

GFC+10: **Executive Pay in Australia**

*Ten years on from the Global Financial Crisis,
average CEO pay is back on the rise*



David Richardson-
March 2018

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GFC+10: Executive pay in Australia

Ten years on from the collapse of Bear Stearns and the Global Financial Crisis that followed, average CEO pay is back on the rise, including in Australia, where it has almost returned to pre GFC peaks. Bank CEOs earned around 100 times average weekly earnings in 2017 compared to 317 times at the peak and around 60 times in 2000. Australia's 'two strike' rule appears to have moderated CEO pay rises, and further policy intervention could be effective.

David Richardson

March 2018

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Summary

In the lead up to the global financial crisis CEO pay skyrocketed while the financial system looked more and more precarious. The tenth anniversary of the collapse of Bear Stearns – the fifth-largest investment bank in the United States, boasting some of the world’s most well-remunerated executives – is an appropriate time to assess what, if anything, has changed.

The average taxable income of Australian companies in 2017 was \$719,000. Clearly, Australia’s ‘average’ company is not paying the sort of salaries that make headlines. The real CEO pay issues are driven by an Australian economy that is dominated by very big businesses and uncompetitive markets, such as banking which is dominated by four big banks.

Australia Institute research in the aftermath of the financial crisis documented how CEO remuneration in Australia had increased from 15 times average earnings in 1993 to 250 times in 2007. Here we update that report by presenting the latest remuneration figures for the CEOs of two big banks relative to average weekly earnings, along with other CEO pay data for the top 100 ASX companies. All of these show that CEO pay remains excessive, although it is no longer accelerating as it did up to around 2007.

The CEOs of the NAB and CBA earned, respectively, 108 and 93 times average weekly earnings (AWE) in 2017. While a retreat from peak levels (267 times AWE for NAB in 2004 and 317 times AWE for CBA in 2010) this is still a large rise compared to the 58 and 70 times AWE they earned in 2000.

Another way of considering this is that while average earnings have less than doubled since 2000, NAB and CBA CEO pay has more than tripled.

Average CEO pay for the largest 100 Australian companies declined from \$5.5 million pre GFC to \$4.7 million in 2011, but has since increased steadily back to \$5.2 million. Similarly, Australia’s highest reported CEO salary peaked pre GFC at \$33.5 million, declined to \$11.8 million in 2011 before bouncing back to \$21.6 million in 2017.

In 2011 Australia introduced the ‘two strike’ rule which required a spill of all a company’s board positions in the event that the remuneration report was rejected twice in a row by the annual general meeting. Australia Institute research at the time was sceptical that the new rule would prove effective, but while it is hard to be definitive it appears the rule has moderated excessive CEO pay at or a bit below its

peak. There is evidence that similar 'say on pay' provisions in other countries have had a similar effect.

By and large one's stance on further action on executive pay depends on whether CEO pay is regarded as having a market solution or whether it reflects the non-market exercise in managerial power. Those two contrasting views are spelt out and evaluated. However, it should be stressed that it is possible to hold the market view as determining CEO pay and incentives but nevertheless believe the market is perverse and characterised by myopic behaviour. An overarching concern with excessive executive pay is that it may contribute to the general worsening in the distribution of income and the need to improve the distribution of income. Baker and Dennis suggested that this was indeed a contributing factor and should be remedied.

Further policy options include denying tax deductions for executive pay above a certain amount. The Clinton administration tried such a policy with a cap of \$1 million on non-performance related pay. While there was criticism that the arrangement was gamed, here it is suggested that there might be a cap on both performance pay and base salary with a maximum 4:1 ratio. The performance component would be administered by an objective body outside the corporation itself. An additional solution might be a binding vote on executive pay, as Malcolm Turnbull advocated for in 2008 (Kozial 2017). Under this mechanism, shareholders would approve in advance a total executive remuneration budget (in cash, shares, options, etc) that the company would pay out to the top 5 executives each year. No amount beyond that approved by shareholders could be paid.

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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.

Some years ago The Australia Institute published a paper *Reining it in: Executive pay in Australia* (Baker and Denniss 2010) which began with the above quote from then Prime Minister, Kevin Rudd. The Australia Institute is proud to reissue that paper with an update which adds new material reflecting some of the research and commentary since 2010. This reissue is also intended to mark the tenth anniversary of the collapse of Bear Stearns on 16 March 2008. On that date Bear Stearns was effectively bought for \$2 a share well down on the \$172 it traded at a year earlier. ‘The firm spiralled from being healthy to practically insolvent in about 72 hours’ (Kelly 2009).

