government bailout funds. Despite these regulations, Anderson *et al.* (2009) find that 20 of the United States' financial institutions that received the most bailout dollars paid their top 5 executives an average of \$32 USD million each because there was no limit on stock awards. After controlling for the need for funds and other firm characteristics, Cadman *et al.* (2012) found that increasing CEO compensation from the 25th to the 75th percentile more than doubled the probability that a firm would turn down bailout funds or repay them before the remuneration restrictions outlined above came into effect. This study indicates that executives are highly self-interested and are willing to turn down funds that could help their firm if it means taking a pay cut themselves. Kim (2010) found that markets reacted negatively to the cap with larger and better performing firms experiencing a bigger drop in stock return than smaller firms.

4.3 Conclusion

Pay caps and mandatory pay ratios are two vehicles to reduce wage inequality. Both can have the effect of containing high levels of executive pay, while pay ratios can also lead to a rise in wages for lower-wage earners. Their overall success is unclear, in part

due to insufficient research available in English and a publication bias that portrays such pay caps as detrimental. Potential hazards include recruitment and retention problems, especially if applied to select sectors or to a subsection of firms, and shifting executive pay away from wages and towards other forms of remuneration to avoid breaching the cap or ratio, indicating the need to include all forms of remuneration. Despite these hazards caps and ratios offer a very direct means through which to close wage pay gaps and achieve greater wage equity. Such caps may be viewed as beneficial by investors, evidenced by the positive stock market returns associated with the announcement of these caps in some jurisdictions. If pay caps are to be pursued, the modalities of implementation and enforcement need careful consideration. Further case study research is recommended.

5 Reforms to corporate governance models

Another means of tackling high levels of executive pay and reducing wage inequality is by reframing the corporate governance model from its sole focus on shareholders to a focus on multiple stakeholders including employees. This can be done by ensuring these stakeholders are adequately informed about the company's remuneration practices and by ensuring that all stakeholders are engaged in the pay-setting process.

5.1 A multi-stakeholder approach

A major problem with the current corporate governance model is its focus on shareholders (and often short-term shareholders) to the exclusion of other stakeholders, and the fact that many company incentive structures reward executives for short-term shareholder gains, often at the expense of long-term growth that could create employment (Smithers, 2013). A widely accepted principle of corporate governance, bolstered by remuneration policies and accepted in many countries across the world, is that directors run companies to increase shareholder value (Williamson *et al.*, 2014). Directors are incentivised, through their remuneration policies, to increase the share price and return profits to shareholders in the form of dividends and share buy-backs. Most major publicly-listed companies have policies that see share incentives vest three years after grant, based on the company achieving a certain increase in shareholder value over that 'long-term' period. However, a major outlay of capital allowing a company to explore, conduct research, build new plants or invent new technology is unlikely to achieve any significant return to shareholders in three years. As Williamson *et al.* (2014) demonstrate, this focus on short-term shareholder value causes cash to be diverted from re-investment in the company to shareholders so that executives can meet their targets, contributing to reduced investment, falling labour productivity, a decrease in real wage growth and a fall in living standards. Davis (2009) points out that prioritising short-term shareholder value ignores that longer-term shareholders may also (more indirectly) benefit from corporate decisions that protect workers' jobs or provide for a more equitable distribution of wages. These benefits may not present themselves immediately, and thus not be desirable to short-term shareholders.

Sarra (1999) suggests that the interests of other stakeholders, including employees, could be made as important as that of shareholders to ensure these considerations are taken into account. For example, Sarra (1999, p. 418) recommends that directors have a fiduciary duty to "act in the best interests of the corporation, having regard to shareholders as contributors of equity capital and employees as contributors of human capital". This would require companies to balance the sometimes-conflicting best interests of capital and labour by focusing on the long-term health of the company rather than movements of the share price in the short-term. Not only would this reduce the focus on short-term decisions that cut costs (and wages) in order to improve short-term shareholder value, it would require directors to take the interests of both workers and long-term shareholders into account when making decisions. Executive remuneration policies would need to be amended to reflect this consideration.

5.2 Engagement of shareholders

The ability of shareholders to hold directors and executives accountable, including with regards to pay practices, is integral to corporate governance. If shareholders are unable to hold boards and executives accountable for pay policies, companies can be

managed to suit the best interests of directors and executives rather than shareholders. One way that shareholders are able to hold boards accountable for executive pay practices is through the use of 'say on pay' (SOP) votes, where laws or governance codes permit shareholders to vote on a company's executive remuneration policies or practices. These votes may be either mandatory or voluntary, and advisory (non-binding) or binding upon remuneration practices. SOPs empower boards by giving them a direct mandate to negotiate with the CEO to amend his or her pay package and by encouraging directors to act in shareholders' best interests by linking pay to performance (Correa and Lel, 2016). In practice, studies of the effectiveness of SOP laws reveal mixed success in restraining executive pay but point to positive effects on company performance. The studies also point to SOPs' potential to successfully restrain executive pay if these laws are accompanied by a consequence for failure.

In South Africa, the *King Code of Corporate Governance (King III)* and corresponding practice notes recommend that companies hold a non-binding shareholder advisory vote on the company's remuneration policy on an apply-or-explain basis (IoDSA, 2009a, 2009b, 2012). This means that companies should either hold a shareholder vote or explain why they have decided not to do so. The United States requires companies to hold a non-binding SOP vote on the remuneration packages given to the 5 highest paid executives once every 3 years (US Government, 2010). The United Kingdom requires a binding shareholder vote to be held on the company's remuneration policy once every 3 years (UK Government, 2013a). Pay must be compliant with the policy, otherwise it is unlawful. Shareholders also have the right to a non-binding vote on the company's annual implementation report which explains how the remuneration policy was applied during the year. In the Netherlands, the proposed remuneration policy is sent to the employee's council which is able to provide its opinion to shareholders at the annual general meeting (Thomas and Van der Elst, 2015). The policy needs shareholder approval to become effective. Shareholders are also able to vote on individual compensation packages unless this power is delegated to the board.

By far the strictest SOP regulations are in Australia and Switzerland. Australia requires a mandatory vote on the company's remuneration report and if the company receives a 25% or greater negative vote, the company must explain how it has responded to the vote (Australian Government, 2011). If it receives a 25% or greater negative vote two years in a row (a 'second strike'), shareholders have the power to require all the directors to stand for re-election, putting directors' jobs on the line for failing to address shareholders' concerns over pay. In Switzerland, shareholders have a binding vote on the level of each director's and executive's compensation relating to a one-year period, either prospectively or retrospectively (Homburger, 2014).

SOP votes across the globe are characterised by high levels of shareholder approval and very few outright rejections (Semler Brossy Consulting Group, LLC, 2016; Willis Towers Watson, 2016b; Vesper-Gräske, 2013; and Thomas and Van der Elst, 2015). Correa and Lel (2016) studied firms holding SOP votes between 2001 and 2012 in 38 countries, finding that following the introduction on SOP laws, the growth rate of CEO pay (but not the level) declined on average by 7%, going down by 18.5% when only firms with excess CEO pay are considered (excess CEO pay was calculated based on firm performance and a sample median). Additionally, the study found that the sensitivity of pay to performance improved. Multiple studies have found that while firms in the United States tended to reduce the rate of pay growth in response to SOP, firms in the United Kingdom instead increased the sensitivity of pay to performance rather than reduce the level of growth, and similar results have been found in Germany

(Kimbrow and Xu, 2016; Ferri and Maber, 2013; Thomas and Van der Elst, 2015; Carter and Zamora, 2007; Powell and Rapp, 2015).

In contrast, Iliev and Vitanova (2014) and Brunarski *et al.* (2015) find that SOP laws in the United States have occurred in tandem with an increase in CEO pay, and similar results have been found in the United Kingdom by Gupta *et al.* (2016). Iliev and Vitanova (2014) found that firms required to hold an SOP increased pay by 14%, theorising that CEOs are being compensated for the additional risk brought by the SOP vote or that boards use the SOP vote to rubber stamp even bigger pay increases. If this is the case, both are unwanted and unintended consequences of the SOP vote which was meant to act as a limiting force on CEO pay levels.

Australia has been more successful with its SOP outcomes given the formula outlined above. Thomas and Van der Elst (2015) found that in 2012, following the first year of second-strike votes, executives in Australia gave up bonuses, raises and incentive compensation while promising to restrain pay policies or cutting or freezing salaries. For the 75 firms that avoided a second negative vote in 2012, the firms reduced average remuneration by 6.8% and improved firm performance (Monem and Ng, 2013). This evidence indicates that when directors' jobs are on the line, boards have an incentive to reduce levels of executive pay in response to a negative SOP vote instead of just reducing the rate of growth of executive pay.

5.3 The role of institutional investors

The effectiveness of using corporate governance policies such as the SOP to rein in executive pay depends on shareholders, and specifically institutional investors (generally large shareholders), holding companies accountable by engaging in dialogue with boards and voting to restrain pay. Encouraging institutional investors to vote can be done in one of two ways: by requiring them to do so, or by requiring them to disclose whether or not they have done so. For example, Swiss pension funds must vote annually on the board's compensation for all their domestic shareholdings or face fines or prison sentences (Röhrbein, 2013). In the United States, fiduciaries must vote in accordance with their beneficiaries' economic interests unless the cost of voting is likely to exceed the benefit (OECD, 2011). For example, institutional investors may hold a number of relatively small passive investments on behalf of clients, where low monitoring costs would result in lower fees. Requiring voting on these types of funds may wipe out a significant portion of the beneficiaries' profits. On the other hand, some argue that institutional investors should have a duty to society to vote due to the "immense size of their collectivized assets" (Solomon and Solomon, 2004, p.4). The OECD (2011) posits that research costs can be shared by institutional investors cooperating to gather information.

Rather than requiring institutional investors to vote, in some countries, such as Australia, the United States and India, institutional investors are required to disclose their voting records or disclose them on a comply-or-explain basis (OECD, 2011). In the United States, mutual funds must file their voting record with the SEC and make it publicly available. In the United Kingdom, the Financial Reporting Council's voluntary *UK Stewardship Code* (2012) recommends that institutional investors disclose their voting records or explain why they will not. Similar requirements exist under the *Code for Responsible Investing in SA* (IoDSA, 2011). However, of the 175 asset managers that have signed up to the *UK Stewardship Code*, Sullivan (2012) found that only 27

disclosed a full voting record, indicating that voluntary solutions are likely to be the least effective.

