Submission by

The HR Nicholls Society Inc.

Executive Remuneration Inquiry

Introduction

The HR Nicholls Society was founded in 1986 following the publication of the Hancock Report, which amongst other things, recommended that the legal privileges then enjoyed by registered trade unions and employer organisations should be extended and entrenched. Since1986 the Society has held many conferences and published much material about Australia's labour market, and has become a strong advocate for the right of individuals to freely contract for the supply and engagement of their labour by mutual agreement.

Three years later, in 1989, the Berlin Wall was torn down, and the USSR collapsed, a collapse driven by ever declining economic performance. By 1989 the USSR was a third world empire, unable to finance the imperial burdens which it had taken on since the Yalta agreements, let alone engage in expansionist ambitions in Afghanistan and elsewhere.

The relevance of this discursion in the context of an inquiry into the regulation of executive remuneration is this.

The collapse of the USSR demonstrated that centrally planned economies simply do not work. The arguments developed by Hayek and Mises decades before were shown to be correct. At the heart of this analysis is what Hayek described as "the knowledge problem". In any economy knowledge about what to produce, what to sell, what investments are likely to be profitable, is very widely dispersed, and cannot be assembled into the memory of any one computer, or any one Chief Central Planner. Further, because economic activity is a dynamic thing, this knowledge is changing all the time, and economic success is driven in large part by predictions of changing circumstances which turn out to be correct.

So freedom for individuals (and corporations) to enter into contracts which each party believes will maximise the benefits (both financial and intangible), accruing to each party is the most certain way of achieving economic success as a nation.

This commitment to the principle of freedom of contract under the law extends to the labour market in general and for corporate executives in particular. The Society believes that this inquiry should keep this principle at the forefront of its analysis and recommendations.

Key Issues

The Society believes there are a number of key issues that the inquiry should examine, analyse and explain using sound economic principles and empirical evidence:

a) The economic importance of freedom of contract under the law and the unintended consequences and broader economic costs for labour markets in general (and the labour market for executives in particular) of inappropriate regulatory arrangements, unnecessary government and third party intervention, and government and bureaucratic failure;

b) The economic consequences for executives and managers of recent and forthcoming changes to labour market regulation in Australia;

c) The distortions created by Australia's tax system with respect to remuneration arrangements, including recent proposed changes to the taxation of employee share schemes;

d) The economic purpose of remuneration packages and incentive contracts, in terms of their effect on productivity and efficiency;

e) The extent and size of agency costs within firms and the role that different kinds of executive remuneration structures can and do play in minimising these costs;

f) The economic structure of the labour market for executives in Australia;

g) The dynamic response of this labour market to changing economic conditions, both domestically and internationally;

h) The effect of various kinds of remuneration structures on investment, productivity and efficiency at the individual firm level, including a comparison of firms within Australia as well as overseas firms;

i) The influence of various kinds of remuneration structures on macroeconomic variables including investment, productivity, long run economic growth and overall living standards – including a comparison across countries;

j) The degree to which existing remuneration arrangements in Australia and elsewhere respond swiftly and effectively to changing macroeconomic and microeconomic conditions;

k) The degree to which existing remuneration arrangements in Australia and elsewhere allow swift and efficient renegotiation or termination of contracts in response to changing macroeconomic and microeconomic conditions;

l) The extent to which executive termination payments allow firms to avoid heavily publicised, drawn-out and costly contractual disputes in the courts, which may ultimately destroy large amounts of shareholder value;

m) The degree to which any proposed changes or alternative arrangements would improve upon or worsen current arrangements – in other words, a thorough cost-benefit analysis of any proposed changes; and

n) A thorough survey and assessment of the international empirical evidence on the elasticity of performance with respect to compensation within different sectors, noting that this elasticity varies with the structure and form of remuneration.

The Economics of Executive Remuneration

The inquiry should conduct a thorough review of the economics literature on this issue. A good place to start is Rosen (1992) and the references he cites.

A key question in examining the issue of executive remuneration is: what is it that executives are expected to achieve within an organisation? Corporate executives play a key role in allocating the resources of a firm to their most efficient uses. This involves making decisions across a wide range of margins. Every decision involves some element of risk, and much of the firm's value is often at stake in key decisions taken by executives.

Hence, the marginal productivity of an executive may be quite high, but because of the very nature of the decisions that must be taken, productivity and measured performance may also be quite volatile. In addition, there may be a great degree of *ex-ante* uncertainty involved in assessing the marginal productivity of executives. Productivity is sometimes not directly observable after the fact.

All of these factors suggest that designing efficient and effective incentive schemes for executives are crucial for the performance of the firm. In some respects the issues involved in executive remuneration are no different from those faced in any employer-employee relationship: the problem is to design employee incentives in such a way as to maximise the value of the firm. However, in the case of executives the stakes are much higher and the risks to both sides of the employment contract can be far greater.

