Executive pay: economic issues from the Commission's report*

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The Productivity Commission's discussion draft on executive remuneration was released two weeks ago. A bit like Goldilocks, it has provoked three responses — 'too strong' from those who consider executive pay does not warrant intervention, 'too weak' from those wanting pay caps or binding shareholder votes, and 'about right' from the rest. This is not a bad place for the Commission to be at the draft report stage!

For those of you who haven't seen the report, the Commission confirmed what everyone thought to be the case — that executive pay has been growing strongly and, at least for the executives of the largest public companies, has attained relatively very high levels. We did not find evidence of *system-wide* failure in executive pay-setting across Australia's 2000 public companies. But we did conclude that there had been episodes of poor practice and excess, pointing to weaknesses in governance that warranted action.

We have made 15 preliminary recommendations to strengthen the regulatory and corporate governance framework, most of which are directed at ensuring that remuneration decisions by boards reflect shareholder interests over the long term. A couple of recommendations have been more contentious than others, especially our proposed 'two-strikes' rule.

I'll come to these, but with the interests of this audience in mind, I'd like to concentrate more tonight on some of the economic considerations behind our recommendations. (These are all discussed in the report, but being buried in chapters haven't had much of an airing.)

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The public company is the *solution*, not the problem

The beginning is always a good place to start, and one of the first articles we dug out after receiving the inquiry, was Ronald Coase's seminal *The Nature of the Firm*, published in 1937. Coase's insight was that companies exist because they reduce transactions costs arising from decentralised production and ownership of assets.

Public company structures, by reducing squabbling over distribution of the profit residual across many asset owners, can facilitate consolidation of asset ownership and control that, in turn, allows economies of scale and scope to be efficiently exploited.

Of course the modern public company model had emerged a century or so before Coase (with joint stock companies dating back even earlier to the 17th century). And there were a number of developments along the way — including the introduction of limited liability for shareholders in the mid 1800s. This key innovation was controversial at the time and a view lingers today that it confers a special benefit on public companies, placing a mutual obligation on them to conform to community expectations. To some extent this is implicit in the initiation of the Commission's public inquiry.

But the policy rationale for limited liability revolves around promoting economic efficiency and wealth creation, not giving preferential status to a particular group of investors. (Indeed without legal backing for limiting liability, companies could offer contracts to investors which would effectively deliver the same deal — a sort of non-recourse claim — but at much greater cost.) And, of course, limited liability for shareholders does not place *companies* above the law.

For our inquiry though, the important point is that the public company structure can be efficient (and, therefore, exist) precisely because it reduces the conflicts that arise from having many owners of capital with different views about what share of the profits they should receive, as well as different views about business strategies and the selection and remuneration of management. Shareholders are a very mixed bunch, with diverse risk preferences and time horizons. Moreover they are highly footloose — with share registers of some major Australian companies turning over twice in a single year.

The mechanism for managing these tensions is the board. Boards are elected by shareholders and delegated authority over company strategy and profit distribution, as well as the hiring and remunerating of the CEO. Importantly, company boards have a fiduciary duty to act in the interests of the company, not shareholders per se. This distinction is deliberate and fundamental — promoting the company's interests will be in the interests of shareholders as a group over time, but unlikely to be in the best interests of each and every shareholder all of the time (an impossibility).

Nonetheless, there are different views about the desirable extent of shareholder influence and board accountability to shareholders. For instance, the so-called Delaware model in the USA essentially involves shareholders putting up their money in return for claims to the profit residual according to how many shares they own and, beyond electing directors, staying out of sight or selling their shares on the market. (And it has to be acknowledged that over the 20th century this model didn't work too badly.)

Governance arrangements are stricter in Australia than in the United States, with shareholders in recent years being given more influence on aspects of board decision-making, including executive pay, although the board's ultimate decision-making authority remains intact. It's worth noting that recent reforms in the United States are now moving that country in the same direction.

But every benefit has a cost: the principal-agent 'problem'

As every economist knows, there is no such thing as a free lunch. Separation of ownership and control creates its own problems — the costs arising from information asymmetries between shareholders and boards, which are their agents, as well as between boards and management.

The nature and extent of the principal–agent problem in public companies lies at the heart of the debate about executive pay — and the question, are executives effectively setting their own pay by gaming or capturing boards?