The OECD (2011) has developed a number of principles which could be incorporated into a voluntary or mandatory code of conduct for institutional investors (similar principles have been developed by the Principles for Responsible Investment Association under the auspices of the United Nations). For example, institutional investors should disclose their corporate governance and voting policies and procedures, work collectively with one another to monitor and engage with companies, incorporate environmental, social and corporate governance (ESG) issues into their analysis and decision-making process, and be active owners and vote and engage in an informed way. A recent report recommends that policy makers clarify that institutional investors *must* take into account ESG issues in order to meet their fiduciary duties and that legislation and codes be strengthened to clarify that these incorporate ESG issues (Sullivan *et al.*, 2015). These principles could also be reformed to specifically mention executive pay practices or pay equity as an ESG issue that should be considered by investors.

Requiring institutional investors to take into account executive remuneration and internal pay scales as an ESG issue, and even requiring them to vote or to disclose their voting record on these issues, would encourage institutional investors to rein in executive excess. However, it is important to note that even if institutional investors are required to vote on ESG issues, this does not mean that they will exercise that vote in a manner that restrains pay. Some institutional investors may simply rubber stamp existing high pay packages which are in line with (and can be used to justify) their own high salaries, highlighting the importance of widening the stakeholder model to include the voices of other individuals, such as employees, in the pay-setting process.

5.4 Engagement of employees

Remuneration committees serve an important role in determining executive pay policies and setting remuneration amounts. Which individuals are selected to serve on these committees deserves attention because their backgrounds determine whether they are likely to support current high pay practices or executive pay reform. First, allowing executive-level employees to serve on the remuneration committees that decide their own pay gives rise to a conflict of interest and can contribute to high levels of executive pay because executives have a self-interest in preserving the status quo. Unlike in South Africa, many countries, including the United Kingdom, require that remuneration committees be composed entirely of non-executive directors in order to combat this conflict of interest, while Australia allows executives to serve only in small companies (European Union Commission, 2005; Financial Reporting Council, 2016; ASX, 2014a; ASX, 2014b). Second, even if executives do not serve directly on remuneration committees, they may play a role in determining which directors are chosen as committee members. To prevent this, Switzerland passed an ordinance that requires shareholders to vote for remuneration committee members (Swiss Federal Council, 2014). Taken together, measures that restrict the ability of executives to serve on remuneration committees and to choose their members reduce the influence executives have over pay levels in the company.

These measures do not solve the problem that remuneration committee members tend to consist solely of directors from corporate and finance backgrounds who are firmly rooted in current models of high executive pay. Including workers on remuneration

committees can disrupt such homogenous thinking because workers have an interest in limiting the pay gap between workers and managers and in maximising the long-term growth of the company (Hargreaves, 2013). There is in fact a strong negative relationship between worker board representation and the total level of CEO pay in 600 European companies, with a study finding that worker board representation does not negatively impact operating performance or stock market valuation (Vitols, 2010). There are multiple ways in which worker representation on boards can be implemented to suit a diverse set of economies and corporate governance models (O’Grady, 2014). This is demonstrated by the fact that 14 very different countries in Europe have extensive legislation related to board-level employee representation, ranging from Germany’s mandatory employee representation structure to voluntary approaches that depend on the initiative of workers or an agreement between unions and management (Vitols, 2010; European Trade Union Institute, 2016).

For example, in Germany, the company supervisory boards tasked with approving executive-pay contracts must include representatives of both shareholders and employees (Hitz and Müller-Bloch, 2015). Employee directors make up one-third to one-half of supervisory board members depending on the size of the corporation (Edwards *et al.*, 2009). Unlike the shareholder primacy model adopted in most countries, the supervisory board is required to take into account the interests of employees and consider the relationship of management’s pay to that of lower-level employees. Hargreaves (2012) states that this policy has “had a positive impact on motivation and important social effects, contributing to social harmony and productivity”. Employee directors in Germany are given training from the Hans-Boeckler Institute, funded by a portion of the income earned by employees in their role as directors, in order to ensure that they are competent to take on the fiduciary duties and liabilities of a director (Hargreaves, 2013). Different models of representation exist in 13 other European countries.

5.5 Corporate governance policies and laws related to executive pay

Corporate governance codes are the primary source of guidance to remuneration committees when designing and implementing remuneration policies. These codes can be voluntary, mandatory, or a mixture of both. For example, some corporate governance provisions may be contained in legislation, which mandate requirements with respect to executive pay. Other corporate governance codes are enacted by an independent body appointed by the government or its securities exchange. Compliance with certain provisions of these codes may form listing requirements of the relevant stock exchange. Still other voluntary codes are enacted by bodies representing directors and other business leaders, such as the Institute of Directors in Southern Africa. Voluntary corporate governance codes, like *King III* in South Africa, recommend best practices but provide companies with the flexibility to apply them in a way that works best for the company (IoDSA, 2009a). This reduces the cost of corporate governance compliance, because companies can adopt and adapt practices as they see fit. Sometimes voluntary codes, like *King III*, require publicly-listed companies to disclose whether they have complied with best practice or explain why not. Anand (2006) points to a company’s incentive to comply with voluntary good governance practices in order to appease major shareholders and entice further investment. However, there is no recourse against companies that fail to comply with best practice, other than disinvestment. On the opposite end of the spectrum are mandatory corporate governance codes which allow for state policy objectives to be built into corporate governance rules. Given the importance to society of reducing pay inequality,

mandatory corporate governance code provisions related to executive pay would be most effective.

Most countries' corporate governance codes contain guidance on the use of remuneration consultants. This is because not all directors are knowledgeable about executive remuneration and executives might capitalise on this by retaining a management-friendly remuneration consultant to advise the board. Some codes require the committee to consider factors that would affect the advisor's independence, recommending that the consultants not advise human resources or the executive, and that the consultants be appointed directly by the remuneration committee to avoid conflicts of interest with executives, and also require disclosure about how much the consultants were paid and how the board ensured their advice was independent (SEC, 2012; European Union Commission, 2009; Financial Reporting Council, 2016; Australian Government, 2011).

5.6 Disclosure

In order for executive pay to be monitored by shareholders and other stakeholders, it is essential that clear information is available on top compensation packages and company remuneration policies. Requiring disclosure of the specifics of executive remuneration and remuneration policies is fairly standard worldwide. However, this disclosure is criticised in South Africa as being difficult to understand due to the complexity of executive pay arrangements, the multiple variables used to evaluate whether incentives vest in a particular year, and the varying methods used to report this information (Massie *et al.*, 2014). Similar criticisms have led to attempts to standardise required remuneration disclosure across companies in other parts of the world. For instance, companies in the United Kingdom must produce both a remuneration report, which explains its remuneration policy, and an annual implementation report (UK Government, 2013a; UK Government, 2013b). The implementation report must include a single figure sum of all components of remuneration paid to each executive. The regulations contain detailed requirements on how this is to be calculated in order to ensure uniformity across companies. Similar requirements on how remuneration is to be disclosed and calculated exist in the United States and Australia. If wage inequality is to be reduced in South Africa, this issue needs to be addressed in order to prevent companies from obscuring actual levels of executive pay.

In an attempt to reduce pay differentials, the United Kingdom also requires companies to disclose various pieces of information related to employee pay, such as any difference between their policy on director remuneration and employee remuneration, whether director remuneration was compared to employee remuneration, whether the pay and employment conditions of other employees was taken into account and whether employees and shareholders were consulted (UK Government, 2013b). These requirements ensure that those concerned with pay equity at least have some information available. They also encourage companies that follow best practices to take the pay of lower-level employees into consideration when setting the pay of executives. These requirements could be strengthened and companies could be required to explain how they are working to reduce differentials between executives and other workers in the company. Boards could also be required to consult with employees on these issues.

5.7 Conclusion

Refocusing the corporate governance model from one based on maximising shareholder value to one based on ensuring the long-term sustainability and growth of the company could be an important step to curbing excessive executive pay and reducing pay ratios. Beyond this, the possibility of strengthening South Africa's SOP should be considered in light of its potential effectiveness and the possibility of unintended consequences, and methods to encourage or require institutional investors to engage with the SOP should be considered. These policies could be accompanied by one that requires employees to sit on remuneration committees in order to expand the perspectives of directors on company remuneration practices. Finally, South Africa's purely voluntary method of corporate governance and its policies with respect to remuneration disclosure and the use of remuneration consultants should be reconsidered in light of international best practices that may help to reduce pay inequality.

6 State incentives, regulation, employment and investment strategies

As one of the main employers in South Africa, the state has an important role to play in setting wage standards. The government should disclose pay levels and pay ratios within its ranks, actively work to reduce those ratios and ensure that its suppliers and contractors are doing the same.

6.1 The government as a model employer

Pay disclosure within all levels of the government could be a useful first step to reducing wage inequality in the public sector. The *Hutton Review of Fair Pay in the Public Sector* (Hutton Review) conducted in the United Kingdom recommended that the government establish benchmarks for the pay of CEOs in public entities and that it disclose the full pay of executives as well as top-to-median pay ratios each year (Hutton, 2011). As a result, legislation was enacted to require certain public bodies to disclose the remuneration policy of its chief officers and its lowest-paid employees, as well as the relationship between the chief officer's pay and that of the rest of its employees (UK Government, 2011).⁹ As another example, California has a searchable database of all government employees' pay (California State Controller, 2016). A study by Mas (2016) found that the California requirement to disclose municipal salaries reduced the compensation of city managers by 7% on average. This reduction occurred in municipalities where salaries appeared to be excessive even if the resulting reduction led to the city manager quitting and the council having a difficult time filling the vacancy (the resignation rate among managers affected by the rule increased by 75%).

The Hutton Review further recommended that employees be members of state remuneration committees on the presumption that this would moderate the pay of top earners by taking into account the views of wider society. Finally, it was recommended that the government should publish a 'Fair Pay Report' that sets out trends in pay multiples across public services and names and shames public bodies that have not provided justifications and explanations for their pay multiples. Should this naming and shaming fail to produce change and certain bodies fail to address unfair multiples, the government should intervene to control pay directly in the organisation concerned by setting pay bands or a maximum pay level as discussed in Section 4. These Fair Pay Report recommendations were not acted upon, but remain sound policy suggestions for pay regulation in the public sector, with possible applicability in the private sector as well.

