INQUIRY INTO THE REGULATION OF DIRECTOR AND EXECUTIVE REMUNERATION

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Introduction

It is unfortunate that the Commonwealth Government did not make the terms of reference for this inquiry by the Productivity Commission much broader. This is because there are significant matters of political economy that arise from the blowout in executive remuneration in recent years. Whilst the specific issues of labour market failure that are central to this inquiry are important, there are also broader issues that go to the wellbeing of the society as a whole.

Corporations employ a large proportion of the Australian workforce, both directly and indirectly and their behaviour is influential well beyond their immediate shareholders, employees, suppliers and customers. However, corporations are also artificial constructs whose obligations and privileges are prescribed by law and are open to amendment for the public good.

It has often been evidenced in periods of sustained growth that the distribution of income becomes more equal. This appears to have not been the case in Australia in the long period of growth just concluded and there is justifiable concern that this increased inequality of income and wealth will spill over into greater social instability and loss for the whole of the society.

In this respect, the increased dispersion in salary incomes in Australia over the last twenty years or so has attracted increasing public concern. However, the public voice has been relatively inchoate and there is no consensus about the precise nature of the problem, much less what to do about it.

This public puzzlement was contributed to by the vague public utterances and hesitant actions of the two major political parties during this period. They appeared torn between an urge to genuflect before the most evident beneficiaries of modern capitalism and mild apprehension that these extravagances might be unjust and contain the seeds of economic and social instability.

That is, until the recent economic downturn, when there was an outpouring of public anger about the inequity of the large pay packages enjoyed by senior executives. It was almost as if that when the economy was growing, employment relatively secure, and most wage earners were enjoying at least nominal increases in wages or salaries, it was felt unseemly to criticise those who were enjoying an increasing proportion of the spoils. The view that there was a rising tide of prosperity that would lift all boats appeared to be very widely held.

When the economy appeared to be performing well, many felt resigned to these egregious and undeserved salary hikes and that there was relatively little that could be done about it. The inability to publicly articulate the possible dysfunction of these

substantial increases in senior executive remuneration also coincided with a marked decline in social solidarity in Australia and growth in economic individualism. Some shareholders attempted to draw comfort from the fact that even if they were being grossly overcompensated there were so few senior executives their impact on profitability would remain relatively minor.

Generally, however, the idea that Australia was a land of opportunity where personal effort and skill was being justly rewarded had taken root. Many people also too readily absorbed corporate propaganda that attributed increases in corporate profitability to the efforts of the few at the top. This was coupled with a growth in the celebrity status of executives and increased use by corporations of public relations techniques to promote an aura of invincibility. Slick campaigns of self-promotion strongly linked the supposedly prodigious capacities of the chief executive with the shining performance of their company. Chief executives claimed a public persona assumed in earlier times by cardinals and more recently by film stars.

Much of this changed with the global financial crash and an increase in unemployment. For many, celebrities became pariahs. Pacific Brands chief executive, Sue Morphet, who happened to be standing in the wrong spot when the change in zeitgeist occurred, deserves qualified sympathy. New to the job, rather less well rewarded than many of her peers, and facing significant indebtedness left by her predecessor, Ms Morphet was doing at Pacific Brands what Australian TCF businesses have been doing for 25 years to maintain profitability: shedding local production jobs and sourcing stock offshore.

Possible causes of the executive wages breakout

Commentators have offered several possible causes to explain the executive wages breakout, including those identified in the Productivity Commission Issues Paper (April 2009). These include the "camouflaging" of pay increases through the use of managerial influence by senior executives and that higher demand for general rather than firm specific skills have stimulated demand for "generalist" managers, thus resulting in higher remuneration. The International Labor Organisation's *World of Work Report 2008: Income Inequalities in the Age of Financial Globalisation* also concludes that executive performance-related pay may reflect manager's "dominant wage bargaining position with respect to company owners, partly as a result of institutional flaws."[1]

Other suggested causes include:

- The introduction of incentive payments, and especially stock options, which in combination with lesser security of tenure, have stimulated higher payments to executives;
- The relaxation of social norms against large pay packages, working in combination with a clubbish relationship between chief executives and remuneration advisers; and
- The growth in the size of firms, principally by merger, which has been strongly matched by the growth in chief executive remuneration.[2]

