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Reining it in
Executive pay in Australia

Submission to the Productivity Commission Inquiry into Executive Remuneration in Australia
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TAI

Summary

The Global Financial Crisis focused attention in the excessive pay of executives in Australia and internationally. Toward the end of 2008 the Prime Minister, Mr Kevin Rudd articulated the wide spread the resentment of most Australians toward this excessive pay. In 2009 the Federal Government charged the Productivity Commission with an inquiry into executive pay in Australia. The Productivity Commission's draft report highlighted the gap between executive pay in Australia and average weekly earnings.

While calls for caps on executive pay have continued international action has settled for linking pay bonuses to company performance and the provision to 'claw back' bonuses where performance fails to meet expectations. The Productivity Commission has settled for even less than this with recommendations for altering governance and some additional shareholder participation. More is needed, however, if greater pay equity between executives and Australian workers is to be achieved.

A number of policy options are available to rein in the excesses of executive pay in Australia. These include removing the tax concession on capital gains and setting an acceptable level of executive pay that can be claimed as a company expense.

1 Introduction

> The key thing with executive pay is this – first of all, people around the world are fed up and angry with these outrageous packages paid to financial company executives who have contributed so much to what has gone wrong in the global economy. And who pays the price? Working people and their jobs.
>
> Kevin Rudd, 15 November 2008[1]

The global financial crisis peaked in September 2008 with front page stories of corporate bankruptcies. By October the banking sector was being recapitalised by national governments. In November, international leaders from the world's 20 largest national economies (the G20) gathered to tackle the global financial crisis and to instigate the necessary reforms to ensure that it didn't happen again.

A focus of reform has been the correlation between the global financial crisis, excessive executive pay and irresponsible corporate risk taking. While the issue of risk and bonuses were prominent in the business pages, public discontent with increasingly excessive and inequitable executive pay dominated front page news alongside the global financial crisis.

Launching a Productivity Commission inquiry into executive pay the Government acknowledged that '[t]here is significant community concern about excessive pay practices' and said that it is 'determined to ensure regulation of executive pay keeps pace with community expectations'.[2] However, six months later the tough talk was gone and the Government was pre-empting the Productivity Commission's draft report, saying it would not impose caps on executive pay.[3] In the end the draft report did

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[1] K Rudd, G20 Leaders' Summit, Washington, transcript of press conference, Washington D.C., 15 November 2008, at <http://canberra.usembassy.gov/irc/us-oz/2008/11/15/pm1.html> accessed 23 September 2009.

[2] C Bowen and W Swan, *Productivity Commission and Allan Fels to Examine Executive Remuneration*, press release, 18 March 2009.

[3] C Kerr 'Anthony Albanese rejects demands to cap bosses' pay' *The Australian*, 21 September 2009.

not even attempt to live up to the heightened expectations raised by the Prime Minster a year ago. Rather than recommend that the Government act to reduce ‘outrageous packages’ the draft report simply recommends an increase in board oversight of executive pay and thresholds for shareholder approval of executive pay and boards.

1.1 Executive pay in Australia

The Productivity Commission draft report reveals that average pay packets for the top 20 CEOs in Australia is almost $10 million. This is 150 times average weekly earnings. The CEO pay packets for the next 20 companies are about half this amount, but this is still 75 times more than the $62,218 a year the average Australian worker earns.[4]

Executive pay grew strongly in the second half of the 1990s, with moderate growth continuing until 2007 and the global financial crisis. Growth in executive pay correlates with a shift from base salaries to incentive based executive pay with short and long-term bonuses. So long as companies can afford to pay increasingly more fro their executives they are able to claim it as a company expense, reducing taxable profit and incidentally the size of dividends paid to shareholders.

The rates of executive pay in Australia are smaller than in the US and UK, being more comparable on average with Western European countries.

1.2 Executive pay and the global financial crisis

The global financial crisis shocked the world out of an extended period of strong economic growth and low inflation. A growing international economy appears to have instilled the banking sector with inflated confidence which, when conflated with incentive based executive pay, led to ‘irrational exuberance’ and increased risk taking in search new profit avenues.[5] This increased risk was exacerbated by a ‘lack of due

[4] At May 2009, the average weekly earnings for a full time worker was $1197.50 a week.

[5] A Turner, *The Turner Review: A regulatory response to the global banking crisis*, Financial Services Authority, United Kingdom, March 2009, p.25 at <http://www.fsa.gov.uk/pubs/other/turner_review.pdf> accessed 18 September 2009.

diligence in assessing credit risk'[6] and contributed to the global financial crisis.

There is a widely acknowledged link between incentive based executive pay, increased risk taking and the global financial crisis. The international Financial Stability Forum (FSF)[7], of which Australia is a member, stated explicitly that executive pay had a role in the global financial crisis:[8]

> Compensation practices at large financial institutions are one factor among many that contributed to the financial crisis that began in 2007. High short-term profits led to generous bonus payments to employees without adequate regard to the longer-term risks they imposed on their firms. These perverse incentives amplified the excessive risk-taking…

A year earlier, the FSF had recommended that risky practices encouraged by executive pay incentives should be mitigated through a working collaboration of regulators, supervisors and companies.