6.2 Pay of government suppliers

The government can reduce pay inequality in its private-sector suppliers and contractors and among those that receive public funding. Using public procurement to support fair pay and social protection is supported by international organisations such as the International Labour Organization (International Labour Conference, 2008). The Hutton Review recommends that the government encourage major suppliers to disclose senior managements' pay so that it can be tracked. Pay disclosure requirements apply in the United States when 80% of a contractor's or supplier's revenue is from federal contracts, grants and loans, giving taxpayers an understanding of how much

⁹ See also: Department for Communities and Local Government, 2015; HM Treasury, 2016.

government funding is used to pay executives (US Government, 2008). Disclosure is a good first step. However, such disclosure could be extended to all salaries paid by contractors and other service providers in order to assess pay ratios, or the direct disclosure of ratios (bearing in mind the methodological issues discussed in Section 3). Alternatively, a certification process could be implemented in which suppliers or contractors have to prove that a company's pay ratio falls below a certain level (analogous to the requirements of black economic empowerment scorecards in South Africa) (Lawless, 2017).

Public procurement laws can be amended to favour suppliers with lower levels of wage inequality. McCrudden (2007) summarises a number of ways that procurement laws can be used to require compliance with certain public policies. For example, procurement laws can prohibit someone from bidding for a government contract if they do not meet established pay ratio criteria. Mandatory pay ratios can be inserted into a public contract once it has been awarded. Alternatively, equity considerations can be taken into account at the award stage: pay ratios can be used as a tie-breaker between equivalent bids; a quota can be established requiring that a certain portion of government contracts meet stipulated pay ratios; contractors who meet stipulated pay ratios can be granted preferred tenderer status; or a price preference can be given to contractors who meet pay ratio criteria, where an additional percentage is added on to the bid price of all firms that do not meet the criteria.

Some American states have attempted to insert pay equity concerns into their procurement policies. For example, a failed bill gave procurement preference to businesses whose highest paid executive received no more than 25 times the median compensation of non-executive employees (Rhode Island, 2015). While the successful implementation of pay ratios into government procurement policies has yet to occur, it remains a viable policy option. Beyond inserting pay ratio criteria into procurement policies, the government can also establish a legislative limit on the amount of executive compensation that contractors can bill the government for reimbursement, as is done in the United States, in order to prevent public funds from being spent to further wage inequality (White House, 2016). Finally, some government procurement policies require suppliers to make provisions for union drives at their establishments. For example, the city of Petaluma included a condition in a loan for the building of a hotel that the hotel must remain neutral during unionisation campaigns, resulting in a unionisation drive, the recognition of a union and the completion of a collective agreement (Luce, 2012).

ILO Convention 94 supports fair pay for government contractors by providing that in contracts with the government for the expenditure of public funds for public works, the manufacture of supplies, or the performance or supply of public services, must include clauses ensuring that workers' wages and other conditions are not less favourable than other government workers in terms of national law, collective agreement or arbitration awards (ILO, 1949a). ILO Recommendation RO84 contains a similar requirement when companies are given government subsidies (ILO 1949b). In accordance with ILO policy, the International Labour Conference (2008) reports that Brazilian law prevents the government from accepting a bid unless the cost is compatible with the payment of market wages and the proposal refers to wages for each occupational category established by collective agreement. Similarly, the International Labour Conference (2008) states that in South Korea, contractors must include premiums for welfare, health and safety insurance and contributions to retirement schemes as itemised expenses in order to prevent contractors from failing to provide insurance to their workers.

These conditions could be adopted by all levels of government, from the national level down to the municipal level. These conditions do not need to be limited to procurement: they could be made a condition of government funding, grants, loans, the lease or purchase of government property or of obtaining planning or zoning permission.

The major criticisms of using procurement policies to achieve social goals are summarised by McCrudden (2007). One criticism is that procurement policies should only prioritise price considerations, on the contention that paying higher prices reduces funds available for other social goals. Additionally, it is argued that it is unfair to require those dependent on government contracts to do more than other companies and that this may reduce competition and create barriers to entry, concentrating power among large companies. Finally, some contend that these policies unfairly privilege workers associated with the public sector. However, governments do not always pay the lowest price for goods and services: for example, many governments would be unlikely to choose companies whose goods were produced using child labour, even if they offered the lowest price. Similarly, government should not pay the lowest price when doing so leaves workers in poverty and exacerbates inequality (even if this does not apply to all workers in the economy). Further, higher wages for lower-paid workers could result in reduced welfare payments, thus easing the burden on the fiscus. The issue of whether procurement policies lead to increased firm concentration is important to consider. However, encouraging large companies to pay fair wages that reduce inequality in society through government procurement may be one of the most effective ways of reducing pay differentials beyond the state sector. Given that the South African government spends R500 billion on procurement a year, this may be a powerful lever (Chipkin, 2016).

6.3 Living wage requirements

The living wage is an independently-calculated amount, often higher than the prevailing statutory minimum wage, that estimates the wage needed to meet the cost of living in a particular country or region. A living wage could be calculated for South Africa, and the government could commit to becoming a living wage employer, paying no less than the living wage and requiring the payment of a living wage by its suppliers and contractors. Certain local councils in the United Kingdom have adopted living wage requirements in their procurement policies. For example, suppliers to the Birmingham City Council must sign a charter which mandates signatories to adopt the living wage (Centre for Local Economic Strategies, 2014). Similarly, the Norwich council requires tenderers to answer questions regarding the living wage and the council scores answers in a manner that favours living wage employers, while in Islington, a living wage requirement is inserted into supply contracts.

Living wage ordinances have also been passed by over 100 cities and counties in the United States, requiring businesses that enter into contracts or receive funding from the government to pay workers a living wage sufficient to keep a family out of poverty (Clain, 2012). Thompson and Chapman (2006), studying 20 American cities, found that the cost of implementing living wage laws added less than 0.1% to each city's budget. Aggregate findings also predominately show such ordinances benefit working families (Thompson and Chapman, 2006; Fairris *et al.*, 2005). While some of these studies have found no evidence of diminished employment or even increases in employment, others found that job losses impacted 1% of workers receiving a raise (the relationship

between job losses and increases to minimum wages has been extensively researched and on aggregate the impact is very slight or neutral and often statistically insignificant). Many firms are able to respond to increased wages by increasing productivity, reducing profit margins, reducing the wages at the top of the pay hierarchy or slightly increasing prices instead of cutting employment; consumer demand in the economy is also likely to be buoyed, with aggregate positive benefits for businesses (Isaacs, 2016).

6.4 How state pension funds can influence pay

State pension funds are some of the largest institutional investors in the world. Beneficiaries of these pensions are not merely shareholders in the companies in which their pensions are invested but may also be workers in those companies and members of a community with diverse interests beyond the share price (Davis, 2009). Davis (2009) argues that pension fund trustees can exercise their duties in a way that furthers the interests of their beneficiaries as workers, retirees and community members, and not merely as shareholders. For example, a policy could be created that requires state pension funds (or even all pension funds) to take steps to encourage companies in which they invest to reduce income differentials and promote pay equity. Additionally, pension funds could include appointees by trade unions representing employees in order to incentivise such funds to engage on this issue for the benefit of those employees (Davis, 2009).

There are many examples of pension funds using their position to engage in activism for the benefit of employees. Norway's Sovereign Wealth Fund will not invest in Wal-Mart because of its employment practices, while the California Public Employees Retirement System is an activist investor that restricts or prohibits investing in countries with poor labour practices (Ghahramani, 2011, 2014; Macalister, 2006). Marlowe (2014), studying the performance of American pension portfolios, found no indication that taking socially responsible investment considerations into account harms the return to beneficiaries.

There are some hurdles to using public pension funds to achieve social goals. As Ghahramani (2011) suggests, legislation may be needed to demarcate how the duty to encourage pay equity interacts with the duty of the trustee to maximise returns. He notes that beneficiaries of pension funds, who pay into the pension funds set up by the employer, have little choice in practice as to what companies to invest in and how their money should be invested, unlike other investors in the market (Ghahramani, 2011). If restricted to state pensions, this may place state employees at a financial disadvantage compared to other investors because every time trustees engage in dialogue or corporate governance negotiations with the companies in which they hold shares, this costs the pension time and money that may not be outweighed by the benefit of the increased engagement. This cost needs to be weighed against the potential benefit of the increased pay equity that may result from the policy. Nevertheless, due to their market size public pension funds have the capacity to significantly influence the behaviour of the corporates within which they invest.

In South Africa, the Public Investment Corporation (PIC) invests on behalf of the Government Employees Pension Fund (GEPF), which in 2015 had assets worth \$103 billion USD under management, making the GEPF the 20th largest pension fund in the world and the 8th largest sovereign pension fund globally (Willis Towers Watson, 2016a). According to the PIC 2015/16 annual report its portfolio "represents over 12.5% of the Johannesburg Stock Exchange (JSE) equities market capitalisation" and

“more than 42% and 50% of Government bonds and SOE bonds respectively”. This means that the PIC is the largest market player. Unfortunately, beyond BEE concerns, the PIC has not historically played the role of an activist investor concerned with wage equity considerations.

6.5 Conclusion

The state is in a strong position to act as a model employer and effect the changes it wants to see in the rest of society. This can be done by publishing pay differentials in the public service and in state-owned enterprises. It can also be done by enacting a fair-pay policy that mandates pay ratios and/or a maximum and minimum salary together with a fair pay report that names and shames poor performers. Beyond this, the state can use procurement policies, conditions of loans and funding, and conditions of leases or zoning permission, to encourage companies to reduce pay differentials. Even further, the state can become a living wage employer to ensure that all of its employees make enough money to support their families. This living wage policy can be extended to government contractors and suppliers. Finally, large public investors can leverage their position as shareholders to achieve greater equity.

7 Tax policy

Tax regimes have far-reaching implications for income distribution. Corporate taxes can be used to influence the behaviour of companies and encourage greater pre-tax income equality, while personal income taxes can be used to reduce post-tax income inequality. Other forms of tax, such as VAT also have an impact on equity in terms of actual spending power. Because our focus in this paper is on wage income inequality, we focus on forms of taxation that impact wage incomes, excluding others, such as a wealth tax. We acknowledge that these other taxation measures are important for issues of equity and need further investigation.