Bear Stearns¹ was one of many firms to join the debt securitization market creating new financial products by aggregating individual housing loans. ‘As a result Bear Stearns was a victim of the mortgage meltdown and Great Recession that followed’. But while it worked Bear Stearns seemed to be on a winner. It was consolidating individual home loans into large securities that should have been guaranteed by the law of large numbers. Their return was higher than Bear Stearns’ borrowing rate so it could borrow heavily and make healthy returns based on the difference between the borrowing and lending rates. The leverage meant that its profit per funds actually employed were very high. High leverage magnified the profits but in the event of any adverse event it would also magnify the losses.

The management of Bear Stearns did very well under its compensation arrangements so that from 2000-2008, the top executives at Bear Stearns enjoyed with cash flows of about \$1.4 billion (Bebchuk et al 2010). Over five years, from 2002 through 2006, former CEO, James Cayne, took home total compensation — salary, bonus, restricted stock, and stock options — worth a combined \$156 million. According to Time Magazine

Plenty of CEOs screwed up on Wall Street. But none seemed more asleep at the switch than Bear Stearns’ Cayne. He left the office by helicopter for 3 ½-day golf weekends. He was regularly out of town at bridge tournaments and reportedly smoked pot. (Cayne denies the marijuana allegations.) ... "I didn't stop it. I didn't rein in the leverage," Cayne later told Fortune (Time 2016).

¹ This paragraph relies heavily on Investopedia (no date).

The wobbling in the market by 2007 caused Bear Stearns to incur its first quarterly loss for 80 years. Bear Stearns' ratings were then reduced on its mortgage-backed securities and other holdings. To maintain liquidity Bear Stearns was forced to sell assets into a declining market which then lowered the prices causing it to need to sell yet more bonds and so on. 'This left the firm with illiquid assets in a down market'. In March 2008 Bear Stearns was forced to approach the Federal Reserve (Fed), the US central bank, for support. That was followed by a further downgrade and a run on the bank. 'By March 13, Bear Stearns was broke and its stock plummeted. Bear Stearns was sold to JP Morgan Chase at a fraction of its previous market capitalization'. This was a deal arranged by the Fed which lent JP Morgan Chase the money to make the purchase. Investopedia is clearly of the view that the collapse of Bear Stearns started the global financial crisis when it said 'The collapse of Bear Stearns and its sale to JP Morgan Chase was the start of bloodletting in the investment banking sector, not the end'.

There has now been a lot of commentary on the real origins and causes of the global financial crisis. However, in many ways the fundamentals were quite simple as suggested above. If you borrow, you enter into a contract to repay the debt and most often there are fixed repayment arrangements. If you use the borrowed money to buy shares or some other asset that is likely to fluctuate wildly then you know there is a good chance their value will collapse and leave you owing more than your shares are worth. That's pretty basic and simple logic.

Banks are also like that—they have a fixed and clearly specified obligation to repay their depositors. With fixed obligations like that, banks should not invest in assets that are subject to fluctuating market values. In other words, they should not apply depositors' funds to speculative investments. Following the financial collapses associated with the great depression in the 1930s, the US introduced legislation (the Glass-Steagall Act) that strictly separated ordinary banking from investment banking. However, the American lawmakers and regulators had allowed banks to again mix and match commercial and investment banking by repealing the Glass-Steagall Act in 1999. The collapse of institutions such as Lehman Brothers and Bear Stearns was an inevitable consequence once the investment banks used their deposit base to fund investments subject to market fluctuations. Australia had gone through something similar in the second half of the 1980s when the banks were attracted by the likes of Alan Bond and Robert Holmes à Court.

It has to be stressed that the issue of massive CEO pay is one associated with industry concentration and the dominance of big business in the Australian economy. According to tax office data 390,774 companies reported a positive income and declared taxable income of \$281 billion, giving the 'average' company an income of \$719,201 in 2015-

16 (ATO 2017). An economy dominated by 'average' companies could never pay CEOs anything like the amounts going to the CEOs of the top Australian oligopolies and monopolies. It seems pretty clear the massive incomes at the top, and the inequality between executive pay at large companies and average weekly incomes, reflect to a large extent the uncompetitive nature of the modern Australian economy.