1.3 Need for regulation

Prior to the global financial crisis, when a growing economy was providing profitable returns executive pay received little attention from either regulators or companies. This lack of attention is beginning to be addressed in response to the global financial crisis.

For example, the US House of Representatives passed legislation in July that requires shareholders in public companies to annually vote on the

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[6] G20 Working Group 1, Enhancing Sound Regulation and Strengthening Transparency, Final Report, March 2009, p.3, at <http://www.g20.org/Documents/g20_wg1_010409.pdf> accessed 18 September 2009.

[7] The Financial Stability Forum was re-established as the Financial Stability Board (FSB) in April 2009 and is charged with developing and implementing 'strong regulatory, supervisory and other policies in the interest of financial stability'.

[8] Financial Stability Forum, *FSF Principles for Sound Compensation Practices*, April 2009, p.1 at <http://www.financialstabilityboard.org/publications/r_0904b.pdf> accessed 18 September 2009.

pay for a company's top five executives.[9] Guidelines adopted by the European Commission have focused on designing executive pay packages so that they promote long-term sustainability of a company.[10] The Australian Prudential Regulation Authority (APRA) has proposed that a remuneration policy and Board Remuneration Committee be two requirements of the banking and insurance companies it regulates.

In September, the Financial Stability Board (FSB) comprised of senior representation of national financial authorities, submitted its proposals for regulating executive pay to the G20 summit in Pittsburgh. Proposed standards included linking bonuses to company performance, 'clawback' arrangements[11] in the structure of bonuses, limits on guaranteed bonuses and enhanced supervisory and board oversight of executive pay.[12]

These changes reinforce the markets failure, despite constant assertions to the contrary, and that of private shareholders to align the long term interests of executives with those of company owners.

In Australia the Productivity Commission released a draft report the week after the G20 summit. Recommendations made in the report were not as far reaching as those proposed by the international FSB. The Productivity Commission limited its focus to improved board level governance and some increased provision for the role of shareholders.

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[9] N Pelosi, *Executive Compensation Reform*, at <http://www.speaker.gov/newsroom/legislation?id=0333> accessed 22 September 2009.

[10] Commission of the European Communities, Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies, 30 April 2009, p.3 at http://ec.europa.eu/internal_market/company/docs/directors-remun/directorspay_290409_en.pdf> accessed 18 September 2009.

[11] Clawback arrangements permit the repayment or deferral of executive pay bonuses if a company's performance is determined to have fallen short of expected performance.

[12] Financial Stability Board, *Financial Stability Board Issues Implementation Standards on Compensation*, press release, 25 September 2009 at <http://www.financialstabilityboard.org/press/pr_090925b.pdf> accessed 30 September 2009.

Proposed reforms for Australia do not appear to have gone as far as those recommended to the G20 to ensure global economic stability, yet there is no evidence to suggest that the problem is smaller in Australia.

Neither the FSB nor the Productivity Commission has recommended that executive pay be capped.

1.4 Labour market influence

The Productivity Commission draft report identified the influence of the labour market on rising levels of executive pay. Influences include company demands for executives with international experience and the correlation between incentive based executive pay and the appointment of US executives to Australian CEO positions in the early 1990s.

It seems unlikely that the 'executive talent' required by some firms is so rare that salaries of more than ten million dollars are required to attract capable people. It is clear that some large public sector organisations can attract people capable of managing tens of thousands of people, delivering high quality services in a timely manner and adapting to rapidly changing environments (including changes in the law and even changes in governments).

It is also clear that executives in non-English speaking companies are capable of managing large complex corporations for much less than is often paid in Australia or the US. It would seem that given the size of the English speaking population, companies seeking executives with the ability to speak languages other than English would find such 'talent' even rarer, and, in turn, should be willing and able to pay even higher wages.

Finally, any perceived shortage of executive talent, and the enormous salaries required to overcome it, should act as a signal for firms and executives to invest more in the training required to expand the size of the pool of capable applicants. However, the recent trend towards such enormous salaries does not appear to have triggered any self-correcting investment in training. On the contrary, remuneration seems to be spiralling upwards rather than being pressured downwards. This suggests that either significant market failure exists and/or that some of the claims about the role of market forces in setting executive salaries are simply self-serving.

2 Evaluating executive pay

2.1 How much are executives paid

Public resentment at the steep rise in executive pay is substantiated by figures compiled by the Productivity Commission. In assessing executive pay rises the Productivity Commission noted that there is limited data and difficulties in putting a dollar value on equity-based incentive payments. Despite this the Productivity Commission was able to identify a pattern of rising executive pay in Australia.