7.1 Corporate tax incentives

Corporate taxes can be used to incentivise a company to reduce wage inequality among its employees. Tax penalties, such as increased tax rates, surtaxes or disallowed deductions make certain forms of remuneration more expensive and thus less attractive, while tax incentives – such as deductions, credits, deferrals and special rates – can increase the benefit to companies of remunerating employees in a certain way.

Tax penalties on certain forms of remuneration raise the cost to the company of paying that form of remuneration in the hopes of discouraging the company from doing so. There are many examples of tax penalties on executive remuneration. The United States placed a 20% excise tax on golden parachute payments (made to executives upon the takeover of the company) above 300% of an executive's base pay (Zolt, 2015). In Israel, a tax penalty prevents an amount equal to twice the difference between an executive's compensation and a set pay cap from being tax deductible (see Section 4 for further detail). An ordinance passed recently in Portland, Oregon, will place a surtax of 10% on publicly-listed companies' existing tax liability to the city if the CEO is paid more than 100 times what the average worker earns, and an extra 25% if the CEO makes more than 250 times (Portland City, 2016). Following the recent financial crisis, a number of proposals in the United States were made to penalise companies for paying exorbitant amounts of remuneration, although none of these proposals were passed into law. One proposal would have made bailed-out companies liable to paying a 35% excise tax on bonuses above \$50,000 USD (Anderson *et al.*, 2009; Smith, 2009). Another would have denied a deduction for any compensation higher than 25 times the lowest paid employee, or \$500,000 USD (Anderson *et al.*, 2009). A final proposal would have denied companies a tax break for any executive compensation paid over \$1 million USD if other individuals in the company earn under \$118,500 USD per annum and are not given raises to reflect increases in the cost of living and labour productivity (US Government, 2016).

Tax penalties on executive remuneration make remuneration more expensive for companies. However, this increased expense alone may not deter companies from paying compensation above the threshold level. Instead, companies might see the threshold as setting a standard or a floor for payments. This happened with the golden parachute excise tax mentioned above, where many companies took the view that the tax created a competitive floor for golden parachute payments (Mullane, 2011; Murphy, 2011). Similarly, when the United States enacted Section 162(m) of the Internal Revenue Code to prohibit companies from deducting from taxable income more than \$1,000,000 USD in non-performance-related compensation, companies began to view the salary cap as a competitive salary floor rather than a ceiling, the

opposite of what was intended, with a large number of firms forfeiting tax deductions (US Government, 1986; Polsky, 2007; Mullane, 2011; Murphy, 2011). Another problem with Section 162(m) was that it only applied to non-performance related pay (such as salaries), while performance-related compensation (such as stocks and options) remained deductible and not subject to the cap. An unintended consequence of this distinction noted by Polsky (2007) and Mullane (2011) was that, following the enactment of Section 162(m), companies increased grants of stock options. It is debated whether the explosion in stock option grants after the enactment of Section 162(m) was caused by this provision or by institutional investors preferring performance-related options to fixed salaries (Hall and Liebman, 2000). Regardless, in order to avoid a similar unintended consequence, any tax penalty or denial of deductibility could be made to apply to all forms of compensation and not merely one component. Additionally, any tax penalties should be supported by other policies to discourage companies from continuing to pay salaries above the limits, including higher personal income tax rates that eliminate the benefit of being paid these amounts.

Tax penalties have a limited reach. For example, Zolt (1989) explains that the loss of a tax deduction will not affect companies that do not pay tax or pay very little tax, such as corporations turning a loss or tax-exempt organisations. It will also not affect companies such as Google that do not pay tax in South Africa despite having employees here, or those companies that use tax planning and avoidance strategies to reduce their tax base such that their taxable income in South Africa is negligible (Smith, 2014). Finally, companies may be willing to stomach the tax surcharge either because it is not large relative to overall company costs or because they still wish to prioritise executive pay. However, when combined with other measures, a properly designed tax penalty may have a role to play in reducing wage inequality in South Africa. It is one of a number of steps that could be taken to enforce compliance with any equity-enhancing policies adopted by the government.

Beyond using tax penalties, companies can be incentivised to engage in certain remuneration strategies if a tax credit is offered to employers for reducing wage inequality. For example, although not related to wage inequality, small businesses in the United States can claim tax credits of between 25% to 40% of an employee's wages for hiring employees who face barriers to employment (McKinley and Datoush, 2014; Danzinger and Boots, 2008). Until recently, the Dutch government also gave tax relief to employers whose workers earned 115% of the minimum wage (Delsen, 2011). A similar tax credit could be given to companies with certain pay ratios or who are certified as living wage employers.

Tax credits are, however, frequently criticised by economists as an inefficient and ineffective way of achieving social goals (Klemm, 2009; Zolt, 1989; Barbour, 2005). Zolt (1989) explains that tax incentives can cause multiple forms of loss, from lost tax revenue, including that foregone from projects that a taxpayer would have undertaken even without the incentive, to the cost of enforcing and monitoring compliance with the conditions of the incentive. Barbour (2005) finds little evidence that tax incentives improve economic welfare once the cost of lost tax revenue, higher taxes for other taxpayers, and the administrative costs are factored in. Tax incentives in South Africa have a shaky record of providing cost-effective results. The Employment Tax Incentive (ETI), which came into effect in January of 2014, provides a tax deduction for a portion of the company's wage bill that is paid to certain youth employees, with the goal of reducing the youth unemployment rate by lowering the cost of hiring young workers. Ranchhod and Finn (2016) find no evidence that the ETI caused an increase in youth

employment. Instead it has resulted in a loss of tax revenue, effectively amounting to a subsidy to firms employing youth in positions that would have been filled even without the ETI.

Beyond a direct tax credit, another method of incentivising equality-enhancing remuneration policies is to lower the corporate income tax rate progressively for companies that have lower pay ratios between the top and bottom, such as a scheme proposed in California which would have reduced corporate tax rates by almost 50% for companies with top-to-median pay ratios below 25:1 (California Legislature, 2014). Rather than penalising companies for bad pay practices, it incentivises companies to reduce differentials, thus taking advantage of a lower corporate tax rate. Like the tax credits discussed above, however, this form of progressive tax scheme has the potential to result in large tax revenue losses while providing an unquantifiable benefit in terms of the number of companies that reduce pay ratios as a direct result of the policy. Griffith *et al.* (2010) find that similar tax reduction schemes in Europe which provide up to a 50% reduction in taxes for the development of patents have resulted in a large loss in tax revenues that are not overcome by revenues from increased economic activity. Therefore, any attempt to reduce corporate taxes or provide tax credits based on lowering executive pay levels should be carefully scrutinised.

Surrey (1970) and Zolt (1989) argue that government incentives should be administered not through tax credits and penalties but through other programmes, allowing agencies tasked with various forms of economic management – for example, labour or industrial policies – to be responsible, rather than expecting the tax authorities to begin to police behaviour unrelated to the payment of taxes. As Surrey (1970, p. 706) states, the government could use “direct expenditures, interest subsidies, direct federal loans, and federal insurance or guarantee of private loans as alternative methods to accomplish the purposes which the special tax provision seeks to achieve or encourage”. Barbour (2005) notes also that government programmes such as grant schemes form part of the government’s budget, allowing for greater levels of supervision, unlike tax incentives whose cost to the system is rarely calculated. Additionally, Surrey (1970) notes that while tax credits favour those businesses with existing high tax burdens, they do not help new businesses with start-up losses or informal businesses, while a government subsidy or loan program designed to achieve the same end could help all businesses regardless of their tax status. These forms of government support were discussed previously in Section 6 and are likely preferable to a system of tax credits or breaks.

7.2 Personal income tax

Progressive taxation directly increases equity by reducing the take-home income of top earners in society more than for other earners and allowing for this income to be redistributed. Guvenen *et al.* (2014) examined the impact of income tax policies on wage inequality, finding that countries with more progressive income tax policies had significantly lower levels of wage inequality and a smaller rise in wage inequality over time. One reason cited by Guvenen *et al.* (2014) that progressive tax policies reduce wage inequality is that progressive taxes reduce the marginal benefit of human capital investment, thus reducing labour supply (at the top), and compress the before-tax wage distribution. Piketty (2014) argues that another reason for this is that executives have a greater ability to bargain pay raises in countries with the lowest top marginal tax rates because more of the raise ends up in the pocket of the executive. At a certain level of taxation, however, the cost and effort required to negotiate an extra dollar of pay will not outweigh the after-tax benefit of that dollar. At the same time, a board will have a

difficult time justifying a million dollar pay rise when the executive would only receive, for example, 10% of that increase. As a result, a high rate of tax will help to moderate pay. According to Piketty (2014), this theory is consistent with the low executive pay levels seen in the United States and Britain between 1940 and 1970 when tax rates were as high as 98%. Piketty concludes that a key policy needed to reduce wage inequality is dissuasive taxation with an optimal rate of tax greater than 80%, as in the United States and the United Kingdom before 1980. Given this, Piketty (2015) argues that redistribution through taxes (rather than directly increasing wages at the lower end) may be more efficient as it still allows the market to play its allocative role.

There is room to increase the rate of tax on high-income individuals beyond South Africa's current highest tax rate of 45%. Tax rates are over 50% in Japan, 47.5% in Germany and 57% in Sweden. In the wake of the global financial crisis such increases have been common, with 21 out of 35 OECD increasing the top marginal tax rate between 2008 and 2014 (OECD, 2014). Similarly, capital gains taxes have increased in a range of countries including France, Italy, South Korea, the United Kingdom and the United States, while in Brazil, Spain and India non-residents were charged higher rates. Given that financial assets are even more unequally distributed than wage income, increasing capital gains taxation can significantly reduce overall income inequality. In addition to arguments in favour of raising rates for high-income earners, lawmakers in the United States have proposed legislation which would place an additional 4.6% tax on families with incomes over \$1,000,000 USD and a 90% tax on bonuses for individuals whose family income exceeds \$250,000 USD (US Government, 2009b and 2009c).