There is a wide range of views. Some think the principal–agent problem is much overstated — and that executives will generally be trustworthy stewards of the companies they are employed to manage. Certainly there are inherent forces for alignment, including professional reputation. Such forces arguably loom larger when the chances of failure increase — for example, as product and capital markets become more competitive, poor performance will be quickly exposed and penalised.

The more conventional view is that, notwithstanding those considerations, executives will not necessarily pursue strategies or exert effort in a way that fully accords with the company's interests.

There are various ways of promoting such alignment: governance arrangements are designed to reduce conflicts of interest and make boards accountable to shareholders; and boards monitor executive effort and decision-making, as well as building incentive structures into their remuneration

Some regard these mechanisms as broadly successful (bearing in mind that perfect alignment will be unattainable because of the costs of monitoring and of incentive pay). Others, such as Professor Lucien Bebchuk from Harvard, consider that they have failed badly, with CEOs manipulating things to further their own interests.

When is high pay a policy problem?

Many in the community obviously have a sense of disbelief or grievance that someone can earn $10 million or more a year. Interestingly, though, people seem more accepting of entertainers or sports stars receiving such amounts. Executives are perceived differently — presumably because they are seen to be able to reward themselves or directly influence what they are paid, at others' expense.

Community sentiment about inequality or fairness cannot be ignored by governments, but neither should the national income consequences of any interventions to assuage it. Government interventions to promote fairness can sometimes have perverse effects, including for those very groups whose interests are uppermost in governments' minds. The Commission therefore has stuck to its last and assessed the case for government intervention on executive pay on efficiency grounds.

Economic efficiency requires that all the potentially most valuable transactions take place, allowing for any social costs. In the market for executives, this means firstly, each company hiring the executive with the greatest potential to enhance its profits over time and, secondly, making sure that he or she does so.

High pay can create wealth

Clearly though, the multi-million dollar pay packets of some top executives exceed what most of them would require for a very comfortable (even luxurious) life, and they probably embody 'rent'. In other words, many of those executives would get up and go to the office for less. But does this mean their pay is 'excessive' from an economic efficiency perspective?

Theory would tell us that paying above the 'reservation' wage can still be an efficient means of allocating executives to their highest valued use. To attract and retain the 'right' person, companies may have to pay a premium to match what other potential employers might be prepared to pay. Executives will then be employed by companies where they are perceived to be worth the most, with the extra remuneration they receive hopefully representing a transfer of some of the (larger) surplus they create. It follows that if the capacity to bid up remuneration to reflect the premium placed on particular characteristics were inhibited, there could be efficiency losses from the misallocation of executives to lower-valued employments.

Of course, if there were an unlimited supply of equally able executives, there would be no ‘scarcity’ premiums — but that doesn’t appear to be the case. While many people might have relevant managerial qualifications, executive quality varies greatly. Only a limited number of executives will be perceived by boards to have the range of key ingredients — such as judgement, leadership and communication skills — of a sufficiently high order. Some of these attributes are inherent and cannot be easily learned, and so the ‘pool’ of high calibre individuals cannot easily be increased.

If well structured, higher pay can also deliver higher company profits by inducing closer alignment of executive actions and decisions with the interests of the company (and thus of shareholders). In other words, pay can be an efficient means of addressing principal–agent issues.

High pay can also transfer wealth or even destroy it

That’s the economist’s case for the defence. On the prosecution’s side, high remuneration could well reflect ‘market power’ stemming from an executive’s information advantage. For instance, executives could employ various strategies to fool boards into believing that they are better than they are. Or they might be able to manipulate and exploit remuneration incentive structures in their favour (for example, by taking short-term actions to increase the share price). Such manipulation at best might only result in a transfer of profits from shareholders to executives. But company performance and profitability could be weakened if executives pursue excessively risky or costly strategies to maximise their pay.

It’s also the case that, even with the best of intentions, boards can get incentive arrangements wrong. Early on in our inquiry, we heard from the ex-CEO of an executive who shut down his factory for a month or so to benefit personally from a short-term, cost-cutting hurdle.

But while such outcomes would seem undesirable (and give rise to real costs), whether or not they are ‘inefficient’ in an economy-wide sense also depends on the costs of taking feasible actions to reduce them.

Whose problem is it anyway?