The greatest increases in executive pay occurred in the 1990s before slowing in the next decade. There was a reduction in executive pay in 2007-08 as the global financial crisis took effect. However indications are that pay increases and bonuses are returning.

Analysis of CEO pay packets by the Productivity Commission found that between 1993-99 there were increases of 16 per cent a year in real terms for the top 50 publically listed companies in Australia. The increase was 13 per cent a year across the top 100 companies. At the same time the mean average rise in average weekly earnings (AWE) for full-time employees was 3.7 per cent.[13]

Between 2000-07 pay increases for CEOs of the top 100 companies was about 6 per cent a year. The mean increase in AWE was 4.5 per cent. The following year the emerging global financial crisis began triggering reductions in executive pay, 12 per cent across the top 100 companies. The increase in average weekly wage in 2008 was 15.1 per cent less than the average increase since 2000.

In comparison the pay packets of non-CEO executives[14] employed in the top 100 public companies was 12 per cent a year between 1993-99 and 7.4 per cent a year between 2000-07. Executive pay decreased by 15.4 per cent in 2007-08.

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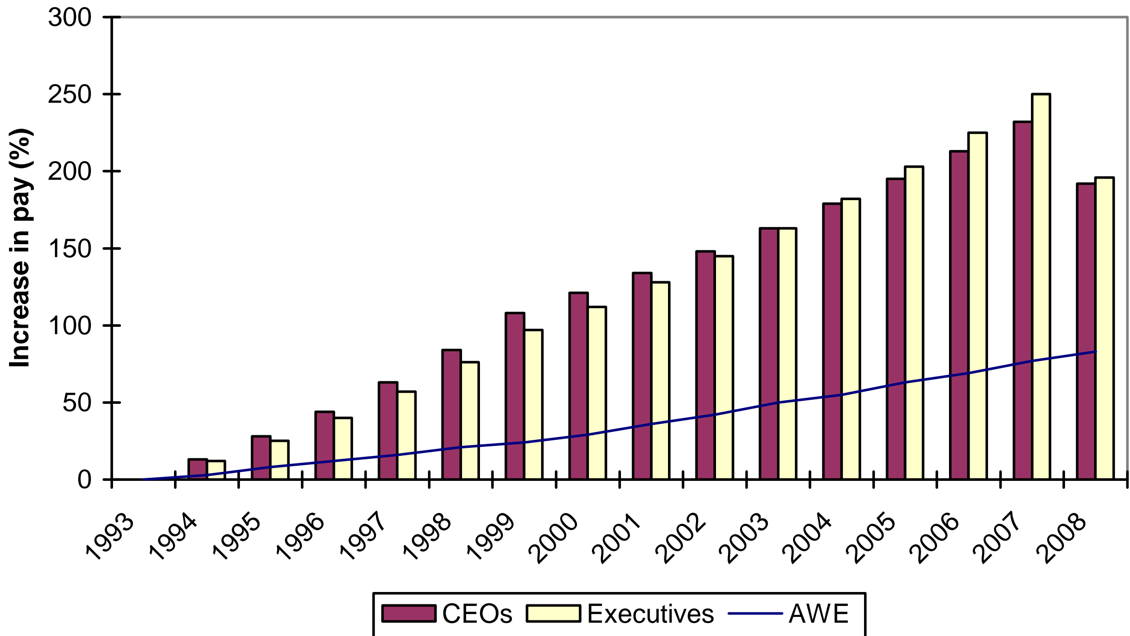
[13] ABS, *Average Weekly Earnings*, Seasonally Adjusted, Time Series Spreadsheet, Cat. 6302.0.

[14] Figure calculated on the average pay of the top five non-CEO company executives.

Figure 1 compares the percentage increases of CEOs, executives and average weekly earnings.

Figure 1 Comparison of percentage increase in pay



Source: Productivity Commission, Executive Remuneration in Australia: Productivity Commission Draft Discussion, September 2009; ABS, Cat. No. 6302.0

Interestingly in percentage terms executives caught up to CEOs in 2003 and started to move ahead. However the downturn in 2008 due to the global financial crisis resulted in a levelling between CEOs and executives. Average earnings failed to keep pace with CEO and executive pay increases despite recording an increase in 2008.

While the Productivity Commission figures reveal that executive pay increased by 250 per cent between 1993 and 2007, figures submitted by Egan Associates to the Productivity Commission's inquiry show even greater increases. Their analysis was also the average pay for CEOs and non-CEO executives across the top 100 companies in Australia. A comparison of increasing executive pay and increases in average weekly earnings over the same period are set out in Table 1.