Despite common arguments to the contrary, there is evidence that indicates that the wealthy do not generally relocate to low-tax jurisdictions in response to tax increases because they are embedded in the communities where they have achieved financial success and are reluctant to move solely to gain a tax advantage (Young *et al.*, 2016; Young and Varner, 2011; Tannenwald *et al.*, 2011). Young *et al.* (2016, p. 421) studied the migration patterns of all millionaires in the United States in response to so-called millionaire taxes on top income-earners over twelve years and found that while some high-wealth individuals do indeed move to lower-tax states in response to tax increases, this occurs "at the margins of statistical and socioeconomic significance" with a 10% tax increase leading to the migration of 1% of millionaires to states with lower tax rates.

Critics of raising the highest rate of income tax argue that this system will not bring in a great amount of additional tax revenue because it will motivate high earners to work less, thus lowering tax revenues (Godar *et al.*, 2015). However, as argued by Piketty (2014), the point of a higher income tax is not to earn revenue, but to reduce top incomes. Additionally, studies of the responsiveness of executives to changes in tax rates suggest that executives fail to respond to tax hikes by changing the level of their income and that the long-run income elasticity of executives is modest (for a summary see Walker, 2013). Thus, changes in executive tax rates do not tend to encourage executives to work fewer hours, meaning tax revenues would potentially increase. Even if individuals at the top of the income tax bracket do respond by working less, inequality will still decrease as top incomes will be lower. However, if high-income individuals respond by engaging in tax evasion, as has been observed in some studies, inequality may increase because they will not pay taxes on unreported portions of their income (Duncan and Peter, 2012). The country context, broader tax code, enforcement

capabilities and institutional framework within which the policy is implemented are therefore important and may need to be strengthened in tandem.

Even with a higher income tax bracket, some companies may continue to pay their executives exorbitant amounts to serve as a benchmark for other executives in the company, to lessen the effect of compression at the top of the company, and to bolster the status of the top executive (Bank *et al.*, 2016). Tax policy is not able to deal with companies who have these motivations. An outright ban or cap on certain amounts of pay would be the only solution in these cases.

Advocates of a higher tax on earnings above a certain threshold have argued that these taxes must have two features: they need to be permanent in order to prevent executives shifting the timing of their income to take advantage of a reduced tax rate, and they need to prevent companies from grossing up an employee's income to cover the tax (Walker, 2013). The abortive attempt by France in 2012 to institute a temporary two-year super tax of 75% on those earnings over €1 million highlights the former issue (among other problems) as companies agreed to compensate affected employees for the loss of income following the expiration of the tax (Penketh, 2014). Regarding the latter, Ruf and Schmider (2015) studied CEO pay and taxation in 28 countries (including South Africa) between 2003 and 2013 and found that an increase in the effective top tax rate by 10% (a feat achieved by many countries including the United Kingdom, Spain, the United States and France) raised pre-tax CEO pay at company level by 12%. While some of the tax burden is borne by the executive, a larger portion of it is borne by the company. Policy makers must, therefore, include measures to discourage grossing-up, such as by making the tax rate sufficiently high that the increased cost of grossing-up the CEO's salary could not be justified by the board. This policy could also be accompanied by other measures.

As with all forms of tax, any proposal to tax only one form of an individual's income may be ineffective at reducing their actual take-home pay, as individuals may negotiate to be paid in a different form. Thus, any increased rate of tax must be directed at total compensation. A higher rate of income tax for South Africa's top earners, combined with tax penalties for companies that pay extreme levels, could be combined to reduce the benefit to both the company and the executive of exorbitant levels of remuneration.

7.3 Conclusion

Taxing high-income earners and using the tax revenue in more equitable ways, whether through redistribution or social programmes, is an effective means of achieving greater equality in after-tax incomes. Taxation could take the form of an additional tax bracket targeting extreme levels of income. Any tax policy must be addressed at total income, or it will be ineffective at reducing the take-home pay of executives. This form of taxation could be combined with corporate tax penalties for companies that pay remuneration above a certain level. This double-pronged tax approach could be effective at reducing the incomes of those in the top pay brackets, especially when combined with other strategies to reduce pay inequality.

8 The role of trade unions and collective bargaining in reducing inequality

A large body of literature has shown that collective bargaining plays an important role in moderating levels of wage inequality (Wallerstein, 1999; Hayter and Weinberg, 2011; Coats, 2013; World Bank, 2012). In fact, within the labour market, collective bargaining institutions may be the most important determinant of earnings inequality, playing a more important role than skills dispersion (Howell and Huebler, 2004). International studies have found that unions have the greatest impact on inequality the higher the level at which bargaining occurs (i.e. national or sectoral vs firm-level), the higher the level of coordination between unions, either formal or informal, the greater the coverage of collective agreements, and the higher the unionisation rate (Wallerstein, 1999; OECD, 2004; Coats, 2013; World Bank, 2012).

Interestingly, in countries with a high level of centralised bargaining coordination, collective agreements result in lower wage increases for unionised workers in some firms than would firm-level bargaining (Speckesser *et al.*, 2015). Industry-level bargaining pulls down wages in firms that would be able to pay higher wages in order to accommodate those firms that are unable to pay at those levels. However, while firm-level bargaining tends to provide greater intra-firm wage equality, it also has the effect of increasing inter-firm wage inequality.

Sectoral-level bargaining also does not have to preclude strong firm-level unions from then engaging in firm-level bargaining in order to receive additional benefits above the minimum negotiated for the sector. Many countries, including South Africa, allow companies and employees to bargain at multiple levels, whether at the national, sectoral or individual firm level, although this tends to be strongly resisted by employers.

One challenge facing firm-level or industry-level bargaining is that employees can be working in the same workplace as workers from one industry or firm but be considered employees of another industry or firm. For example, temporary contractors, security personnel or cleaning staff can be outsourced. Although these employees work in the same workplace as unionised employees in a firm, they are covered by a completely different collective bargaining arrangement, if they are covered at all. Both enterprise-level and industry-level bargaining, which results in lower intra-firm inequality, fail to cover these marginalised workers.

Over the last three decades, collective bargaining coverage has reduced globally as unionisation rates plummet. South Africa is no exception, with unionisation of the workforce dropping from a peak of 45.2% of total employment in 1997 to 25.4% in 2012 (Steyn, 2014). In part, this is due to global trends of work shifting away from formal full-time employment (the traditional bread and butter of trade unions) to more flexible arrangements, including part-time employment, outsourcing, temporary-agency work and contract work. Unions have been unable to keep pace with the changing face of employment. Given the success of collective bargaining at reducing wage inequality, it is important to consider ways of strengthening unions and collective bargaining. Methods to increase unionisation rates, expand collective bargaining coverage, strengthen unions' collective bargaining strategies and expand their focus beyond traditional full-time employment need to be key aspects of any policy South Africa adopts to reduce wage inequality.

8.1 Strengthening bargaining institutions

One means through which to incentivise previously non-unionised workers to join unions, described by the Trésor-Economics République Française (2014), is to link union membership to the provision of benefits, such as unemployment benefits, as is done in Sweden (although this has the potential to rob some workers of unemployment benefits), or by offering services such as advice on labour laws and employment legislation, free legal aid, financial services such as home insurance, quarterly union bonuses or bonuses for marriage and birth. Making union membership beneficial to employees beyond the scope of wages would encourage more employees to become members. Furthermore, some unions, such as UNISON in the United Kingdom, have focused on new ways of marketing themselves beyond the traditional union rally (Economist, 2015). UNISON has, for example, created an app which is popular with younger workers, advertises in newspapers and on television, and highlights the provision of free legal advice for members. If unions are to be successful in recruiting members in the new millennium, they must adapt to new technology and appeal to workers of a younger generation.

In order to provide additional benefits to union members, unions must have sufficient funds to do so. In France, Trésor-Economics République Française (2014) notes that the government provides tax credits to employees on union dues paid. Trésor-Economics République Française also describes how companies have taken proactive steps to support unionisation. For example, the Axa Group pays union cheques to its employees who may then decide which union to pay it to, or not to pay it at all, in which case it gets returned to the company. Such schemes could form part of regulation designed to increase union membership.

As a last resort, union membership could be made a mandatory condition of employment in an industry, similar to the concept of a closed-shop union in a firm. For example, in the province of Quebec in Canada, the government passed legislation requiring that employers only hire construction workers that are members of one of five unions (Supreme Court of Canada, 2001). Wyatt and Robillard (2013) report that this provision has not had an impact on the ability of small employers to compete with larger employers, given that 82% of the industry has five or fewer employees. Not only could such a provision provide protection for temporary agency employees and informal workers by requiring them to become union members, it would naturally increase the size of the bargaining unit. This approach overcame a constitutional challenge when the Supreme Court of Canada (2001) declared that it did not constitute an infringement of the freedom not to associate because union members were not required to conform to the views espoused by their unions. Furthermore, the court found that even if the law did constitute a violation of the freedom not to associate, it would have been a reasonable limit on that right in order to establish peace and harmony in an industry plagued by conflict.

While increasing membership must be a focus of unions, another possible approach is for the government to recognise declining union membership as a reality and eliminate the requirement for unions to represent 50% of employees in a workplace in order to be entitled to certain organisational rights. In France, for example, unions have vast powers to conclude collective agreements even if they do not represent the majority of the workforce. All companies with 50 or more employees must set up a works council and employees then vote on representatives (Laulom, 1995). A union must have the

support of 10% of the workforce in the works council election in order to sign a valid collective agreement. The agreement must be signed by unions that combine to receive at least 30% support in the works council election (European Trade Union Institute, 2014). Similar rules apply at the industry and national level. These agreements can then be extended by the Minister of Labour across the industry despite the relatively low levels of formal support required to establish them. However, this strategy must be considered in light of the fact that it may reduce the impetus on unions to revitalise their membership and encourage employees to free ride off the work of union members.

Another way to strengthen the collective bargaining system is to provide unions with a right to engage in collective bargaining with an employer. Many countries, including the United States, France and Canada, require companies to bargain with trade unions in the form of a legally enforceable right and a corresponding duty to bargain collectively. A duty to bargain is meant to prevent strikes for union recognition, and prohibit companies from breaking up unions that are too weak to strike for recognition, by balancing the bargaining power of the employer and the union. This system essentially ensures that once a union is recognised by law it then has the ability to negotiate with the employer to influence pay decisions. Inherent in the duty to bargain in good faith is the substantial role played by courts, labour boards and arbitrators in determining the content of that duty. What are the subjects over which they must bargain? What does it mean to bargain in good faith? What happens if the parties fail to bargain in good faith? While some of these issues can be resolved by statute, the presence of strong, independent courts, labour boards and arbitrators is crucial (Labour Law Casebook Group, 2004). In some instances, the high level of involvement from courts and arbitrators can be negative. Rather than being a voluntary process enforced by the right to strike, bargaining becomes a highly-regulated activity with the court making pronouncements on the behaviour and obligations of the parties at many stages of the process. It complicates and legalises the process while also making it very costly. Additionally, it is very difficult to transplant a duty to bargain at the level of the firm to the level of the industry because both the number of bargaining partners and number of topics to be bargained increases. A complicated and legalistic system becomes even more complicated at the industry level.

