LSE Centre for Economic Performance: Bankers’ Bonuses

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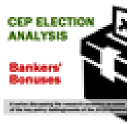
A new series of Election Analyses is now available from the LSE’s Centre for Economic Performance (CEP). The series will discuss the research evidence on some of the key policy battlegrounds of the 2010 General Election, including macroeconomic policy, immigration, health, education, crime, poverty and inequality, labour market policy, regional policy, energy and the environment, financial regulation and bankers’ bonuses, and foreign aid.

The latest CEP Election Analysis, by Brian Bell, gives an overview of bankers’ bonuses and extreme wage inequality, one of the key battlegrounds of the 2010 General Election. The publication is summarised below and can be found in full on the CEP Election Analysis Site.



- Over the decade from 1998, the top 10% of workers in the UK saw their share of total annual wages rise from 27% to 30%. The majority of this went to the top 1% and can be mainly accounted for by bonuses to financial sector workers. By 2008, the increased share that bankers were taking amounted to an extra £12 billion per year in wages alone.
- The size of these bonuses and their structure may have been a contributing factor to the financial crisis. Bankers paid large cash bonuses on the basis of short-term returns often unadjusted for risk have incentives to take on excessive risk.
- All the parties have attacked bankers’ bonuses – the Liberal Democrats have said that they would ban all bonuses to board members and force all bonuses above £2,500 to be paid in shares.
- It is unclear why shifting away from cash toward equity-based compensation would alter any perverse risk incentives since unlike a CEO (chief executive officer), an individual banker typically has only a small effect on the share price.
- Another proposal is to ‘claw back’ bonuses if performance is sub-standard in the future. Unlike simply deferring bonuses, this in principle could improve incentives.
- The government has increased the marginal tax rate to 50% for those earning over £150,000 and introduced a one-off 50% tax on bankers’ bonuses over £25,000 for the 2009/10 pay period. The Conservatives do not pledge to reverse the first policy and the second will theoretically have been completed by the time of the election.
- There is very little evidence whether such tax rises will cause a significant number of firms and workers to leave Britain. In any case, highly paid workers are likely to change their behaviour to minimise the impact of the tax rises and so reduce the expected revenue gains to the Exchequer.