Table 1 Comparison of executive pay and average full-time earnings

	1993	2008
CEO	$510,000	$3.2 million
Non-CEO	$250,000	$1.4 million
Average annual wage	$31,075	$62,218
Ratio of CEO to non-CEO pay	2:1	2.3:1
Ratio of CEO to the Average annual wage	15.3:1	51.4:1

Source: Egan Associates submission to the Productivity Commission Public Inquiry into Executive Remuneration; ABS Cat. No. 6302.0

The data from Egan Associates tells a story of ballooning executive pay packets compared with the gradual climb of average weekly earnings. In 1993 a company CEO earned twice as much as other executives and 15 times as much as the average full-time worker. While the ratio between CEOs and executives remained relatively constant up to 2008 while the gap between executives and the average wage has widened out to more than 50 times as much. In contrast non-CEO executive pay packets have maintained growth relative to that of CEOs.

Excessive executive pay and apparent reward for failure is not restricted to the private sector. In October 2009, it was reported that with bonuses the acting head of the Victorian Funds Management Corporation, which manages Victoria's public sector superannuation was paid over $1 million despite the fund recording a loss of more than $5 billion or 13.7 per cent in the same year.[15]

[15] D Rood, 'Million-dollar public servant presided over lost billions', *The Age*, 16 October 2009, <http://www.theage.com.au/national/milliondollar-public-servant-presided-over-lost-billions-20091015-gz62.html> accessed 16 October 2009.

International comparison

Analysis of CEO pay for companies with market capitalisation between A$5 million and A$30 billion has been used by the Productivity Commission to compare executive pay packets in Australia with those paid internationally, in 2008. In the US the average executive payment was A$7.36 million and in the UK A$5.56 million. In comparison it was A$4.41 in Germany and A$4.04 in France and in Australia $3.45 million. These figures suggest that Australia is aligned with Europe and that it is in the US and UK that executives receive truly excessive pay packets.[16]

However, the Productivity Commission acknowledges that executive pay packets in the Australian finance sector are closer to the high levels of executive pay paid in the US, for similarly sized banks. Whereas equivalently sized banks in Europe pay significantly less to their executives. Figure 2 illustrates the disparities between executive pay for banks with comparable market capitalisation.

Figure 2 reveals that the CEOs of Australian banks are receiving a better deal than even North American banking executives. While North American CEOs are paid up to $2.8 million more, the market capitalisation of their banks is at least $7.4 billion greater than the Australian banks cited. The nearest comparable example is Unicredit (Italy) with slightly lower market capitalisation but pays its executive $2.5 million less than if they were doing the same job at Westpac. Alternatively, executive pay is similar between BBVA and the Australia examples but the market capitalisation is a minimum of $4.5 billion more. The competitive examples from the UK, France and Switzerland illustrate the excessive levels of executive pay in the Australian banking sector.

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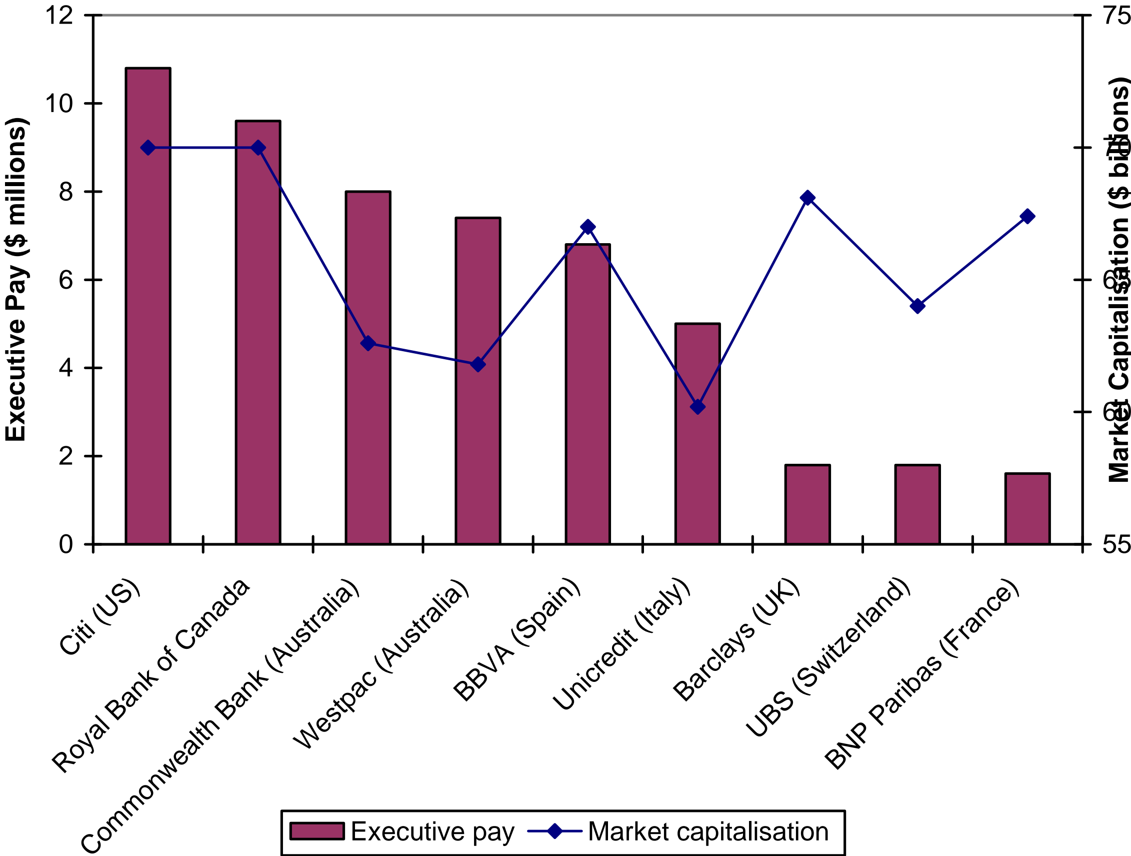
[16] Productivity Commission, *Executive remuneration in Australia: Productivity Commission Draft Discussion*, September 2009, p.xix