8.2 Extension of collective agreements

Hayter and Weinberg (2011) find that the extension of collective agreements (instead of just bargaining alone) reduces wage inequality. The extension of collective agreements is supported by ILO Convention RO91 which recommends that states extend collective agreements when one of the parties to the agreement requests the extension, and the parties to the agreement are sufficiently representative (ILO, 1951). In accordance with the Convention, any parties that will be subject to the extended agreement must be able to submit their opinion before the agreement is extended. There are three main forms of extension as explained by Traxler and Behrens (2002). First, extension of collective agreements to non-parties within the agreement's area of application may be automatic or subject to certain criteria being met (*erga omnes*). Second, extension by 'enlargement' occurs where a collective agreement concluded in one area is made to apply in sectors or regions where there is no union or employers' association capable of concluding a collective agreement. Third, functional equivalents to extensions, such as making membership in an employers' association mandatory or making compliance with a collective agreement a condition of government procurement, also exist.

There are examples of countries with *erga omnes* extension clauses that are virtually automatic. For example, in France, a country with only 8% of its employees belonging to a union, collective bargaining coverage is very high (93%) due to the Minister of Labour's extensive power to extend collective agreements to non-parties (Trésor-Economics République Française, 2014). The Minister is able to extend any agreement if one of the parties to the agreement or the state requests it, even if the parties do not represent 50% of the members of an industry. In order to refuse extensions, the refusal must be based on public interest, economic or social policy reasons and a court must ensure the Minister is not abusing its power in refusing the extension. As a result, Trésor-Economics République Française (2014) finds that 80% of collective agreements are submitted for extension and these requests are very rarely turned down. Similar almost-automatic extension powers exist in Austria and Luxembourg (Traxler and Behrens, 2002).

Opponents of the government extension mechanism argue that extensions hamper competition among employers, lead to firms closing down or fewer firms starting up, and discourage employment, because they force some employers to pay higher wages than they can afford (OECD, 2004; Villanueva, 2015). These concerns can be alleviated by allowing firms to apply for an exemption from the collective agreement on the basis that it will force closure or cause job loss (a practice that already occurs in South Africa). Similarly, wage concessions could be provided for in an agreement for small companies or start-ups. Legislation could require these features before an agreement would be extended. Whether these criticisms apply in the local South African environment will be studied in the policy brief series. However, many countries have successful collective bargaining regimes that do not result in unemployment, productivity losses and rigidity. In fact, unions in many countries have worked with employers to prevent wages agreements from resulting in job losses in times of economic hardship.

In Germany, the erosion of collective bargaining and the rising level of income inequality is attributed in part to an erosion of the government's will to extend collective agreements to non-parties. Retaining and strengthening this power is important although it should be balanced against the possibility that easy extension of collective agreements may disincentivise organising more workers and workers may free ride off existing unions.

8.3 Government involvement in collective bargaining

Governments can play a role in reducing wage differentials through collective bargaining, whether by setting wage guidelines for the bargaining partners, engaging in tripartite negotiations and social pacts with unions and employers' associations, or mandating collective agreements or wage settlements that achieve certain pay ratios (Wallerstein, 1999). Wage guidelines have been used by some governments as a guide for the bargaining partners. For example, while employers in the Czech Republic are free to determine wages on their own or through collective bargaining, a system of 192 pay levels (based on 16 pay tariffs) has been established by the government for use in the public sector, which serves as a guide for other employers (Festing and Sahakiant, 2013; Veverková, 2009). The tariffs are distinguished on the basis of the kind of work, the strenuousness of the work and the qualifications required, with pay in the 16th tariff level being at least 3.4 times the pay in the first tariff level. Similarly, China issued a Wage Guideline System that requires local labour administration authorities to survey, collect and analyse wages for different occupations in each city and formulate wage

levels, which are then published (OECD, 2010; Meiyang and Fang, 2016). The guidelines include a bottom line, an intermediate line, a top line and an average line, and the calculations are to be comparable across regions. According to the OECD (2010), this system is helpful for determining wage levels and has been welcomed by employers and employees in the collective bargaining process. Similar guidelines in South Africa could focus on reducing wage differentials, signalling the government's policy on these issues and encouraging the partners to reach agreement in order to encourage voluntary action in this regard.

Wage pacts between the bargaining partners and the government have been used as important tools to achieve wage policies (Speckesser *et al.*, 2015). While often used to restrict wage growth, there is no reason for social pacts to be limited to this purpose. Addressing wage inequality (for example via implementing pay ratios) could be incorporated into a wage pact. In order to encourage union and employer compliance, the OECD (2004) explains that social pacts usually involve the government committing to undertake some form of action, such as reducing corporate or personal income taxes, reducing corporate social welfare contributions, prohibiting local-level bargaining or issuing wage guidelines. The type of action taken by the government depends on the willingness of the bargaining partners to engage in a social pact.

The example of Norway demonstrates that it is possible to reverse the trend of increasing inequality levels if the bargaining partners are able to work together to achieve these goals. Following a prolonged period of decentralisation and increasing inequality in the early 1980s, Norway's government, employer associations and union federations undertook a proactive approach to strengthen collective bargaining in the country and battle inequality (Kahn, 1998). Regulation was put in place – such as the 85% rule, which holds that average wages in a company cannot be lower than 85% of the overall average wage of manual workers within the manufacturing industry (later, low-wage industries) – to secure wages at the bottom end. In addition, a low-wage fund was established in 1980 that required direct contributions from employers and workers to be distributed to low-wage workers; the fund was abolished in the 1990s and low-wage increments now tend to be calculated by doubling the increase given to higher-waged workers through collective bargaining (Fennefoss and Høgsnes, 2001). As a result of these policies, Kahn (1998, p. 633) states that:

workers at the bottom gained relative to the middle during the 1987-91 period, at the same time that low wage workers in other countries were losing ground relatively. This diverging behavior suggests that something was different about Norway, specifically the reassertion of centralized wage negotiations in 1988 with special attention given to raising the wages of the low paid.

Sweden provides another excellent example of how unions, employers and the government can work together to create a social pact that is effective at reducing inequality. Between the mid-1960s and the early 1980s, wage dispersion in Sweden declined by up to 75% (Hibbs, 1990). This is widely attributed to collective bargaining's focus on the country's solidarity wage policy – designed to reduce wage disparity within and between firms by implementing the principles of equal pay for equal work and equal pay for all work (Tsarouhas, 2008). This policy supported the concept that it is fundamentally unfair that workers of the same skill level receive different wages in different industries or firms simply because the firm or industry is more productive or profitable.

National framework agreements between Sweden's main trade union association and employers' federation set national benchmarks, and local and industry-level bargaining followed (within a set of guidelines) to improve upon the agreement where possible (Edin and Holmlund, 1995). Hibbs (1990) describes that under the typical central framework agreement, every worker would receive a common flat-rate pay increase, a wage drift guarantee payment, a flat-rate cost-of-living adjustment and a low-wage adjustment payment. The common flat-rate payment was designed to provide greater benefit to those at the lowest end of the wage scale. For example, a flat-rate increase of R1,000 on a salary of R50,000 is much more valuable than it is to someone earning a salary of R200,000. The wage drift guarantee payment was designed to compensate workers for 'wage drift' which occurs when one worker's actual wage increase is higher than the nationally-agreed-to wage increase. This happens when some workers are able to bargain for a higher wage at the firm-level. The framework agreement, expecting some wage drift, set an amount of wage drift, known as the ceiling, that was permitted at the local level. Workers who did not benefit from wage drift or whose wages rose to a level below the ceiling following firm-level bargaining would receive an amount up to the ceiling to compensate them for the fact that some employees benefitted from wage drift higher than the ceiling during the previous year. As Hibbs (1990) notes, this ensured that wage drift that benefitted only certain workers or regions would be spread throughout the entire wage structure after a period of a year, increasing pay equity within and between firms. Finally, Hibbs (1990) explains how low-wage-adjustment amounts targeted workers whose hourly wages were below a reference wage, called the low-wage-boundary. Each worker contributed to or received money from a low-wage-pot based on a proportion of the difference between their yearly hourly wage and the pre-established low-wage boundary. This redistributed income from workers earning above the low-wage-boundary to those earning below the low-wage-boundary contributed to increasing pay equality.

Erixon (2010; 2016) notes that it was recognised in advance that the solidarity wage policy may result in some unemployment and potentially the closure of firms (as all firms were required to pay at the same wage levels). As Edin and Topel (2007) explain, the policy's ultimate impact on low-skilled employment was slight due to the rapid expansion of the public sector, Swedish macroeconomic policies and the Swedish government's active re-employment policies – government programmes which were essential to the success of the solidarity wage policy and formed part of the wage pact. However, Davis and Henrekson (2005) and Arai (1994) note that the policy led to a drop in the supply of highly-educated and highly-skilled workers, in part through emigration, while Edin and Topel (2007) found that low returns to education caused by compressed wages resulted in enrolment rates in higher education dropping significantly.

Tsarouhas (2008) describes how unions representing metalworkers and engineers began to criticise the solidarity policy on the basis that it led to redistribution among wage earners rather than an increased share of the company's profits being distributed to labour. These unions left centralised bargaining in 1983 in order to secure higher wage increases for their better-paid members, leading to the dissolution of the centralised bargaining model in Sweden, demonstrating the importance that any collective bargaining strategy designed to reduce wage inequality should take into account the needs of both its low-skilled and high-skilled workers. At the same time, social pacts should be aimed at shifting the functional distribution of income from

capital to labour and creating more wage equality between workers by raising wages for low-wage workers more than those of high-wage workers.