Executive pay is likely to have played an important role in the global financial crisis. Remuneration packages linked to short-term performance can induce CEOs to risk long-term on the promise of short-term gains. For example, much of the toxic debt involved loans to low income earners in the US which had not been a problem for the lender since US house prices had been growing steadily. Problem debtors could be turned out and the property resold at a profit. Once house prices stopped rising the bottom fell out of the securitised loans to low income borrowers and the rest of course is history. Of course by the time the crisis hit many of the players were already out of the industry and enjoying their 'winnings'. Stein's (1989) views on the myopia of company executives is important here and is discussed below.

Since Baker and Denniss the outrage has hardly abated and in many respects it has become worse. An article in *The Economist* encouraged us to look backwards and consider how far we have gone towards increased inequality through executive remuneration:

These sorts of pay packages seem outrageous to many, especially when compared with wages elsewhere in the economy. Peter Drucker, the doyen of management theorists, reckoned that exceeding a 20-1 multiple of pay within a firm between executives and the average worker was bad for morale. Mr Drucker was worrying about the gap back in the 1980s, when the economy-wide difference between CEOs of big American firms and average workers was in the 40-1 range. How quaint that seems: depending on how you count things, the multiple now is somewhere between 140-1 and 335-1 (The Economist 2016).

It would seem reasonable to suggest we should set the goal of getting back to those historic values.

CEO PAY DATA

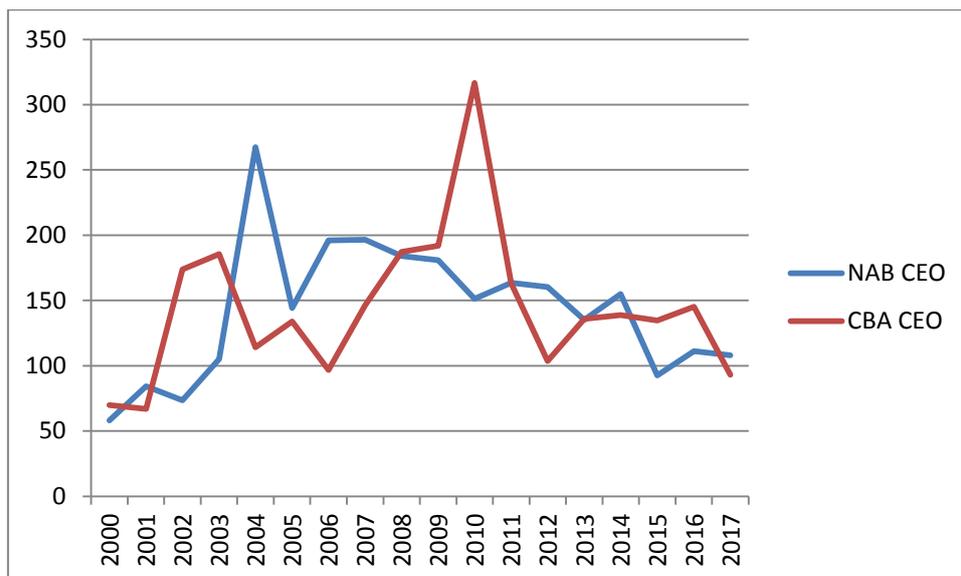
The inflation in executive salaries is a clear manifestation of the problems at the top of the income distribution. The outrage over CEO pay has only grown louder across the world; not long after the publication of Baker and Denniss (2010), the Occupy Wall Street movement beginning in September 2011 drew attention to similar issues. This movement was soon emulated in other countries, including Australia.

Baker and Denniss (2010) cite the Productivity Commission’s interim report on executive remuneration. In the final report, published after the Australia Institute’s paper, the PC’s figures reveal that executive pay had increased by 250 per cent between 1993 and 2007. Figures submitted to the Commission’s inquiry by Egan Associates, executive remuneration consultants, showed even greater increases. These were derived from an analysis that also considered the average pay of CEOs and senior executives across the top 100 public companies in Australia. The data from Egan Associates show that in 1993, a company CEO earned 15 times as much as the average full-time worker but by 2007 the gap between executives and the average wage widened out to 250 times.

