REGULATION OF DIRECTOR AND EXECUTIVE REMUNERATION

I accept the widely held view that executive salaries and directors fees are excessive, in some cases outrageously so, and out of alignment with remuneration levels in other professions. I also strongly agree that it is important for executive remuneration to provide leadership standards for other income earners to follow in times when wage restraint is a necessary ingredient of macroeconomic policy (*Issues Paper.* p.5). But I question the appropriateness of the words 'unrestrained greed' (*Issues Paper, p.* 3), an emotional expression which serves to divert attention from more fundamental principles. Self interest is a biological fact which is present in all economic systems, whether it be capitalist, socialist, feudal or tribal. If we define **greed** as the pursuit of self interest ahead of public interest, then it would explain most of the imperfections in our market economy, including those which have contributed to excessive executive salaries. The challenge is to identify those **market imperfections.** This submission attempts to address that issue.

The fundamental imperfection that might explain salary excess is, I believe, embodied in the **separation of ownership and control** of public companies, as enunciated by *Berle and Means* in their pioneering study *The Modern Corporation and Private Property* (1932), (and alluded to in the *Issues Paper, p. 19* as the 'principle-agent problem'). According to this principle, shareholders are too numerous and scattered for any one shareholder to exercise effective control of the company, and this they are content to delegate to elected directors.

But the majority of shareholders are apathetic, relatively few attend shareholders' meetings, some are short-term speculators with little genuine interest in the long-term future of the company, many cannot understand the complexities of the published reports, most have little knowledge of the inside organisation and operations of the company, and some are gullible enough to give their proxy votes to the Chairman. For these reasons, directors can control a company with little fear of scrutiny.

Although these comments apply to the smaller shareholders, they raise the question of whether the larger **institutional shareholders** can exercise effective control, especially in relation to remuneration. My impression is that this is unlikely. The management of financial institutions is in the hands of persons whose interests coincide rather than conflict with those controlling the companies in which they invest; that is they also have a vested interest in maximising their own remuneration and that of the managerial profession generally. If this is the case, a solution might be to introduce legislation which requires these institutions to set up **remuneration panels** whose function would be to represent the institutions when voting on remuneration decisions for the companies in which they hold shares. These panels would be elected by the members of each institution (e.g. policy holders) who would need to be completely independent and impartial, and whose decisions at company meetings would be binding rather than non-binding as at present.

The above comments apply mainly to directors' fees, so the question remains as to why **executive salaries** (which are determined by the directors) can also be excessive. My suspicion is that because most directors

are drawn from the ranks of retired senior executives, they have a sense of loyalty to, rather than betrayal of, a system from which they have previously benefited. Sociological considerations may also play a part. A study by *Rolfe H.A (The Controllers, Cheshire, 1967)* found a tendency for directors to conform to certain social characteristics; a private school background, membership of prestigious clubs, a residential concentration in Melbourne's Toorak or Sydney's fashionable eastern suburbs and north shore, and probably some degree of inter-marriage, all of which support a social cohesion hypothesis. Presumably, senior executives would also be part of this social network.

If, therefore, company directors see their loyalties aligned more with their senior executives than with their shareholders, a case can be made out for legislative change to empower **shareholders to vote on executive remuneration packages**.

Two arguments could be advanced against a public attempt to restrain executive salaries. The first is that abnormally high executive salaries are justified when company profits or share prices are abnormally high. For example, it is worth paying an executive $10 million if he can increase profits by S20 million. Leaving aside the possibility of market power, favourable macroeconomic conditions, fortuitous events or other influences on profit not ascribed to the executive, it should be noted that this $10 million may include a component of **wage surplus** (the difference between the wage actually paid and what the employee is prepared to accept; it is the labour equivalent of *consumer surplus and producer surplus*). Surpluses such as these are usually attributed to some undesirable market imperfection and should be eradicated. This should be taken into account when

considering performance hurdles and company profitability (*Issues Paper, p. 27*).

A second argument against salary restraint is that **talented executives might emigrate** to overseas countries where salaries are not so restrained. I suspect that the market imperfections alluded to in this submission are inherent in all capitalist democracies, so it is important that any solutions should be implemented world-wide. The present state of the world economy and widespread ill-feeling towards salary abuse suggests that now is the perfect time to encourage such world-wide response.

In **summary**, I propose:

(1) that consideration be given to legislative changes that would:

- (a) require shareholders' votes on directors' fees to be binding on the company instead of non-binding,
- (b) require financial institutions to establish members' remuneration panels, and
- (c) empower shareholders to exercise a binding vote on executive remuneration decisions,

(2) that performance hurdles be raised to take into account the 'opportunity cost' of executive retainment, free of 'labour surplus' and

(3) that decisions emanating from this inquiry be part of an urgent world-wide campaign of remuneration reform.

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