Should social pacts fail, another option is for the government to impose mandatory wage levels, wage differentials or a wage band on the bargaining partners to structure their negotiations, similar to imposing a minimum wage. For example, the government in Uruguay is able to impose a collective agreement by decree when no consensus is reached by the bargaining partners. Mazzuchi (2009) explains how Uruguay was able to cover unprotected workers through this system, including obtaining agreements for hard-to-organise rural and domestic workers. According to Mazzuchi (2009), between 2005 to 2008, almost all formally employed workers in Uruguay were covered by collective bargaining, with the majority of agreements (184 of the 213 signed in 2006 alone), being achieved by a consensus between government, industry and labour. Bargaining was conducted in the context of guidelines published by the executive branch and minimum wages were increased more than the highest wages in order to reduce wage dispersion. A number of agreements allowed for wage differences based on geographic locations or company size and exemptions for certain firms unable to meet the terms of the agreement. Real wages increased by an average of 18.6% in four years, while employment grew by 8% and poverty rates dropped from 31.7% of the population in 2004 to 21.7% in 2008 (Mazzuchi, 2009). The ratio between minimum wages and the average wage increased by 22% between 2004 and 2012 while the ratio between the minimum wage and the median wage increased by 24%, indicating a compression of the wage structure (Maurizio and Vázquez, 2016). Whether or not this form of government involvement in the bargaining process is possible in South Africa, it is clear that the ability to impose collective agreements by decree on entire sectors if the parties are unable or unwilling to agree provides a major incentive for the bargaining partners to reach agreement that is mutually acceptable to all.

8.4 Collective bargaining strategies to reduce inequality

Various targeted collective bargaining strategies have been used by unions to reduce wage inequality. For example, Grimshaw *et al.* (2014) note that in both the British and Hungarian security services industries, collective framework agreements exist that set a minimum fee for services that the security companies can charge to clients. Part of the fee is to be passed on to the worker, raising the minimum wage. However, because unions in the United Kingdom and Hungary cannot penalise an employer for failing to charge the collectively agreed rate, employers are able to ignore the agreement. As Grimshaw *et al.* (2014) explain, this has unfortunately resulted in an increase in inequality, as workers receive different amounts for the same job depending on what the client is willing to pay. Such an approach must, therefore, be combined with a method of enforcement if it is to be successful, but it remains a viable option open to unions in the service industry.

Grimshaw *et al.* (2014) also note that in Hungary and the United Kingdom, some unions have adopted bottom-weighted bargaining strategies. In Hungary, for example, the commercial employees' trade union sought to improve pay equity in two stages. In the first stage, pay rises for senior managers were capped at a lump sum while the wages of the lowest-paid were increased by a certain percentage between 2005 and 2009. For example, in 2006, workers at one supermarket chain earning below HUF 100,000 per month received a raise of 5% while all those earning above this amount received a lump sum of HUF 5,000, meaning that the percentage increase in salaries above HUF 100,000 was progressively lower than 5% (Neumann, 2010). In 2010, the

lowest-paid workers received a lump sum increase of HUF 25,000 with no increase for higher-paid workers, resulting in an increase of the bottom pay grade relative to the minimum wage between 2007 and 2010 of between 10% and 17% (Neumann, 2010; Grimshaw *et al.*, 2014). In the United Kingdom, the retail union Usdaw managed to abolish the bottom pay grade in both 2001 and 2005, earning pay raises of 8% and then 5% for the lowest-paid workers (Grimshaw *et al.*, 2014). More recently, Japanese unions have focused on reducing wage differentials between smaller and medium-sized corporations and large corporations, announcing benchmarks for wage hike demands for smaller firms and setting settlement criteria for small unions (Japan Institute for Labour Policy and Training, 2004; Ji, 2016).

Finally, the example of the German metal and electrical engineering industry, one of the biggest sectors in the German economy, shows how unions can actively engage in a strategy to reduce inequality amongst union members (Bispinck and Dribbusch, 2011). Prior to the implementation of a new wage agreement, there were high levels of pay inequality in the industry. Workers across the industry were paid differently for doing the same or similar jobs and in order to combat this, the union engaged in a bargaining campaign to create one wage system for all employees in the industry (Bahn Müller, 2015). As an example, Metall North Rhine-Westphalia (Metall NRW) is one of the two largest bargaining regions in the metalworking industry. According to the Metall NRW 2015 salary schedule (which is similar to salary schedules bargained for by regions in the rest of the industry), pay is determined on a points-based system that evaluates job function, with 14 wage groups. The ratio between the highest and lowest-paid is almost 3:1. Obviously, this does not include executives and other management members who are not part of the union. It does, however, contain provisions for the inclusion of temporary agency workers – companies must offer temporary agency workers a permanent position after a certain period of time (18-24 months) as well as supplemental payments to increase their wages over time, resulting in increases of 15-50% (Vogel, 2012). This is an example of how unions can use their power to protect the most vulnerable workers in an industry who may not be members of the bargaining unit. It also serves as a model for achieving low levels of inequality between highly-skilled and unskilled labour in an industry.

When supported by other policies to increase minimum wages and reduce levels of executive pay, bargaining strategies aimed at reducing levels of inequality within the ranks of the union can have a great impact on wage inequality within a sector or region. However, as was discussed in the Swedish example above, this strategy should take care to ensure that wages are not only shifted from highly-skilled union members to lower-skilled union members, but that the functional distribution of income is shifted from capital to labour in order for profits to be distributed more evenly across the workforce.

8.5 Power of unions as shareholders

Unions have the ability, through union-controlled pension funds and investment corporations, to voice their concerns over pay equity at annual meetings and vote for reforms of a company's corporate governance standards as they relate specifically to employee and executive pay (Gomez and Tzioumis, 2006). In the United Kingdom, the Trade Union Congress and two of its largest affiliated unions launched the Trade Union Share Owners group (TUSO). TUSO (2013) enacted policy guidelines that recommend that TUSO and fund managers:

- oppose remuneration policies that have a top-to-average pay ratio that is higher than 20:1 and “support an aspirational goal of a 20:1 maximum pay ratio within companies”;
- oppose policies that offer pay increases for directors that are significantly higher than those for employees;
- encourage companies to adopt living wages for its employees;
- oppose performance-related pay that is more than 10% of the salary; and
- oppose pension schemes that are more favourable for directors than other employees.

Similar guidelines were enacted by the AFL-CIO in the United States (AFL-CIO, 2012). In the 2015 AGM season, TUSO voted against 16 remuneration policies at firms listed in the United Kingdom, the highest number of votes against policies of any investor group in the country that discloses its voting history (Trades Union Congress, 2016). In 2014, Kentz Corporation lost a binding vote on its remuneration policy while Burberry lost an advisory vote on its remuneration report, with TUSO voting against both resolutions (Global Unions Committee on Workers’ Capital, 2014).

8.6 Conclusion

Collective bargaining plays a central role in compressing the wage structure. Methods to strengthen collective bargaining, increase unionisation rates and extend collective agreements across sectors must be considered of primary importance in reducing inequality. For example, collective bargaining has resulted in the compression of the wage structure in Sweden, Germany and Uruguay. Steps to strengthen collective bargaining could include making union membership mandatory in certain industries, establishing a legally enforceable duty to bargain, and encouraging unions to exercise their rights as shareholders to impact corporate governance decisions and executive remuneration. Additionally, the government’s ability to extend collective agreements across a sector could be strengthened or used more routinely. Finally, methods to extend collective bargaining’s protection to workers in the informal economy or outsourced workers should be considered. Employers are likely to resist these efforts, claiming that higher labour costs will drive companies out of business and that the unemployment rate will rise. However, multiple studies have shown that employers tend to profit from centralised bargaining’s productivity and efficiency gains and that countries with more centralised and coordinated bargaining have a lower unemployment rate than other countries, especially if centralised bargaining is coordinated with industrial and economic policies to boost economic growth and productivity (OECD, 1997; Speckesser *et al.*, 2015; Howell and Huebler, 2004).

9 Labour market policies

Labour market policies, other than policies related to collective bargaining, can also be used to reduce wage inequality. These include minimum wage laws, living wages, policies to increase the formalisation of the workforce and methods to ensure the enforcement of labour market standards such as the minimum wage. While there are also many policies that can be used to reduce unemployment and create income-generating opportunities,¹⁰ these other labour market policies are beyond the scope of this paper, which focuses solely on measures directly designed to reduce wage inequality.

9.1 Minimum wages

This section will only briefly discuss minimum wages because a large body of work has already been produced on this topic by the *National Minimum Wage Research Initiative*, including the potential of minimum wages to reduce inequality (Isaacs, 2016; Mudronova, 2016). A minimum wage serves a number of functions, it: protects the most vulnerable workers in the labour market; combats poverty; reduces inequality of wages based on discriminatory characteristics; provides a reference for wages to workers entering the labour market and a reference for income in general; spurs productivity gains; organises the creation of a hierarchy of remuneration; reduces the turnover of workers; promotes regional equality; reduces the gender pay gap; introduces a floor for social security benefits; and benefits economic development by increasing consumption levels for the lowest paid (de Melo *et al.*, 2012). In addition to raising real wages in the formal sector, the minimum wage serves as a reference point for the remuneration of workers in the informal sector and may form a focus for trade union organisation and the promotion of collective bargaining (de Andrade Baltar *et al.*, 2010).

Increasingly, research has focused on the equity-enhancing effect of minimum wages. Studies have shown that the fall in the real value of the national minimum wage in the United States between 1979 and 1988 caused 25% or more of the rise in inequality over that period (Isaacs, 2016). On the other hand, the introduction of a minimum wage in the United Kingdom in 1999 had significant positive effects on reducing wage inequality, causing 50% of the reduction of wage inequality at the bottom half of the wage distribution over a twelve-year period and having positive spillover effects by raising wages of earners up to the 25th percentile (Isaacs, 2016). Maurizio and Vazquez (2016) found that minimum wages had a positive impact on the incomes of full-time workers in Argentina, Brazil, Chile and Uruguay between 2003 and 2012, reducing the p50/p10 ratio between low and middle income wage earners significantly in addition to reducing the Gini coefficient. The study also found that in Brazil, a 130% increase in the minimum wage over this period caused 80% of the reduction in its Gini coefficient, while in Argentina, where minimum wages increased by 200%, this increase caused 32% of the reduction in its Gini coefficient. In Brazil, wages for many other workers are benchmarked as a certain multiple of the minimum wage such that when the minimum wage increases, wages benchmarked to that minimum must also increase, positively

¹⁰ Examples include: expanding social transfers, creating a job guarantee system where every unskilled worker who is unable to find employment is provided with a minimum wage job, providing easier access to credit and capital markets for small and medium-sized enterprises in order to help them expand their business, and strengthening the system of skills training in the workplace in order to help workers move up the income ladder.

impacting the wages of a much broader labour force than those simply earning the minimum wage. Beyond its effects in the formal economy, there is much evidence, reviewed in Isaacs (2016) and Mudronova (2016), to suggest that minimum wages in the formal sector can also cause an increase in wages in the informal sector.