Baker and Denniss (2010) mention that the Rudd/Gillard Government took action to strengthen corporate governance over remuneration and there appears to be more self-restraint on the part of executives. The reforms from 1 July 2011 included a provision that shareholders can vote to spill a board and force fresh elections if there have been 'no' votes of 25 per cent or more recorded against the remuneration report at two consecutive annual general meetings of the company. This is the ‘two strikes’ test.

Banks in Australia have been a particular focus of attention and Figure 1 shows the pay of the CEOs of the National Australia Bank and the Commonwealth Bank since 2000, compared with average weekly earnings over the same period. We start in 2000 when the NAB CEO was paid 58 times average weekly earnings and take that forward to 2017.

Figure 1: CEO pay NAB and CBA, multiples of average weekly earnings

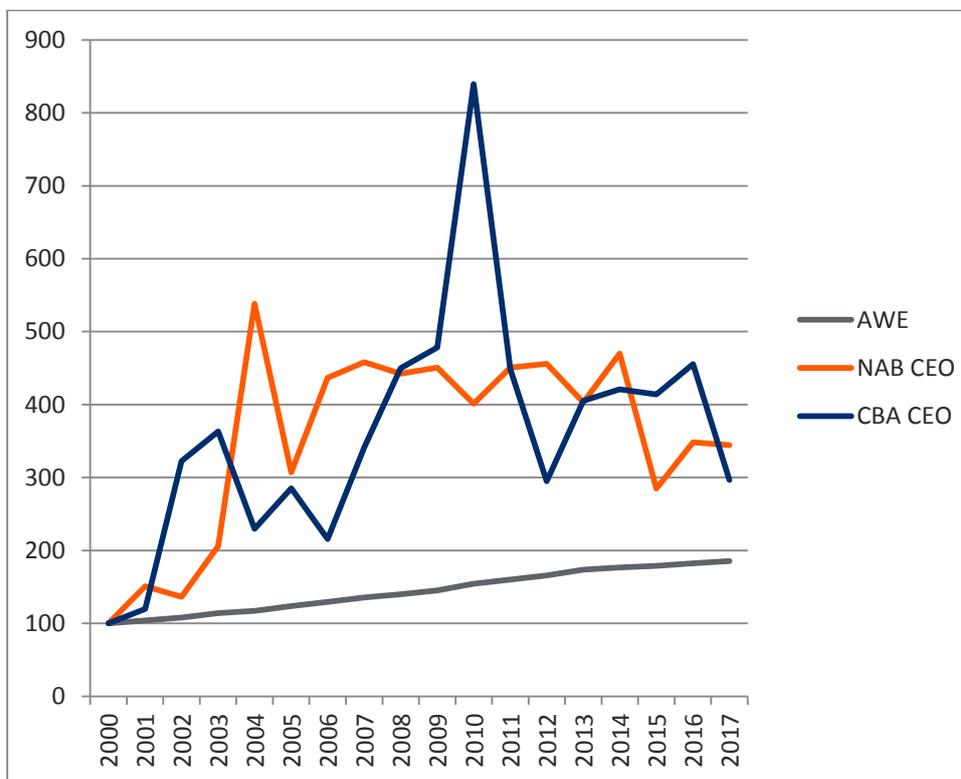


Source: National Australia Bank and Commonwealth Bank (various years) and ABS (2017).

Overall CEO pay has clearly grown relative to average weekly earnings for the two companies in Figure 1. The CEOs of NAB and CBA started out at 58 and 70 times average weekly earnings in 2000 and are now (2017) respectively 108 and 93 times average weekly earnings. However, between then and now they respectively peaked at 267 and 317 times average weekly earnings in 2004 and 2010 respectively. More recently the two CEOs have probably had to take a lot of flak for poor investments in the case of NAB and appalling treatment of customers and the money laundering in the case of CBA.

Figure 2 examines the growth in CEO pay for NAB and CBA compared with average weekly earnings by setting each at 100 in the year 2000.