If an executive is simply ‘overpaid’, the profits available for distribution to company shareholders or for reinvestment will be reduced and, all else equal, so will the share price. But from an efficiency perspective this is simply an income transfer, with the impacts internalised within the company. Moreover, shareholders presumably have an incentive to do something about it, including selling their shares. Similarly, they will have an interest in preventing executives from taking actions that increase their pay at the expense of real wealth creation. But at the end of the day, if boards and shareholders cannot prevent such actions and the company performs poorly as a result, it will lose market share, be taken over, possibly even bankrupted. Some would argue that this illustrates efficient ‘destruction’ — and problem solved.

They might indeed be right. But lower profits and company failure, with consequent wealth losses and adjustment costs, nonetheless represent real economic losses for the community, which might have been avoidable at lower cost. Moreover, losses in a number of companies that are driven by poor remuneration practices might damage perceptions of, and trust in, other companies, potentially reducing confidence in equity investments more broadly.

And in the finance sector, allowing companies to collapse could generate system-wide contagion effects, as is now well appreciated. This of course is the policy space APRA and the GFS are grappling with at the moment.

Big pay is a big company story

At a presentation to CEDA last week I noted that Australia has good corporate governance but poor data, while in the United States it’s the opposite. Graham Bradley (from the BCA) quipped that he’d much prefer the former to the latter. That seems undeniable. But the lack of consistent time series certainly has made our job challenging, and has limited the scope for rigorous quantitative analysis. That said, we have managed to build up a picture of what has happened, drawing on a variety of quantitative and qualitative sources (and will try to tap more data for the final report).

Our report confirms that, by any measure, executive remuneration has grown strongly since the early 1990s. Depending on the sample used, CEO remuneration at the 50–100 largest Australian listed companies grew by around 10 per cent a year in real terms between 1993 and 2007, translating to cumulative increases of more than 250 per cent.

In 2007-08 total executive pay fell in these largest companies by around 13% in real terms as the GFC hit, but we won't know to what extent this continued into 2008-09 until the reporting season has wound up. (ACSI/Riskmetrics data for calendar '08 suggest a smaller decline.)

These aggregate data miss the clear divide between larger and smaller companies in relation to pay growth, quantum and structure. The reality is that Australia has almost 2000 publicly-listed companies and there is tremendous diversity among them.

In 2007-08, remuneration for CEOs of the top 20 companies averaged almost $10 million, or 150 times average wages — and we hear a lot about that. But CEOs of the next biggest 20 companies were paid about half this, with multi-million dollar packages all but disappearing for companies ranked 150–200.

For the smallest companies, CEO remuneration averaged around $180 000 (or three times average wages).

Remuneration levels also vary significantly across industries, being highest in the finance, telecommunications and consumer sectors, and lowest for the CEOs of information technology and utility companies.

So multi-million dollar pay is a big company story in Australia, mainly confined to the top 1–2 per cent of public companies.

It's also important to note that nearly all of the recent growth in measured CEO pay for the top 300 companies is attributable to increases in performance pay (at least, as it is valued for accounting purposes). Much of this was in the form of 'long-term' incentives, which more than tripled between 2003-04 and 2007-08.

Dominant influences on pay quantum: efficient or inefficient markets?

In fundamental ways, the market for executives is similar to other markets. It has demand and supply sides, mediated by institutions, rules and inter-relationships among the parties, and various other incentives. In broad terms, the remuneration outcome will be higher the stronger is demand and the tighter is (perceived) supply. There are a variety of influences on both.

Our analysis suggests that there has been a mix of drivers of the executive pay growth observed in Australia. Some of these relate to 'normal' market pressures and developments; others revolve around corporate governance and how incentive pay structures have been implemented in practice.

Increased company size, globalisation and competition for top talent

The broader context is also important. As you know, the market environment for most companies has changed dramatically over the past few decades. Liberalisation of product and financial markets, and removal of government monopolies, have driven substantial domestic structural changes — including corporate consolidation and the emergence of internationally-competitive companies with global operations. Today, for example, BHP Billiton (Australia's largest listed company) has market capitalisation of some $244 billion compared to $16 billion in 1989 at the end of the high protection era. Wesfarmers' capitalisation increased from $800 million to almost $30 billion over the same period. (All in 2008 dollars.)