Anytime there is a call for a minimum wage or a minimum wage increase, employers, pro-business lobby groups and economists, and parts of the media, invariably protest that the increased cost is prohibitive and will result in job losses. However, the empirical evidence supporting this position is questionable (Dube *et al.*, 2010; Doucouliagos and Stanley, 2009; de Linde *et al.*, 2014). There is significant and convincing empirical evidence, reviewed in Isaacs (2016), demonstrating that when a country increases its minimum wage, this usually has a small or statistically insignificant effect on unemployment, and can actually have a positive effect on employment levels in some cases.

9.2 Living wage

Minimum wages, despite their stated objectives of securing sufficient income for workers to meet their basic needs, have not always been high enough to ensure workers have sufficient wage income to cover their cost of living. This has led to the advent of living wage campaigns, through which a second benchmark – above the minimum wage – is established and campaigned for, and/or which is proposed as the level at which the minimum wage should be set. The role of living wage campaigns in the public sector was discussed in Section 6.3, where it was demonstrated that local and regional or state governments implementing living wage policies have seen little to no impact on employment levels, an insignificant increase in costs, and a rise in income levels associated with the payment of living wages. This section will look briefly at the payment of living wages in the private sector.

In the United Kingdom a non-profit organisation called the Living Wage Commission (2016) has calculated a Living Wage that a full-time worker and their dependents would need to live on based on the cost of meeting a minimum standard of living for a broad mix of family types. The organisation then accredits employers that pay their entire staff and all contractors at least the Living Wage. Currently, there are over 2,900 accredited Living Wage employers, including companies operating in South Africa such as Aviva, KPMG, Deloitte, Anglo American and Barclays (Living Wage Foundation, 2016). An independent study of businesses paying the Living Wage found that Living Wage employers experienced significantly lower turnover rates and lower recruitment and training costs and a 25% average reduction in absenteeism (London Economics, 2009). The same study found that 80% of employers believed that the Living Wage had resulted in improved work quality. Although the study did find that Living Wage employers faced increased costs, half of Living Wage employers saw no change in their profits, with some seeing an increase in profits.

While the benefits for employers voluntarily implementing the Living Wage have been substantial, Linneker and Wills (2016) found that contractors forced to pay the Living Wage in order to continue to supply Living Wage employers have not seen such positive benefits. While some contractors paying the Living Wage were able to pass on the higher wage bill to the client, others compensated through a reduction in profits, hours of work or employment levels to counteract the higher wage costs. While the total number of jobs increased among large contractors, small contractors reduced both the number of jobs and the number of hours worked by employees. Full-time workers

received the greatest benefit, while those whose hours were reduced were worse off. According to Linneker and Wills (2016, p. 774):

Only a minority of workers reported positive effects on personal incomes and family life, and the LW was no 'magic bullet' for reducing in-work poverty, since higher wages did not necessarily translate into higher incomes for all workers involved.

Living wages clearly benefit workers of accredited employers who voluntarily adopt the Living Wage as a commitment to being an ethical employer. However, these same benefits may not accrue to employees of contractors, who may see a reduction in their hours.

9.3 Enforcement of labour legislation

While labour market policies such as minimum wages and living wages are integral to reducing wage inequality, these policies rely on appropriate enforcement measures. As mentioned above, Brazil and Argentina have seen a significant drop in wage inequality and a reversal of the trend of the informalisation of employment (Maurizio, 2015). One factor contributing to the reduction in inequality in both countries is that policies were implemented to formalise businesses, bringing them under the regulation of labour authorities and minimum wage legislation. The government in both countries simplified the registration process for businesses, provided incentives to improve firm profitability for registered businesses, reduced taxes and social security contribution costs for small and microenterprises, and implemented grace periods for the payment of taxes and social security contributions (Maurizio, 2015). As an example of the incentives offered to firms to formalise, some Brazilian employers were offered customised courses to improve their profitability in exchange for formalising their business, with a grace period for registering until the business improved its productivity, which resulted in a large increase in firm profitability (Berg, 2010). In Argentina, the rate of formalisation increased by 10% (Maurizio, 2015). The *SIMPLES* law in Brazil, operating along these lines, is estimated to have led to the formalisation of over 500,000 firms and two million jobs in five years (Berg, 2010). Fajnzylber *et al.* (2009) found that *SIMPLES* led to higher revenue, employment and profits among firms that registered because registration increased the likelihood that the firm would have a fixed locale and formally contracted labour, allowing them to adopt permanent production technology, capital and business plans. In Argentina's domestic work sector, formalisation rose after the government allowed employers to deduct social security payments and wages paid from their taxable income, with the number of contributors more than tripling and non-registered employees declining from 95% of the industry in 2003 to 83.7% of the industry in 2012 (Casanova and Saravia, 2013). A similar policy in France allows employers to deduct 50% of domestic worker wages from their taxable income, with 66% of domestic workers in the country now being employed legally (Konopelko, 2016).

Enforcement strategies are critical for the implementation of labour market policies such as the minimum wage. A sufficient number of inspectors must have proper training and powers of enforcement to deal with violations of the law. Adequate penalties for non-compliance must exist in order to deter violations, while incentive schemes could be created to encourage compliance with labour market standards (Murahwa, 2016). Greater enforcement measures have been put in place to increase the process of formalisation in Brazil and Argentina. For example, Maurizio (2015)

describes how Argentina established a plan to find employees not registered in the social security system by improving their technology, coordinating the process of registration under the Ministry of Labour, increasing the number of inspectors from 40 to 470 between 2003 and 2011, and increasing the number of inspections. According to Maurizio (2015), inspectors found that an average of 28% of workers were not registered, and 37% of these became registered following inspection. While Brazil did not hire more inspectors, Maurizio (2015) explains that inspectors' powers were strengthened and their pay was linked to performance. Special inspection groups were used to deal with tougher situations, and these groups were trained not only to inspect and sanction but to find ways to work with firms to improve working conditions. This resulted in the number of workers registered due to inspection increasing from 268,000 to 669,000 a year between 1996 and 2008 (Berg, 2010). Similar strategies should be considered to increase the capability of South Africa's labour inspectors to ensure compliance with any additional regulations created to reduce wage inequality, including a minimum wage (see Murahwa, 2016 for a discussion of this in the context of implementing a national minimum wage in South Africa).

9.4 Conclusion

Labour market policies can reduce wage inequality. One such policy already agreed to by the social partners in South Africa is the implementation of a national minimum wage. Beyond this, governments, unions and society are able to encourage a movement towards a living wage which would push up wages at the bottom of the distribution even beyond the minimum wage. These provisions rely on effective enforcement mechanisms and policies aimed at increasing business formalisation in order to ensure that all workers are protected.

10 Summary and conclusion

Wage inequality in South Africa is high, contributing to the country's title of the world's most unequal society. In order to reverse South Africa's well-entrenched history of compensating highly-skilled workers at the expense of the low-skilled, and ensure that future economic growth benefits all members of society and not just the privileged, a multi-faceted approach needs to be taken to address pay differentials within both the public and private sector.

The first strategy discussed in this report was the disclosure of pay ratios within businesses or sectors. This serves as a necessary precondition to reducing those pay ratios: without this information, steps cannot be taken to actively reduce them. As South African companies are already required to collect much of the information needed to calculate pay ratios, it would not be impracticable to require them to calculate and publish this information.

One means of reducing these pay ratios is by placing a mandatory cap on executive pay at a certain level or stipulating a maximum allowable pay ratio. Such caps and ratios have been applied in limited sectors of the economy in a handful of countries. These have had mixed results with some studies raising concerns over recruiting and retaining high-skilled workers, possibly because they are only applied to a limited subsection of the economy. They are, however, fairly straightforward to implement – all forms of remuneration, including share incentives, and not just on wages or salaries are included – and can have a direct impact on levels of executive pay and wage dispersion. Further research on the impact of an economy-wide cap in South Africa is recommended.

A rethinking of corporate governance's focus on shareholder primacy to the exclusion of workers' interests is another fruitful avenue. Altering corporate governance procedures to ensure broader societal issues are considered and the involvement of employee directors in the remuneration-setting process, with a focus on remuneration policies regulating the relationship between executive pay and employee pay, have the potential to change remuneration practices throughout the economy and contribute to reduced pay differentials.

The state has a variety of other instruments available to entice companies to reduce wage inequality, in addition to actively reducing inequality within its own ranks. These range from inserting pay ratio conditions as a mandatory condition of government procurement policies, government loans and government grants, to applying tax penalties to companies that engage in problematic remuneration practices. The state's power to incentivise compliance with a pay ratio is a powerful tool that could enact real change in how workers are remunerated. These policies, combined with a higher tax bracket that reduces the take-home pay of individuals earning extremely high incomes, have the potential to significantly impact wage inequality.

Collective bargaining plays an important role in reducing wage inequality. Methods to increase unionisation rates, such as making union membership mandatory or creating incentives to join a union, have been successfully implemented. A legal duty to bargain can ensure that employers are not able to ignore unions in the workplace. The state's power to extend collective agreements to an entire sector is a powerful tool to ensure that wage inequality across a sector is reduced. Beyond this, there are various bargaining strategies that unions can adopt to reduce pay differentials, including

bargaining for provisions such as those in Sweden's solidarity wage policy framework agreements, advocating for a rule like Norway's 85% rule, or channelling government support to create wage guidelines as was done in Uruguay. Other labour market policies, such as minimum wages, living wages, and methods to increase the formalisation of workplaces and ensure enforcement of labour standards are critical.

The world is filled with a rich body of examples South Africa can draw from to reduce wage inequality. The tools to reduce this form of inequality in South Africa exist, and with a multi-pronged approach, each policy can work to support the others. The next part of this research will focus on which approaches will work best in South Africa given its unique history, economic climate and collective bargaining culture.

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