Figure 2: Growth in CEO pay, NAB CBA compared with average weekly earnings (AWE): Index with 2000 = 100

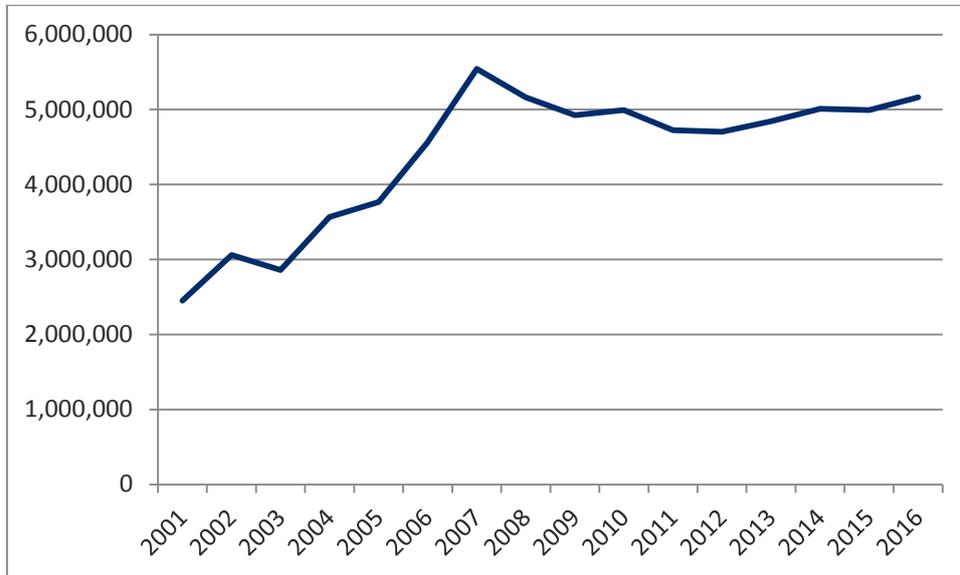


Source: National Australia Bank and Commonwealth Bank (various years) and ABS (2017).

Pay for the NAB CEO peaked in 2004 but even if we ignore that spike the data still show that CEO pay was increasing rapidly during the bulk of the 2000s, as people were expressing the most concern. Since then there has been a moderation and no real increase in pay for the NAB CEO. With the retirement of Cameron Clyne in 2014 there was a marked reduction in NAB CEO pay. Whether it was public revulsion, government changes to corporate governance or CEO restraint, pay seems to have moderated since the late 2000s.

The pattern at NAB and CBA is repeated in other corporations albeit less starkly. Figure 2 shows data collected by the Australian Council of Superannuation Investors for the average reported pay among the top 100 companies.

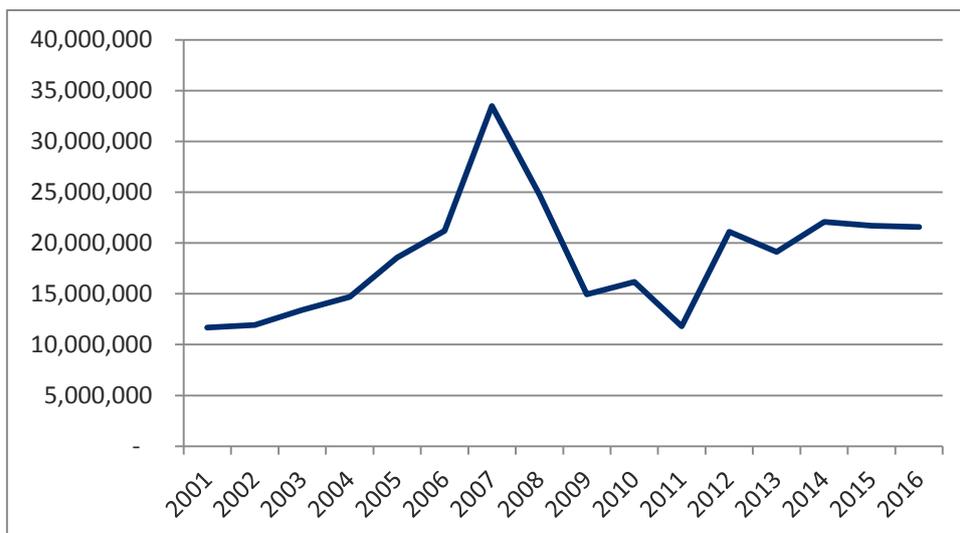
Figure 3: CEOs average reported pay \$ pa.



Source: Australian Council of Superannuation Investors (2017).

Figure 3 clearly shows how the growth in CEO pay was quite dramatic in the lead up to around 2007 or 2008. This can also be appreciated by examining how the maximum CEO pay has evolved in Australia. Figure 4 gives the maximum CEO remuneration in every year since 2001.