Figure 2 Executive pay for similar sized banks in Europe, North America and Australia



Source: Reuters, 'Banking Compensation', accessed 8 October 2009, <http://graphics.thomsonreuters.com/099/GLB_EXCMP0909.gif>

Note: MUFG (Japan) has a market capitalisation of $69.7 billion but did not disclose executive pay figures.

The latest reports from overseas are that bonuses and pay increases are now returning following the global financial crisis. In the US, investment bank Goldman Sachs has set aside close to $17 billion or 47 per cent of its profits for paying bonuses. Bonuses are the company's largest expense.[17]

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[17] P Ryan, Goldman profits, but home defaults surge, Australian Broadcasting Corporation 16 October 2009, <http://www.abc.net.au/news/stories/2009/10/16/2716193.htm?section=justin> accessed 16 October 2009.

2.2 How are executives paid

Until the mid 1990s executive pay was comprised largely of a base salary and some allowances. Bonuses usually accounted for less than a tenth of total executive pay.[18] Since the mid 1990s bonuses as a proportion of executive pay have increased. This change is attributed to the new pay practices introduced by the appointment of US executives in the early part of the decade. Recently, Leighton Holdings executive Mr Wal King acknowledged that Australian executives have benefitted from the adoption of US style remuneration packages, the legacy of short stay US executives. Mr King said:[19]

> you name me one American chief executive that has stayed in Australia. I think all they in fact have done is ratchet up the salaries for guys like me.

Up unto the beginning of the global financial crisis incentive bonuses increasingly comprised a larger proportion of executive pay.

When former CEO Mr Geoff Dixon left Qantas he was paid a base salary of $1.9 million for his last five months of work. On top of this he also received $3.2 million in share-based payments, $3 million in long-term benefits, $1.7 million in annual leave and $657,000 in termination benefits.[20] This adds up to 10.5 million which is more than eleven times what the average Australian worker earns in a year.

The Productivity Commission has identified the following trends in the structure of executive pay in the top 300 companies listed on the

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[18] Productivity Commission, *Executive remuneration in Australia: Productivity Commission Draft Discussion*, September 2009, p.51

[19] W King, 'Wal King defends big pay packet' PM program, ABC Radio National, 5 November 2009, <http://www.abc.net.au/pm/content/2009/s2734533.htm> accessed 6 November 2009

[20] M Janda, Dixon's $11m parachute from Qantas nosedive, ABC News online, 21 September 2009, <http://www.abc.net.au/news/stories/2009/09/21/2692044.htm> accessed 20 October 2009.

Australian stock exchange in the five years from 2003-04 to 2007-08. There has been:[21]

- a slight real reduction in the average base salary of CEOs (and a larger real reduction in the average base salary of non-CEOs)
- a 30 to 40 per cent real increase in the average value of short-term incentives
- a more than tripling of the average estimated value of equity-based and long-term incentives

Starting with a fixed salary (including superannuation) executive pay can be enhanced by bonuses, non-recourse loans and/or termination payments.

Bonuses

A bonus is defined in the Macquarie dictionary as: something given or paid over and above what is due; a sum of money paid to an employee over and above their regular pay.

Bonuses are intended as incentives for executives to improve the profit outcomes of a company. Short-term bonuses tend to be cash payments with shares awarded as long-term bonuses. Despite the definition of a bonus, the practice of guaranteed bonuses to lure executives to a company has also been employed and contributed to spiralling increases in the size of executive pay packets. Reforms recommended by the multinational Financial Stability Board (FSB) have focused on deferring bonuses and the clawback of payments where company performance is significantly below expectations to encourage a longer-term focus from executives.