Former Reserve Bank governor, Bernie Fraser, has said that greedy people and a "slimy culture" are responsible for excessive executive pay and that they are in effect

the beneficiaries of uncontestable markets and significant economic rents as a consequence. [3] It has also been contended that the blow out in executive remuneration dates back, in the US at least, to when Congress attempted to legislate restrictions. These included the 1984 elimination of tax deductibility for golden parachutes that exceeded three times base salary and the 1993 prohibition on tax deductibility for salaries exceeding $US1 million.[4]

It is also interesting to note that rapid increases in executive remuneration coincided with the breakdown in centralised wage fixation in Australia, a significant reduction in union density in many firms and in nearly all industries. It also coincided with, and was a consequence of deliberate policy, implemented by both major parties in government since the mid-1980's to replace industry-wide wage fixation and compulsory arbitration with enterprise bargaining. The policy change was justified as a response to structural inefficiencies in the labour market and the halting economic performance since the mid-1970's, which had been characterised, by stagflation and the decreased responsiveness of the national economy to external shocks.

Concern about vertical and horizontal equity in the wages system was a hallmark of the centralised system of wage fixation and was most marked by the notion of "comparative wage justice." This concept was that employees performing similar work should expect to be similarly rewarded through the remuneration system. In the same vein, there was a strong understanding, enforced by the decisions of federal and state industrial tribunals, that carefully enumerated margins for skills and experience would be recognised. This provided an underlying template for career paths and a marker for organisational hierarchies and patterns of remuneration within and across firms.

Whilst the remuneration of senior management was never part of formalised wage-fixing arrangements, firms appeared to have regard for the concepts of relativities and arbitrated and negotiated wage agreements struck for their larger workforce in setting the remuneration levels of executives. Arguably, the decline in the centralised wage fixation system provided an important pre-condition for a breakout in executive remuneration levels.

Chief executive remuneration, globalisation, scarcity and business performance

In October 2003 the former chief executive of National Australia Bank and current chairman of BHP Billiton, Don Argus, invoked the concept of globalisation to defend high executive remuneration. [5] Argus argued, "Once you move out of your economic zone you're exposing your talent bank to the world markets, and global pay scales."

However, it is to be seriously questioned whether there is any such thing as a global pay scale. It appears that the greatest growth in executive pay scales has occurred in the English speaking developed economies, including the US, the UK and Australia. Increases in executive remuneration, in absolute terms and relative to other occupational groups, have been much more modest in Western Europe and Japan.

In this respect, it is interesting that exposure to world markets should have elevated the salaries paid to executives whilst possibly simultaneously having the opposite effect for other workers. At the same time that Mr Argus and others from the

corporate world were attempting to justify inflated executive salaries they were threatening their employees with job losses on the strength of international labour market competition.

One would have thought that the expansion of firms into global markets would have had the effect of attracting proportionately more competition for the relatively few senior executive positions. But no. It seems rather that the blow out in executive remuneration has been the result of a particular form of labour market failure.

When Sol Trujillo took over as chief executive at Telstra he also recruited other executives from the US. Similarly, when AWB was in its privatisation phase a phalanx of senior executives followed the newly appointed chief executive from the Victorian WorkCover Authority. In 2000, newly appointed Mayne Group chief executive officer, Peter Smedley, brought an executive team with him. There have been other such cases. The subsequent performance of many of these companies has been mediocre, and in the case of AWB ended in tears.[6] What is most interesting for the present argument, however, is that whilst current corporate culture is inured with the worth of competition, and the rewarding of individual worth, companies have had no qualms with the non-competitive recruitment of teams of senior managers seemingly in conflict with these competitive principles.

Have executives really been earning no more than they contribute to production, and have their remuneration packages equalled the marginal product of their labour? In February 2003, the former Prime Minister, John Howard, when challenged that the former Colonial First State executive, Chris Cuffe, was overpaid with a termination payout of $33 million retorted: “He was successful.”[7] In October 2003, high profile business commentator Gregory Hywood described a corporate world in which the average Australian chief executive officer, who then made about $2 million a year, was responsible for initiatives at individual firm level that increased shareholder returns and improved the health of the Australian economy.[8]

However, there appears to be little empirical support for a conclusion that the substantial increase in salaries received in recent years by executives is justified by the contribution they have made in the workplace. The UK-based research group, The Work Foundation, also concluded in their paper, *Performance Related Pay: Rewarding A While Hoping for B*, that reliance on performance pay is a blunt instrument.[9] A study undertaken by three labour market specialists for the Labor Council of NSW found that, measured by return on equity, share price change and change in earnings per share in Australia’s largest companies, that there was an inverse correlation between the level of remuneration enjoyed by Australian chief executive officers and the performance of the company that they led.[10] The largesse increasingly ladled out to senior executives in recent years showed how imperfectly labour markets can behave.