The other key distinguishing feature is that labour market for executives is far more globally integrated and internationally competitive than most other labour markets. This places a constraint on the design of both the structure and level of remuneration packages, an issue to which the inquiry should pay careful attention.

All of these considerations suggest that there is no "one size fits all" or "correct" approach to executive remuneration. For this reason, the Society would take a dim view of any move towards more heavy-handed regulation of the labour market for executives, particularly regulation which attempted to prescribe a "one size fits all" approach to remuneration. This is not to say that there is no case for improving existing regulatory arrangements and removing existing distortions. But in a free society the onus is on those who seek more regulation to make out that case using thorough economic analysis and prove beyond reasonable doubt that the benefits of regulation outweigh the costs.

The advantage of allowing market forces to work in labour markets in general – and in the market for executives in particular - is that market participants seek out alternative ways of increasing the value of the firm in a way that centralised control and "one size fits all" regulation cannot.

It is a fact of life that executives sometime make poor or incorrect decisions. Sometimes incentive structures do not work in the way that they are intended to. But shareholders who see a company's value being eroded away by poorly designed remuneration schemes will not be shareholders in that company for very long. The advantage of markets is that such unintended consequences, inefficient remuneration schemes or inappropriate practices are identified and weeded out over time, often very quickly.

Free labour markets tend to respond rapidly and efficiently to economic conditions. For example, many executives have recently seen large reductions in bonuses, and many have voluntarily taken pay cuts. Some have been fired. To the extent that these outcomes reflect poor performance and are part of the agreed contractual arrangements and compensation structure, they are entirely appropriate.

However, the logic of marginal productivity analysis suggests that the fact that a firm performs poorly may not necessarily justify termination or reduced bonuses and incentive payments. If macroeconomic conditions have taken a turn for the worse and the firm's performance would have been even worse in the absence of key decisions taken by executives, then the executive has still increased shareholder value relative to the counterfactual situation - and the case for reducing incentive payments under these circumstances is weakened.

Finally, if the goal of incentive payments is to use bonuses and other incentives to reward good performance and punish poor performance, then the flipside of recent events is that large increases on bonuses may be warranted when economic performance improves. Again, however, the key is to think in terms of marginal productivity and value-added. If the firm has performed well but would have performed even better if different decisions had been taken by executives, then the case for greater incentive payments is weakened.

Background to the Inquiry

The Society is concerned that from the very outset the inquiry seems to have been driven more by political factors and the current cyclical position of the Australian macro economy than by a desire to obtain and analyse hard economic evidence on executive remuneration. The concern is that as a result, the inquiry will be influenced more by short term political considerations, class warfare and an attack individual economic freedom, rather than by thorough economic analysis.

The inquiry's primary role should be to inject economic rigour and hard evidence into a debate which has thus far been sadly lacking in both and appears to be driven more by emotion than reason. The inquiry should be mindful of any unintended and deleterious consequences that might flow from additional regulation in this labour market, and should explore these consequences fully.

The Society's concerns are heightened by the fact that the global financial crisis, claims about excessive risk-taking and concerns about financial mismanagement have been used as the main justification for the inquiry. The terms of reference (TOR) for the inquiry state that:

"The current global financial crisis has highlighted the importance of ensuring that remuneration packages are appropriately structured and do not reward excessive risk taking or promote corporate greed. The crisis has also highlighted the need to maintain a robust regulatory framework that promotes transparency and accountability on remuneration practices, and better aligns the interests of shareholders and the community with the performance and reward structures of Australia's corporate directors and executives."

With all due respect to the inquiry, and without wishing to get bogged down in a debate about the causes of the global financial crisis, the Society does not agree. The Terms of Reference show a disturbing lack of understanding of the causes of the global financial crisis and a complete lack of awareness of the recent evolution of economic conditions in Australia, as well as the current state of the economy and the reasons for our economic performance.

The global financial crisis began in a narrow market: the US subprime mortgage market. It did not result from excessive risk taking or corporate greed across a wide range of sectors in the United States. It was not caused by – and so has <u>not</u> highlighted - a general problem of inappropriate structuring of remuneration packages across all economic sectors in the US.

Claims that deregulation in the US banking industry led to a deterioration of incentives are not borne out by the empirical evidence. For example, Becher et al (2005) find that "firms respond to deregulation by improving internal monitoring through aligning directors' and shareholders' incentives." Barro and Barro (1990) find that executive compensation in the US banking sector "is highly sensitive to performance".

A large part of the problem in the US is that economic conditions in the residential mortgage market are severely distorted by the presence of government sponsored enterprises (GSEs) in the market for residential mortgage-backed securities (RMBS). As many authors - including, for example, Greenspan (2004), Poole (2005, 2007), Frame and White (2005), Sowell (2009), Woods (2009) and Taylor (2009) - have pointed out, the problems in the US housing market stem from inappropriate institutional arrangements, poorly designed regulation, and political rent seeking on a vast scale. The problem is government failure, not market failure or a widespread culture of excessive risk taking caused by the poor design of executive remuneration packages.