Termination payments

Termination payments (or golden handshakes) have been subject to public scrutiny because they are often seen as a reward for failure when an executive is compensated for early termination. The reported size of termination payments for leading executives has not helped. On

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[21] Productivity Commission, *Executive remuneration in Australia: Productivity Commission Draft Discussion*, September 2009, p.51

departing Telstra former CEO, Mr. Sol Trujillo received $3 million dollars in termination payments over and above a base salary of $13.4 million.[22]

The Australian Government announced changes to the Corporations Act in March 2009 that effected termination payments.[23] The changes reduced the threshold at which shareholders must approve payment equal to one year's base salary, extended approval requirements to all executives listed in a company's remuneration report and broadened the definition of a termination payment. These changes are not retrospective. In contrast the FSB has recommended that existing termination clauses in executive contracts be re-examined.

[22] P. Ryan, 'Swan cracks down on 'golden handshakes'', 18 March 2009, accessed 15 October 2009, <http://www.abc.net.au/pm/content/2008/s2519973.htm>

[23] N Sherry and W Swan, *Action on golden handshakes*, press release, 18 March 2009.

3 Reining in executive pay

At the height of the global financial crisis the G20 met in Washington. From this summit of panicking world leaders came a call for immediate action to avoid executive pay 'which reward excessive short-term returns or risk taking'.[24] This action, we were told, could be achieved through voluntary measures or regulatory means so long as the desired outcome was achieved.

Proposed international reforms to rein in executive pay since the G20 Washington Summit have largely focused on the payment of bonuses. The reason for such a focus is that incentives, and in particular short-term incentives are viewed as the primary motivator behind risky business and investment decisions. The objective of reforms has been to increase the accountability of executives for their decisions by aligning long-term interests of executives with the long-term interests of shareholders. The excessive size of executive pay before bonuses and other incentives has not been subject to any limitations or reform measures.

In the UK the Financial Services Authority (FSA) has argued that increased regulation is justified when the social costs of corporate sector losses exceed private costs (i.e. company profits, shareholders). Regulation, the FSA argues, is further justified as the market is unlikely to successfully address externalities resulting from the effects of executive pay packages.[25] However, the FSA recognises that there are limitations to the extent Government policy can change executive pay practices stating that changes to capital, accounting and liquidity and associated market responses will have as much, if not more, effect than regulation of executive pay.[26]

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[24] Declaration of the Summit on Financial Markets and the World Economy, 15 November 2008, p.3 at <http://www.g20.org/Documents/g20_summit_declaration.pdf> accessed 18 September 2009.

[25] Financial Services Authority, Reforming remuneration practices in financial services, Consultation Paper, March 2009 p.13 at <http://www.fsa.gov.uk/pubs/cp/cp09_10.pdf> accessed 18 September 2009.

[26] A Turner, *The Turner Review: A regulatory response to the global banking crisis*, Financial Services Authority, United Kingdom, March 2009, p.81 at <http://www.fsa.gov.uk/pubs/other/turner_review.pdf> accessed 18 September 2009.

In Australia, the Australian Prudential Regulation Authority (APRA) recognises that it can directly influence the boards of the financial institutions it regulates. However APRA has stated that it 'does not intend to focus on the levels of [pay] paid to executives.'[27] Instead, APRA has proposed extending governance standards to ensure that companies themselves address executive pay issues. These changes are focused at the board level of institutions regulated by APRA. Boards will be required to have a remuneration policy and a Board Remuneration Committee.[28] These reforms are aligned with the principles set out by the Financial Stability Board that independent and effective boards oversee executive pay policies and practices.

The Productivity Commission has similarly recommended in its draft report that board governance of executive pay be strengthened. In addition, the Productivity Commission recommends a marginal increase in the role of shareholders in relation to a board's oversight of executive pay.

Yet, by leaving the issue of executive pay to the prerogative of companies regulators are only attempting to address part of the problem. It is not clear why it is the government's responsibility to protect shareholders from the greed of the executives they appoint to run their companies. It is clear, however, that the government has a role to regulate companies and the market to prevent another global financial crisis and a need to address the inequity of executive pay.

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[27] Australian Prudential Regulation Authority, *APRA outlines approach on executive remuneration*, press release 9 Dec 2008 at <http://www.apra.gov.au/Media-Releases/08_32.cfm> accessed 22 September 2009.

[28] Australian Prudential Regulation Authority, *Remuneration: Proposed extensions to governance requirements for APRA-regulated institutions*, Discussion paper, May 2009, p.6 at <http://www.apra.gov.au/policy/Remuneration-requirements-consultation-May-2009.cfm> accessed 22 September 2009

3.1 Managing risk

The Financial Stability Board (FSB), senior representatives from national financial authorities tasked with implementing policies to ensure global financial stability, has proposed to the G20 that executive pay should be aligned with a full risk assessment. By using risk-adjusted profit to calculate bonuses excessive risk taking is less likely to be encouraged. It also recommends that executive payments be deferred to further reflect actual company performance over time. It must be remembered, however, that these proposed standards relate only to 'significant financial institutions'.[29] Other FSB recommendations include:

- linking bonuses to negative company performance
- proportion of deferred (minimum three years) bonus should increase relative to seniority and/or responsibility, starting at 40 per cent and increasing to more than 60 per cent
- at least half of bonus payments should be in shares linked to a share retention policy
- cash bonuses should be vested over time and clawed back in instances where future company performance declines
- guaranteed bonuses restricted to new staff and be minimal
- re-examination of termination clauses and payments

While these reforms are intended to shift the focus of executives from a short to long-term perspective they also entail an increase in company regulation and supervision. Emphasis upon shares as bonuses serves as a market form of regulation and supervision.