Historical and international experience

The blowout in executive remuneration has had historical precedents. It has been pointed out that there was a similar Gilded Age in the US in 1915-16 and at the end of the 1920’s and that these periods were characterised by a reduction in government regulation. Most recently, this was reflected in the abolition by the Clinton

administration of the 1933 Glass-Steagall Act, which had prohibited the combination of commercial and investment banking, insurance and stock broking. The spiralling growth in the prices of financial assets which followed provided fertile ground for the growth in executive remuneration in the financial services sector, in particular, and then with inflation of equity prices, in other industry sectors as well.

William McDonough, chief executive and president of the Federal Reserve Bank of New York, in quoting a study that showed that the average salary of chief executives in US public companies had jumped from 42 times that of a standard production worker 20 years previously to more than 400 times now said "I am old enough to have known both the CEOs of 20 years ago and those of today. I can assure you that we CEOs of today are not 10 times better than those of 20 years ago."[11]

In fact, many US commentators attribute the growth in executive salaries to the stock market bubble, a phenomenon somewhat detached from real wealth creation and quite unattributable to individual talent or endeavour. A former Federal Reserve Board chairman, Paul A. Volker agrees, saying "I don't see a relationship between the extremes of income now and the performance of the economy" and " The market did not go up because businessmen got so much smarter." He added that the 1950's and 1960's "were very good economic times and no one was making what they are making now."[12]

Performance pay

The rapid growth in executive remuneration in Australia has occurred contemporaneously with the expansion of so called "performance pay." This concept has spread through much of the workforce, including the public sector, in recent years. There is even talk of extending it to the teaching profession. At senior executive levels remuneration packages now typically comprise a base fixed amount; a short-run performance element, based on measured performance during the previous reporting period; and a long-run performance component, say over a three period, which purports to reward the employee's contribution to the longer-term performance of the organisation. Over the years, the base amount has declined relative to the short-term and long-term "at risk" components, both in terms of what has been potentially payable and what has actually been paid to executives. It has been reported that average chief executive pay rose 21.3% to $5.53 million in 2007 in sixty nine of the top one hundred listed companies analysed by the Australian Council of Superannuation Investors, of which $2.18 million was in short-term payments. [13]

Much of the debate, both within companies, and more publicly, concerning performance pay for executives has addressed techniques for aligning executive incentives with the objectives of the employer organisation. That is, in ensuring that the executive is rewarded when his efforts result in positive performance by the company. What has been too little discussed is whether the idea of performance pay is a good one at all. In fact, there is plenty of evidence to suggest that it is not.

All performance schemes have impossible conceptual and measurement problems. In fact, the performance pay route raises issues of unresolvable complexity for companies. To maintain the fiction of robustness they either sweep the difficult issues under the carpet or engage remuneration consultants to undertake some additional

tinkering with the system. The underlying weaknesses of these systems include the issue of deciding the criteria to be used to measure performance, which is always contestable. Secondly, there is a need to distinguish between correlation and cause in assessing the performance of the firm. It might be thought that comparison with peers would fix that, but that is difficult, too. Is the peer group an appropriate comparator? Thirdly, there is the issue of correct attribution. Is the inspired suggestion of a subordinate seized in desperation as a punt by the chief executive, to be given the same weight as an original idea and action taken in a measured way? Who is to be granted the credit and how much is it really worth? And isn't that what executives are paid to do anyway?

Firms are relatively complex things, and contemporary results can often be the consequence of factors with a longer history, and be little understood. In fact, it is probably the ahistorical pretence of performance-based systems of remuneration that are their greatest flaw. It is interesting to listen to the oversimplifying public language used by firms and executives to mask this complexity. It is too often couched in terms of the omniscient helmsman (the chief executive) and his coterie of capable underlings.

When things go badly the memory is swept away and the same type of presentation is made, this time with a new helmsman out the front. There is nothing technical or measurable with any precision about this. It seems to owe more to some of the worst features of modern politics, most characterised by a culture of celebrity and strict limits on memory and knowledge. Firms need to understand and measure their performance as best they can, but having performance based systems of pay as the centre of this activity has proven to be a very bad idea.