The pay-offs for these and other large companies from having a highly-talented CEO and senior executives (and the losses from having inferior ones) are potentially commensurately large. In line with their global focus, many companies now demand candidates with international experience. At the same time, Australian (and other) executives have become more mobile across companies and internationally.

For any company, getting the best possible CEO matters a lot. CEOs perform a distinct and powerful role, their actions having pervasive effects throughout the companies they run, including on the performance of other employees.

But as Sherwin Rosen first demonstrated, highly-talented executives are worth more to larger companies than to smaller ones — given that a marginal improvement in the average quality of decision-making could deliver millions of dollars of additional profits.

Bearing in mind the caveats about the quality of Australian data, the Commission conducted a simple regression analysis to estimate the effect of changes in company size on changes in Australian CEO pay since the early 2000s. The results are in line with overseas and local research — a 10 per cent increase in company size seems to be associated with around a 4 per cent increase in CEO pay. (This same relationship (with opposite sign) can be observed during the recent decline in market capitalisation.)

Broadly speaking, bigger companies here and overseas simply pay more — both to compensate for increased job importance and complexity and to attract those they regard as the most talented people. (Whether they indeed are the most talented of course will be tested on the job.) Given this relationship, changes in company size seem to explain about one-third of reported increases in executive pay in Australia.

Increased mobility of executives, coupled with the very high levels of executive pay in the United States (which is the outlier globally by far), have also had flow-on effects to Australia. In particular, the 'importation' of a few high profile US executives to key CEO positions in the early 1990s, essentially introduced US-style remuneration structures to this country.

That said, Australian executive remuneration levels generally remain well below those in the United States and even the United Kingdom (for companies of similar size), being more in line with smaller European economies. This could reflect non-pecuniary benefits or lower costs of living in Australia, or the much higher proportion of at-risk pay for US CEOs. It could also indicate that US pay has become distorted, and that Australian companies with different governance arrangements (and more shareholder say on pay) simply refuse to consider candidates who command such rates.

Lake Wobegon effects?

An intuitively appealing (and much-debated) driver of pay increases is disclosure itself. On the one hand, according to the managerial power view, disclosure should suppress pay increases because of a strengthened 'outrage constraint'. But many corporate 'insiders' argue that public disclosure introduced in 1998 triggered a pay adjustment spiral as companies and executives sought to 'position' themselves in the top half of the market.

In the literature, this is often referred to as the 'Lake Wobegon' effect — named after Garrison Keillor's mythical place in the mid-West of the USA where 'all the women are strong, all the men are good looking and all the children are above average'. Senior executives naturally all want to be 'above average' too!

In practice, we couldn't find clear evidence of an acceleration in the growth of executive remuneration in aggregate, or of convergence in pay across different companies or industries, following introduction of the new disclosure rules. Indeed, the rate of increase in pay slowed somewhat in the 2000s compared to the late 1990s. The observed decline in executive remuneration since 2007 also provides some evidence that the Lake Wobegon effect is not unbounded. Nonetheless, public disclosure probably triggered a one-off realignment of relativities, as well as more rapid adjustments to any market developments.

Incentive pay

Developments in performance-based pay provide an important window for understanding the growth of executive remuneration and any policy issues arising. Since the 1990s, the composition of remuneration for senior executives in Australia has changed fundamentally, with a much greater focus on performance-based or ‘incentive’ pay. Indeed this accounts for virtually of the growth in reported executive pay in bigger companies over the 2000s.

The ‘efficiency’ rationale for incentive pay is that it has the potential to reduce the ‘agency’ costs that would result from executives being paid fixed cash amounts regardless. That is, the costs of executives taking decisions that reflect their own preferences rather than those of the company, as well as the costs of monitoring them to make sure this doesn’t happen.

In Australia, it typically involves:

- Paying executives in shares or options and requiring them to hold equity for a defined period. This directly links some of the executive’s wealth to the share price (and dividends) of the company.
- Awarding remuneration (cash, options or equity) only when performance hurdles are met, either in the short term (generally one year) or long term (around three years).

What you see is not what you get — measurement issues

Measuring such incentive pay is not straightforward. Available data are based on disclosed estimates of the value of equity-based remuneration, not amounts actually received by executives. Black–Scholes or Monte Carlo techniques are used to forecast the value of equity into the future plus the probability of hurdles being met.