Figure 4: Maximum CEO pay (excl News Corp)



Source: Australian Council of Superannuation Investors (2017).

Figure 4 shows a similar pattern but with more significant reduction from the peak in 2007 when \$33.5 million was paid to former Macquarie Bank CEO Allan Moss (Durkin and Tadros 2012). The present head of Macquarie Group was second in the latest rankings with Peter and Steven Lowy topping the group.

It can be appreciated from Figures 2 and 3 that there was a clear break in 2007 and Baker and Denniss (2010) refer to the then relatively new 'two strikes' legislation. ASIC says 'the two strikes rule started in 2012 and is designed to give shareholders a strong say on director and executive remuneration' (Price 2015). Baker and Denniss (2010) were not convinced that the two strikes rule would moderate executive pay. However law firm Baker and McKenzie (2015) consider Australia's two strikes rule 'leads the way in enforceable shareholder votes over executive remuneration'. Certainly there does seem to have been some moderation after around the time of the 'two strikes' rule.

While the 'two strikes' reforms obviously go in the right direction it can be argued that they should have gone further and that other policies might have been implemented. It also seems there has been some watering down of the two-strikes legislation with amendments that allow the chair of the meeting, who is likely to be chair of the company, to vote undirected proxies in favour of the company's remuneration report (Wiggins 2012). That has the effect of reducing the likelihood of a 'no' vote. Nevertheless there is empirical evidence that suggests the two strikes rule has had the effect of moderating executive pay. There soon appeared to be both more self-restraint on the part of executives and more direct action on the part of shareholders. As examples of the former, executive pay had been frozen in the Commonwealth Bank of Australia, PaperlinX and Rio Tinto (Liondis 2012). It was also reported that

More than 100 companies, including BlueScope Steel, casino group Crown and apparel maker Pacific Brands, received a "no" vote of 25 per cent or more against their remuneration reports last year following the introduction of new laws on executive pay. Another strike this year on remuneration reports will force directors to stand for re-election (Liondis 2012).

Later that year (2012) the changes were said to have caused an eight per cent drop in annual cash bonuses, a slowing down in total exec remuneration increases, and an overhaul in pay in 'dozens of companies' (Durkin and Tadros 2012). *The Financial Review's* team found that in 2011 108 companies had their remuneration report rejected by 25 per cent or more of shareholders and the figure for 2012 should exceed

that. By late November three companies had passed a spill motion and face new elections (Durkin and Tadros 2012).²

Results reported by Faghani et al (2015) suggest CEO pay has both declined and contained an increase in the proportion of performance based pay following a 'first strike'. Hence 'empowering shareholders by giving them a "say on pay" has the potential of curbing excessive executive pay and improving the alignment between shareholders' and managers' incentives' (p 39). Duong and Evans (2015) report evidence suggesting

While there may have been some moderation one thing seems clear. The setting of CEO pay contrasts dramatically with the forces through which companies keep ordinary wages low and reduce labour's share of national income. Before going too much further we should pause to consider the two competing theories about executive pay.

² Some directors have been concerned that the 25 per cent threshold is too easily reached for example, in the case of large shareholders such as Gina Rinehart who had a large holding in Fairfax. It is well known that Ms Rinehart was in conflict with the Fairfax board.

A just reward for skill or managerial power?

The first theory of executive pay is that executives like other factors of production are paid what they are worth to the firm. A common view is that executives are rewarded for their skill, effort and performance. Such views are common among corporate circles as might be expected. For simplicity we can call this the 'market view'.

The other theory is that managers have market power in a relatively closed labour market and that they are able to extract rents from companies, especially the large companies in industries associated with a degree of monopoly power. This might be described as a 'market' but the mechanism is more akin to feudal lords being able to extract a surplus from their serfs and the better the land the higher the incomes of the owner. 'Rents' are seen as a predatory mechanism rather than some sort of market exchange. Following normal practice we refer to this theory as the 'managerial power' theory.

The market view

There is tendency in a lot of the commentary to think that the issue of CEO pay is just the workings of the market whereby managers are being paid what they are worth—the value of their marginal product. There have been attempts to explain high CEO pay using marginal productivity theory and Piketty (2014) cites Galaix and Landier who argued that executive pay is a mechanical consequence of increased firm size. The higher the size of a firm then, so the argument goes, the higher is the productivity of the most talented managers. This sort of thinking can reflect the view that the market is always right so there must be some market mechanism that drives executive pay.