There are, however, drawbacks in awarding shares as bonuses in order to reduce risk-taking while also continuing to provide an incentive for executives. The Productivity Commission has noted that shares offer little in the way of consistent incentives to executives (being 'akin to a

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[29] Financial Stability Board, *FSB Principles for Sound Compensation Practices: implementation standards*, September 2009, p.2 at <http://www.financialstabilityboard.org/publications/r_090925c.pdf> accessed 18 September 2009

lottery') but can have large cost implications for companies.[30] The advantage for Australian executives in receiving bonuses in the form of shares is that they are subject to a concessional rate of capital gains tax. Capital gains are taxed at half an executive's marginal tax rate, resulting in a tax rate of 24.3 per cent tax on proceeds from shares sold after more than a year. There are profitable advantages of capital gains tax concessions for those subject to the top marginal tax bracket. Tax concessions, such as those applied to capital gains:

> undermine the progressivity of the income tax regime and make it possible to craft executive pay packages with a strong bias towards such tax breaks.[31]

Given the tax advantages available to executives by being payed in the form of share bonuses rather than a base salary it seems naively optimistic to assume that companies or executives will work very hard to reduce their reliance on such incentives unless the underlying advantage of tax concessions are removed.

The link between risk and executive pay was discussed at a seminar of the International Monetary Fund Executive Board in June 2009. Directors attending the seminar discussed the role of tax and different forms of pay available to executives. It was noted that tax treatments 'may have contributed to greater risk-taking and short-termism'. The seminar further noted that 'it is important that taxation not encourage the use of inappropriate compensation arrangements'.[32]

The proposed FSB standards tackle incentive pay based risk-taking through increased use of shares and deferred divestment. What this approach does not take into account is the tax advantages that remain

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[30] Productivity Commission, *Executive remuneration in Australia: Productivity Commission Draft Discussion*, September 2009, p.xxiii

[31] D Ingles, *Tax equity: Reforming capital gains tax in Australia*, Technical Brief No.1, The Australia Institute, April 2009, p.2

[32] International Monetary Fund, *IMF Executive Board Holds Board Seminar on Debt Bias and Other Distortions: Crisis-Related Issues in Tax Policy*, Public Information Notice (PIN) No. 09/76, 16 June 2009 <http://www.imf.org/external/np/sec/pn/2009/pn0976.htm> accessed 22 September 2009.

available to executives. The application of concession tax on capital gains undermines international reforms to encourage more prudent management by executives. The rationale for tax concessions on capital gains runs contrary to this goal as it is intended to encourage risk-taking.[33] To ensure that reforms designed by the FSB are effective in Australia the concession on capital gains has to be removed.

3.2 Capping executive pay

United multi-national efforts through the G20 to reform executive pay have stressed that capping executive pay is not the agenda. There are exceptions, however.

The French President, Mr Nicolas Sarkozy had been advocating capping executive pay in the lead up to the September meeting of G20 leaders in Pittsburgh. Similarly, the UK House of Commons Treasury Committee had argued that the FSA should 'regulate levels or the amount of pay within the banking sector'.[34] The argument for capping executive pay has, however, remained the exception despite its public appeal.

In Australia, despite enthusiasm for addressing 'outrageous' executive pay the Prime Minister indicated that the government did not advocate caps on executive pay – 'without specifying a number'.[35] The Productivity Commission has followed the Prime Minister's lead stating that they are:[36]

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[33] Ralph Committee Report, *A tax system redesigned: More certain, equitable and durable, Report of the Review of Business Taxation*, Canberra, Australian Government, 1999, at <http://www.rbt.treasury.gov.au/publications/paper4/index.htm>

[34] House of Commons Treasury Committee, *Banking Crisis: reforming corporate governance and pay in the City*, United Kingdom, 12 May 2009, p.22 at <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf> accessed 18 September 2009.

[35] K Rudd, G20 Leaders' Summit, Washington, transcript of press conference, Washington D.C., 15 November 2008, at <http://canberra.usembassy.gov/irc/us-oz/2008/11/15/pm1.html> accessed 23 September 2009.

[36] Productivity Commission, *Executive remuneration in Australia: Productivity Commission Draft Discussion*, September 2009, p.xxv

> …convinced that the way forward is not to by-pass the central role of boards in remuneration-setting through prescriptive regulatory measures such as pay caps.