This estimated value at the grant date (the accounting ‘fair value’, which is reported in the annual remuneration report and given headline coverage in the media) will almost certainly differ from the value when (and if) shares or options vest. The value that executives place on equity-based payments and other forms of at-risk pay will differ again.

Performance pay means more pay

Performance-based pay inevitably involves a bigger executive wage bill for companies than fixed salary because of the additional uncertainty for the executive.

- It introduces uncertainty about the level of remuneration eventually received (to the extent that performance hurdles are not trivial or are susceptible to forces outside their control)
- It can constrain executives' ability to diversify their wealth, exposing them to portfolio risk
- It usually involves deferment of pay (and thus losses from delaying access to it).

Several US studies estimate that executives discount the reported value of incentive pay by anything between 10 and 50 per cent, depending on the associated uncertainty, portfolio risk and deferral period.

One recent US study estimates that 40 per cent of the observed gap between executive pay in the US and other countries can be explained by the much greater use of incentive pay in that country and the risk premium associated with it.

More incentive pay for bigger firms?

Agency costs tend to be higher for larger companies, because of more dispersed ownership and the potentially greater influence of executives over company assets. So larger companies would be expected to rely more heavily on incentive pay, and the data for Australia support this. Around two thirds of the pay of CEOs of Australia's largest companies is performance related, compared with around 10 per cent for CEOs of the smallest companies.

Has incentive pay worked?

While the shift to incentive pay in Australia has almost certainly led to higher reported pay, the key issue is whether it has led to improved company performance. If it has not, then at best it will simply mean higher pay packets; at worst, it could encourage behaviours that lead to perverse outcomes for companies (and the wider economy).

Because of data shortcomings, it has not been possible to estimate this empirically. At an aggregate level there is some correlation between the growth in overall market returns and pay growth, but this is not proof that performance pay has delivered.

Another way is to look at the design of the arrangements themselves. Bebchuk and Fried criticise the use of options and performance pay that is not linked to explicit performance hurdles. And Australian shareholder groups are similarly wary of undisclosed hurdles, or 'soft' hurdles that reward what they regard as mediocre performance (relative to comparable companies) and good luck (yet shield executive pay from bad luck).

It is broadly accepted that Australian boards have not found performance pay easy. Performance hurdles in the 1990s could in many cases be described as 'permissive', while pay arrangements have become very complex since. It seems likely that under both regimes some executives received bigger payoffs than appropriate — more for luck than performance. Some termination payments also appear hard to justify (even after adjusting them properly), suggesting weakness or complicity in the boards concerned.

But we have also heard that some executives view complicated long-term incentives linked to share market performance as akin to a lottery. If true, it means that the arrangements have little incentive effect, yet could perversely end up delivering large payments to the executive at a large cost to the company — the opposite of what shareholders expect from them.

In considering possible remedies, however, we came to the view that there is no 'right' or 'wrong' incentive structure. Appropriate alignment will be time, company and individual specific. Thus a pay vehicle that delivers 'money for jam', or even dangerous incentives, in one situation, could deliver closer alignment in another. For example, options are often seen as inappropriate because they provide only 'upside' for executives. But offering 'carrots' could be less costly for a company than imposing penalties for poor performance if the executive is highly risk averse. Moreover, the risk-taking that options encourage might be appropriate for an immature company seeking to grow rapidly, though not for a more mature company where there is greater potential for loss of shareholder value.

On the other hand, some arrangements that are generally regarded as benign or desirable — such as executives holding substantial equity in the company — can in some circumstances have perverse effects. For example, an executive could become excessively risk averse on approaching retirement, in order to preserve the share price.

Many shareholders are also adamant that executives should not receive performance pay when the company share price falls, even if this is due to a general market downturn. But performance pay ultimately is about promoting performance relative to the (unobservable) counterfactual. In the absence of appropriate inducements, company performance could have been even worse in a difficult economic environment.

The bottom line is that assessing, or worse 'prescribing', pay structures against a 'vanilla' template, would more than likely get the wrong result for many of our public companies.

Accordingly we have focussed more on the integrity of the sausage-making than the sausage. In other words, do Australian executives have scope to exert undue influence in setting their own pay, and are boards adequately focused on ensuring companies get value for money?