Baker and Denniss (2010) did not comment on the competing theories which have come into starker relief since 2010. However the then chair of the Productivity Commission made it clear that the PC endorsed the market theory when he said:

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 (Banks 2009).

The report itself PC (2009) said that Australian executives appear to be paid in line with smaller European countries, but below the UK and US. The driving factors were globalisation, increased company size, and the shift to incentive pay structures. It claimed companies compete to hire the best person for the job, and 'try to structure pay to maximise the executive's contribution to company performance'. However, the PC admitted inconsistencies 'with an efficient executive labour market, and possibly weakened company performance'. Some of the growth in executive pay in the 1990s was put down to uncritical incentive pay structures 'imported' from the United States and introduced without appropriate hurdles' and that rewarded executives for 'good luck'. They admitted that 'some termination payments look excessive and could indicate compliant boards'. However, the view was that these things are largely behind us and discipline by corporate boards would be sufficient. Their recommendations involved independent remuneration committees and improved processes for use of remuneration consultants as well as promoting board accountability and shareholder engagement, through 'enhanced pay disclosure and strengthening the consequences for those boards that are unresponsive to shareholders' 'say on pay'' (PC 2009 p xiv).

Hence the PC report reflected the market view but recommended some reforms to make it work better in practice as it should in theory. The PC was aware of alternative

theoretical positions. In the words of one submission by M Vanderlaan to the PC and quoted in the final report:

... the problem with this is the perception of a self-interested 'directors club' of board members, fund managers, and executives past and present. 'You vote for my pay rise and I'll vote for yours'. This is an inherently conflicted plutocracy (cited in PC 2009).

However, as mentioned the PC did not think these were systemic issues. *The Economist* at one stage seemed to endorse the PC view when it said:

Adding to these frictions is another specific trait of executive pay. In other parts of the labour market, you might assume that firms are generally aiming to pay as little as possible, and individuals are trying to drive up the price. But when it comes to the corner office, the incentives to bear down on pay are less clear. The amounts involved matter enormously to the individual concerned, much less to the compensation committee (which does not want to be responsible for encouraging executives to look elsewhere) or to the shareholders (for whom a payment of a few million dollars is well worth it if an executive can bring about a small extra uptick in market value) (The Economist 2016).

Before leaving this section it is important to point out that the market view does not rule out the possibility of perverse behaviour. In the 1980s Jeremy Stein (1989) was arguing that CEOs took an unnecessarily short-term view. His modelling of CEO behaviour showed that it was perfectly rational for CEOs to concentrate on short-term results at the expense of investing in the long-term performance of the company through appropriate investment.

Prior to Stein the usual argument was

based on the tenet of efficient markets: since it is unlikely that the market can be systematically fooled by inflated earnings, managers will only lower stock prices by undertaking actions that are not in the best long-run interests of their companies. Hence, managers who are concerned with high stock prices will not behave myopically' (Stein p 655).

By contrast the Stein view was able to explain the cutting of research and development, employee training and long-term investments.

Empirical testing of the myopia thesis has shown for example that public-listed firms invest less than half as much as privately owned firms when adjusted for firm size and industry. Private firms are 3.5 times more responsive to changes in investment opportunities (Starvish 2013). The difference was put down to 'the tendency for public firm managers to favour short-term profits over long-term gains'. Those are not a concern for privately owned companies that do not have to worry about stock market valuations. It is worth reflecting on the investments, R&D and other beneficial activities that have not taken place among the listed companies of Australia. Earlier

research showed that the sales of just the top five non-financial listed companies in Australia are equal to 16 per cent of GDP and the top 50 for over a third of GDP (Richardson 2013).

It is worth observing that the use of performance criteria seems to be an attempt to bring the market into the corporation. That fits uneasily with the fact that corporations are essentially run on 'command and control' or military-style models. The whole idea is that corporations do things in-house either because it is cheaper or that outsourcing would involve too much trouble or may even be impossible do given the difficulty in designing appropriate performance contracts (Williamson 1981). The CEO has to be brought inside the corporation and it is impossible to fully specify the CEO role in a duty statement or performance contract.