It has been argued that pay or compensation systems that that do not reward individual effort encourage free loading by employees and that as a consequence it is much superior to have at least some proportion of employee pay "at risk" and assessed for individual performance. Accordingly, it is argued that both pay systems and performance measurement practices are of vital importance to the health of the firm.[14] However, some of the major problems with individual merit or performance-based pay systems which adversely affect the firm include: "subjectivity and capriciousness that reward political skills or ingratiating personalities rather than performance; an emphasis on the individual sometimes at the expense of the success of his or her peers, consequently undermining teamwork; an absence of concern for organisational performance; encouragement of a short-term focus and discouragement of long-term planning; and the tendency of such systems to produce fear in the workplace." [15]

As discussed above it is often asserted that any problems with these systems are technical in nature. However, as Herbert Simon recognised: "In general, the greater the interdependence among the various members of the organization, the more difficult it is to measure the separate contributions…But, of course, intense interdependence is precisely what makes it advantageous to organise people instead of depending wholly on market transactions."[16] In fact, it could be argued that the degree of interdependence, and indeed, dependence, that executives, and chief executives in particular, have on others in the organisation is greater than for other occupational groups.

Also, the deep dysfunction of individualised performance pay systems which is evident at all occupational levels can be accentuated for senior executive appointments, especially that of chief executive officers. This is because they are reliant on board appointment and the board has a vested interest in projecting the view that these appointments have been successful. Any early assessment which limits the "at-risk" payment to these executives is likely to be taken as a measure of board failure.

A consistent negative feature of performance pay systems is that they are very resource intensive for firms. One intimation of this fact is the reporting on senior executive remuneration in company annual reports. They are frequently more extensive than the public reporting on the business itself. This is largely the result of statutory disclosure requirements which, if its purpose was to inhibit the overpayment of executives, it has clearly failed.

The greater cost to many firms, however, has been the extension of performance remuneration systems to subordinate workers. Unlike the performance management systems introduced for senior managers, which has been an avenue for successful rent seeking behaviour, those further down the hierarchy are likely to be of a different character. As Pfeffer points out it is likely to have created fear in the workplace and the work environment will be much the worse for that. In addition, as with executives, a substantial reporting mechanism is required to legitimate the process which draws resources from more productive uses.

The executive recruitment and remuneration advisory industry

Michael Robinson, director of Sydney and Melbourne based remuneration consultants Guerdon Associates Pty Ltd, recently made a plea on behalf of Australian-based executives.[17] He said there is no need for the Australian government to regulate executive remuneration in the manner contemplated by the US government because none of the excesses that occurred in the US occurred in Australia as Australian chief executive remuneration, including termination payouts are reasonable. Many would differ. Whilst the scale of increase in executive remuneration in Australia may not have reached those of the US, it has been prodigious and should invite an effective public policy response.

In November 1999, the corporate remuneration adviser John Egan of John Egan and Associates also made a plea on behalf of corporate executives, contrasting what he viewed as the public's reluctance to properly reward senior executives whilst being more than happy to shower riches on sports stars and entertainers.[18] He also pointed out the long hours that the modern-day senior executive puts in. Egan concluded that "If, due to uninformed public comment, an effective chief executive walks away from a billion-dollar Australian company and the share price falls $2, the question may well be asked whether accountability lies only with the board."

However, in the succeeding decade or so since Egan wrote, there have been few if any senior executives that have abandoned Australian companies because of hostile public comment. Nevertheless, many have been seen sitting wooden faced at annual general meetings stonewalling angry stockholder questioning of their remuneration packages.

They are nothing if not stoic in the face of these work-related stresses. As to whether share prices fall by $2, or any other amount for that matter, upon the departure of particular executives that appears more to do with the “animal spirits” alive on the day in the stock market rather than any sensible assessment of individual employee worth or performance. Matching employee remuneration with stock market gyrations has proved to be especially inappropriate.

Extensive hours and gruelling working conditions are often presented as a justification for higher levels of executive remuneration. There is little evidence thus far that this compensates for reduced life opportunities or other rewards foregone. There are no special health risks. Epidemiological and other studies routinely find that those with strong autonomy in their life and relatively greater wealth and income (as have executives relative to process workers) typically enjoy longer and healthier lives.