On the positive side, Australia's corporate governance consistently ranks highly internationally:

- The boards of larger Australian companies appear to be relatively 'independent' (for example, with few CEO/Chairs), and most have arms-length remuneration committees. They have also been made increasingly accountable on remuneration matters through disclosure requirements and the (non-binding) shareholder vote on the remuneration report.
- It also seems that many boards have been striving to improve performance pay arrangements. For example, long-term incentive hurdles have been increasingly linked to shareholder return relative to comparable companies.

On the negative side, we found that governance arrangements still allow certain conflicts of interest that potentially enable executives to unduly influence their own pay. While these arise more at the smaller end of the company scale, a significant minority (about 25 per cent) of remuneration committees of large companies include an executive member, and might also receive remuneration advice from consultants who undertake other (more lucrative) work for the CEO, or who might not report directly to the board.

What role for government?

I'm reasonably sure that most of this audience would accept that wage controls are not the answer. Although pay caps might superficially address concerns about fairness, caps on *total* remuneration for executives would give rise to all the problems of administered prices. Particularly if set at levels the community might consider 'reasonable' (which surveys suggest are in the order of \$300 000–\$500 000), they would have undesirable commercial consequences for Australian companies and their shareholders. And given the fungibility of pay, caps on some components, like bonuses, would inevitably lead to readjustment of packages in ways that perversely could weaken incentive alignment. In short, such proposals risk 'throwing the baby out with the bathwater'.

Given the *raison d'être* for (and benefits of) the public company structure, it must be the boards' role to ensure that executives are worth what they are paid, and they should be held accountable for doing this job well.

Accordingly, most of the Commission's recommendations go to improving disclosure and removing scope for conflicts of interest in pay-setting (for example, prohibiting executives from sitting on remuneration committees and from voting their shares on the remuneration report.) These changes we believe would generate worthwhile benefits at negligible cost. They essentially codify accepted best practice. We have also sought to accommodate the great diversity of companies through a multi-tiered approach which involves a mix of soft and black letter law, differentiated by company size.

Two of our recommendations go further in the direction of increasing 'shareholder say', and these have attracted particular criticism from board representatives. The first is a proposal to remove the 'no vacancy' rule (which can give board-endorsed candidates an advantage over shareholder-endorsed ones). We saw this as a possible mechanism for improving board diversity (without compromising merit). But we acknowledge (as Professor Peter Swan has observed) that it could limit flexibility and/or lead to bigger boards (which can be less efficient). If there are better ways of promoting board diversity and addressing perceptions of a directors' club, we want to hear about them!

Perhaps the most contentious issue revolves around directly increasing shareholder leverage in relation to executive remuneration setting: our proposed 'two-strikes rule'. If implemented, it would push the boundary of shareholder influence somewhat, though still well short of a binding vote on pay. The latter we concluded would be a step too far — it would be unworkable and compromise the board's authority to negotiate (unless they were somehow given precise riding instructions by shareholders — but how would they co-ordinate this?). And binding votes on equity pay, as advocated by some investor groups, could perversely discourage the use of an incentive vehicle they actually favour.

But many obviously also see the two-strikes rule itself as a step too far! Some argue it is a Trojan horse for corporate raiders; others that it will unduly consume the attention of boards. We are aware of such risks and encourage our corporate critics to spell out the possible consequences. Much of the impact of the two strikes rule in practice will depend on the level of the second voting threshold, and we deliberately left this open at this stage.

We are also well aware of the risks of giving shareholders too much influence on pay arrangements. Rather than having shareholders effectively set pay, we are endeavouring with the two-strikes rule and other proposals to encourage better dialogue between boards and shareholders. Many shareholders have clearly not understood what boards are trying to achieve, and ultimately it will be up to boards to convince them. That said, shareholders need to be realistic in their expectations: there is no holy grail and there would be dangers in adopting formulaic approaches.

In conclusion, the Commission has sought to bring economic analysis and evidence (imperfect though the latter may be) to bear on an issue which had hitherto mainly been characterised by emotion. We have ventured a range of policy recommendations that we believe get the balance right and would enhance efficiency as well as promoting greater trust in public companies. But we are also very conscious of the Law of Unintended Consequences. Our Discussion Draft is designed to encourage the feedback that we (and, ultimately, the Government) need to be confident of securing better outcomes in the long run for the Australian community.