Recent Policy Decisions

Every corporate decision involves some element of risk. Risk is something to be managed, not avoided completely. With regard to Australia, there is little evidence that the structure or level of executive remuneration in Australia's financial institutions has led to these institutions issuing an excessively risky volume of domestic subprime mortgages or "low-doc" loans in Australia. Indeed, there is little evidence of a widespread culture of excessive

risk taking among Australian corporate executives. Furthermore, there is little evidence that executive remuneration caused our financial institutions to invest too heavily in US sub-prime mortgages which subsequently went bad.

Recent policy decisions suggest that far from discouraging risk taking, lending and borrowing, policymakers are desperately trying to encourage these activities. Short term interest rates are at record lows, and over the year to November 2008 the money base in Australia increased by 43 per cent. In addition, the government has recently announced:

- Taxpayer-backed guarantees for bank wholesale funding, which ultimately act as an implicit interest rate subsidy and induce banks to lend higher volumes than they otherwise would. Since such debt is guaranteed by the taxpayer, it dulls the incentives for prudent risk management of this debt.
- An $8 billion government purchase of mortgage-backed securities;
- A substantial enhancement of the taxpayer-funded first home owners grant (FHOG) scheme;
- A special purpose vehicle to bail out car dealerships;
- Plans to encourage the major banks to grant temporary repayment moratoriums to borrowers who lose their jobs.
- The Australian Business Investment Partnership (ABIP, better known as the "Ruddbank"), which will use taxpayer funds to prop up commercial property prices, as well as engaging in up to $28 billion in taxpayer-guaranteed lending to other (hitherto unspecified) sectors;
- Tens of billions of taxpayer dollars in "cash splash" handouts, which has included payments to the deceased, ex-pats, and dogs and cats;
- Tens of billions of taxpayer dollars in "infrastructure spending", including up to $43 billion on the National Broadband Network. None of these projects has been the subject of a rigorous cost-benefit analysis. In the case of the NBN, no cost-benefit analysis will be carried out.

If the government believes that Australia's corporate sector has been overwhelmed by a culture of imprudent borrowing and lending and excessively risky financial behaviour, then encouraging banks and other financial institutions to increase lending in these risky areas whilst racking up more than $300 billion in gross public debt is a very strange, if not perverse, way of addressing these concerns. In the light of these recent policy decisions – which show a complete disregard for financial prudence and the consequences of excessive risk taking - conducting an inquiry into executive remuneration on the grounds that existing arrangements encourage excessive risk taking is a clear manifestation of "the knowledge problem". Those at the centre of decision making in Canberra cannot co-ordinate, not from

malice but from innate incapacity, the activities and decisions of the Left Hand and the Right Hand at the one time.

The Recession

Australia has so far avoided the technical definition of a recession, but there is little doubt that we are experiencing recessionary conditions. However, there is no evidence that current economic conditions have been caused by – or exacerbated by –excessive executive remuneration or inappropriate remuneration practices in the financial and banking sectors, or indeed in any other sector.

Australia is a price taker on the world capital market and our financial institutions fund a significant proportion of housing loans on the global market for securitised mortgages. When conditions on that market tightened early in 2008 as a result of the US meltdown, the increase in the cost of funds and risk aversion inevitably had adverse consequences for domestic credit markets (particularly the smaller non-bank financial institutions, global commodity markets, and our major export markets around the world.

At the same time, the Government – motivated solely by political considerations and the need to demonise its predecessors – recklessly exacerbated inflationary expectations and desperately urged the Reserve Bank of Australia to increase interest rates, which it did. The negative effects of these earlier interest rate increases are still flowing through into our economy.

Before the 2008/09 Budget the Government – again as part of a political strategy - emphasised that its budget policies would cause much “pain” in the community, and then followed this up with a confused Budget that increased taxes and increased spending.

Finally, the Government announced that it would push on with plans to reregulate the labour market and introduce a crippling emissions trading scheme that was nothing more than a tax on business and consumers.

These economic developments and the government’s policy mismanagement have destroyed business and consumer confidence and made a bad situation worse. More importantly, the collapse in confidence and the subsequent downturn had absolutely nothing to do with the structure or level of executive remuneration in Australia. No serious economist or commentator in Australia would argue otherwise.

Nor is there any evidence that current economic conditions in Australia have come about because of inappropriate risk taking by executives in the banking sector or other sectors. Indeed, the low exposure of Australian banks to US sub-prime assets suggests exactly the opposite may be true.

Conclusion

The Society trusts that this inquiry will use the very best tools of theoretical and empirical economic analysis to address the key issues outlined at the beginning of this submission.

However, the Society is concerned that by stating that "*The current global financial crisis has highlighted the importance of ensuring that remuneration packages are appropriately structured and do not reward excessive risk taking or promote corporate greed",* the terms of reference implicitly presume that excessive executive remuneration and "corporate greed" was behind the crisis in the United States. This view is mistaken, is not supported by economic evidence, and carries very little weight in the Australian case.

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