It is unlikely that social or moral suasion is ever going to be a sufficient disincentive for discouraging executive excess. Their major source of social affirmation is their peer group not an indignant public. On being queried on his extravagant golden goodbye on departing a UK listed company, a former chief executive made the enlightening comment that “Of course I won’t need it (the money) nor can (I) spend it but I needed to show the market that I was valued as highly as everyone else.”[19]

The relative payments made to sports stars and others are worth a comment, but from an entirely different perspective from that imagined by Egan. This is the phenomenon of the “winner-take-all” labour markets coined in 1995 by Robert Frank and Philip Cook.[20] Whilst these markets have historically been the province of show business and sports entertainment, in more recent years the phenomenon has become much more widespread and have had the effect of increasing the disparity between the rich and the poor and contributed to wasteful investment (especially through excessive entry into winner-take-all labour markets) and consumption.[21]

Conclusions and recommendations

Executive remuneration paid in Australia has become grossly excessive. The major vehicle for this growth has been the almost universal application of performance pay, a prime instrument of the neo-liberal supremacy now in sharp decline. At senior levels, this system has systematically over-rewarded senior executives, and at lower levels of the workforce been used as a control technique which is inimical to organisational harmony and contributes significantly to loss of voice by most workers. It is a touchstone of the intrinsically inefficient and unproductive winner-take-all society. It is also a source of social disaffection and causes the erosion of loyalty, both to firms and between employees.

There is no evidence that performance pay systems enhance organisational performance at any level. They overrate the importance of extrinsic job rewards at the expense of intrinsic benefits. Such systems are inimical to successful teamwork. Their administration is very resource-intensive and distracts attention from more productive activities in the firm.

Resort to a system of remuneration for all employees that is simple and readily understood would be far superior. It is possible that the current recession will force a

realisation in the corporate community that this should be so. Accordingly, it is recommended that executives be paid an annual fixed rate of salary, reviewable from time to time, as the preferred form of remuneration.

Robust changes in regulation should be used to facilitate such changes. This inquiry should consider appropriate amendments to the Corporations Law and the taxation laws that would give effect to these objectives in the setting of executive remuneration.

This would restore stability in executive remuneration and greater equity in the overall wages system. Such an initiative would provide strong impetus for economic fairness and justice in the society as a whole.

Footnotes

1. Quoted in Paul Gollan, 'When compensation goes feral,' *The Age*, 21 October, 2008

2. Andrew Leigh, 'Little house on the contrary: a stock picking tool,' *The Australian Financial Review*, 20 April 2007

3. The ACTU Whitlam Lecture, 9 December 2008, quoted in *The Age*, 11 December, 2008

4. Michael Robinson, 'Big payouts not a problem here,' *The Australian Financial Review*, 6 October 2008

5. The Age Business Roundtable, *The Age*, 11 October 2003

6. Ian Hundley, 'Corporate corruption and personnel management at AWB,' *Dissent*, No. 23, Autumn/ Winter 2007

7. John Howard, transcript of interview by Ray Hadley, Radio 2GB, 28 February 2003

8. Gregory Hywood, 'Do CEO's deserve what they get?' *The Age*, 16 October 2003

9. Leon Gettler, 'No proof donkey's years of carrot-dangling works,' *The Age*, 30 May 2007

10. John Shields, Michael O'Donnell and John O'Brien, *The Bucks Stop Here: Private Sector Executive Remuneration in Australia: A Report Prepared for the Labor Council of NSW* (2003)

11. Luke Collins, 'Top banker questions morality of executive pay,' *The Australian Financial Review*, 13 September 2002

12. Louis Uchitelle, 'The Richest of the Rich, Proud of the New Gilded Age,' *The New York Times*, July 15, 2007

13. Malcolm Maiden, ‘Short-term pay toxic to our long-term interests,’ *The Age*, March 14, 2009

14. Jeffrey Pfeffer, *Human Equation: Building Profits by Putting People First* (Harvard Business School Press 1998) p. 195

15. Pfeffer (1998), pp. 203, 204

16. Pfeffer (1998), p. 207

17.Michael Robinson, ‘Big payouts not a problem here,’ *The Australian Financial Review*, 6 October 2008

18. John Egan, ‘Time for reality check in debate over CEO pay,’ *The Age*, 22 November, 1999

19. Will Hutton, ‘We all suffer when greed is the creed,’ *Guardian Weekly*, November 10, 2006

20. Robert H. Frank and Philip J. Cook, *The Winner-Take-All Society* (Penguin 1996).

21.Robert H. Frank and Philip J. Cook (1996), p. 4