3.3 Labour market

The labour market is used as justification for not setting caps on executive pay. A competitive labour market for company executives is required as executives are seen as the key to company success. This view is perpetuated in the Productivity Commission's report. The report outlines how executive pay is determined by the market rationale of supply and demand with additional negotiation determining bonuses and considering tax implications to determine an executive's final pay packet.

While some criticisms of the view that 'market forces' provide a sufficient explanation of the growth in senior executive remuneration were advanced above, it is also important to consider the problems associated with imperfect information, risk aversion and board decision making in relation to executive pay. The role of the board is central to any understanding of executive pay as while it might be said that 'markets' set pay in general, it is individual boards that set them in particular.

Ironically, it is possible that prudent, risk averse boards, can play a role in driving up executive salaries and creating remuneration structures that subsequently serve to encourage excessive risk taking by management. Consider the following example:

> The board of a company has narrowed down the number of candidates for a new executive position to two people who both appear to be equally suitable. One is currently being paid $500,000 and the other is being paid $2 million. The board is likely to be perceived as taking less risk by choosing the second candidate, even though they will have to pay them more. The rationale for this perception is that the 'labour market' has already determined the executive's market value. A decision to employ the better paid candidate suggests that the boards decision is supported by the market. A decision to employ the second candidate suggest the Board has rejected the 'advice' of the market.
>
> Furthermore, if the better paid candidate turns out to be a poor performer, it is not just the board that has been duped, but the

> entire ‘market’. Whereas, if the Board takes the more ‘risky’ decision of employing the lower paid executive, and that person is a poor performer, then the mistake is more likely to be perceived as a mistake purely of the Board.

The Productivity Commission has summarised this predicament faced by boards.

> The pay-offs for … companies from having a highly-talented CEO and senior executives (and the losses from having inferior ones) are potentially commensurately large.[37]

The dynamics of the labour market helps ensure that executive pay will continue to rise. Indeed, an executive’s market value will increase even before they have started work as the company will pay more in order to lure him to their company. Amidst the large executive pay hikes in the 1990s this was described as the ‘virtuous circle’.[38]

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[37] Productivity Commission, *Executive remuneration in Australia: Productivity Commission Draft Discussion*, September 2009, p.xviii

[38] Ivor Ries, ‘The fat-cat gap is growing’, *The Australian Financial Review*, 5 December 1996, p.52

4 Policy solutions

Reining in executive pay and reducing the incentive for executives to take large risks with other peoples money are not mutually exclusive. Internationally reforms have ignored the inequity of executive pay. Yet both public concern at the exuberance of executive pay and the international focus on economic stability can be addressed simultaneously. Outlined below are two policy proposals to achieve the combined goal of increased pay equity and a more stable economic structure. The two policy solutions presented propose reforming inequitable tax concessions; and linking executive pay as a proportion of a company's total wages bill.

4.1 Removing tax concessions on capital gains

As discussed above share based incentives are attractive for executives because they are subject to highly concessional capital gains tax. These concessions ensure that the capital gains tax rate is only half the top marginal income tax bracket. Addressing the tax advantages of shares for executives would reinforce global reforms proposed for executive pay. Both the conflation of incentives and risk and size of executive pay packets would be addressed by removing inequitable tax concessions on capital gains. This reform would not require any further regulation of executive pay, unlike the reforms proposed by the Financial Stability Board and Productivity Commission.

While this approach does not cap the size of executive pay it does result in increased equity and a reduced incentive on large bonuses rather than negotiated base salaries. Removing tax concessions on capital gains would inevitably result in executives demanding increased pay. Despite this, the net increase in the tax base would go some way to indirectly addressing the inequity of executive pay. The ability to rein in executive pay and address (indirectly) pay inequity through the tax system is a straightforward option. While executive pay itself would not be capped under this proposal greater equity would be achieved.

4.2 Acceptable company expenses

Setting a cap on executive pay is not a practicable policy solution, but, setting an acceptability cap for how much an executive can acceptably be payed is feasible. It would remain the prerogative of the company to pay above this acceptable limit, but payments in excess of this cap could be deemed not to be a legitimate business expense and, in turn, deemed not to be tax deductible. This approach has been employed by some countries in relation to 'facilitation payments' (sometimes called bribes). In effect it would convert excessive salaries into a gift from shareholders to senior management. While the increase in tax revenue would be small, such a change would be likely to ensure that shareholders, including institutional shareholders, subjected claims concerning the shareholders benefit from executive salaries to significantly greater scrutiny

4.3 Conclusion

The excesses of executive pay can be reined in through targeted reforms. Removing the concession on capital gains tax would go someway to mitigating the link between incentive and risk, the focus of international reform of executive pay, without requiring any further regulation. However, this option does not address the spiralling flaw of the labour market which ensures increases in executive pay. Addressing this flaw in the labour market does require regulation. Companies could be dissuaded from fostering the spiralling of executive pay by having a limit set on the portion of an executive's salary that could be claimed as a company expense.

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