Managerial power

Bebchuk and Fried have been influential in changing the perceptions of executive pay in the US. According to their position executives essentially set their own pay using their power over the board of the company, if not exploiting the complicity of the board in extracting excessive pay from the company (Bebchuk and Fried 2004). We earlier referred to this as the 'managerial power' explanation of high executive pay. It has also been described as the perception of a self-interested 'directors club' of board members, fund managers, and executives past and present. 'You vote for my pay rise and I'll vote for yours'. This is an inherently conflicted plutocracy (M Vanderlaan cited in Productivity Commission 2009). We referred to this as the 'managerial power' explanation of high executive pay which is fundamentally different from any explanations based on market forces. Complacency on the part of boards is reinforced by directors not wanting to be seen to be employing a CEO who earns substantially less than benchmarked companies. To get someone at a lower salary may be taken to mean someone who the 'market' thinks is inferior. If you hire someone 'cheap' who is seen to fail then the board is to blame.

Bebchuk and Fried document with a mass of evidence how managers have control over their own pay and conditions. As one reviewer said:

Even a casual reading of the business press indicates that many CEOs have a great deal of control over their boards, and thus over the process by which their own pay is determined. ...It is possible that the contracts we observe in practice represent something more like what is often described in the business press, in which managers extract enormous sums of money through their control of their own pay-setting process (Weinbach 2007 p 421).

Of course, managerial power is not unlimited, instead Bebchuk and Fried (2004) suggest executives set their own pay subject to 'an outrage constraint'. By that they mean that the only real limit on their behaviour is the adverse public reaction they are likely to encounter. Certainly in Australia there has been a good deal of public outrage over some of the high salaries of CEOs.

Piketty (2014) has forcefully put the managerial power view when he said:

'[Remunerations of CEOs] are generally set by hierarchical superiors, and at the very highest levels salaries are set by the executives themselves or by corporate compensation committees whose members usually earn comparable salaries (such as senior executives of other large corporations)...it is inevitable that this process yields decisions that are largely arbitrary and dependent on the hierarchical relationships and on the relative bargaining power of the individuals involved. It is

only reasonable to assume that people in a position to set their own salaries have a natural incentive to treat themselves generously (331-2)

An attribute of the managerial power explanation of executive salaries is that, in order to counter the public outrage, much of the executive pay will be in forms that Bebchuk and Fried describe as 'camouflaged'. In Australia only a proportion of the typical CEO package is actually in cash. For example, in 2016-17 the CEO of Telstra, Andrew Penn, received a total income of \$5.10 million of which \$2.06 million was in cash and fees.

There has long been a view that the CEO remuneration should be constructed to align the CEO's incentives with those of the shareholders. To that effect most executives now receive part of their income in the form of shares or options. That seemed to satisfy the demands of those who wanted CEOs to face the same reward and punishments as shareholders. However, the executives have gamed this and while they receive much of their remuneration in shares and options to buy shares, they receive adjustments when share prices fall when it is no fault of the executives. That of course does not work in reverse. If shares rise because of general rises in the market, the executives get to keep theirs. To the superficial observer it looks as if the executives are receiving incentives to perform but in practice they are able to unwind those incentives if they work against them (Bebchuk and Fried 2004).

Edmans and Gabaix (2016) make the strong point that behaviour that tries to keep details of CEO remuneration secret it is hard to reconcile with theories that suggest they are set in the shareholders' interest as in the market view. Keeping things secret is more likely to be associated with managerial power through which a deal is struck with the board but may well be perceived as too generous by the shareholders.

Another factor not mentioned so far is that directors will not want to be seen to be employing a CEO who earns substantially less than benchmarked companies. To get someone at a lower salary may be taken to mean someone who the 'market' thinks is inferior. It is well-known that management ability is almost impossible to define or quantify and there are no objective standards for saying one executive is worth more than another. Only their salary is quantifiable and that is quantifiable down to the last cent. That certainly works in favour of the executive on the one hand.

It is worth noting that CEOs have developed apparently objective approaches to setting their remuneration seeking the professional opinions of remuneration consultants. Recent research has shown that CEOs who organise a compensation consultant to recommend their pay are likely to earn more than those who do not. Moreover, those consultants who make such recommendations for CEOs are more likely to be retained for future business (Chu and Rau 2014). *The Economist* summarised this paper and quoted Warren Buffett who had pointed out that 'if you

want independent advice, don't ask a barber whether you need a haircut' (*The Economist* 2014).

"The prevalent practice is to be at or above the median, which means pay goes higher," says one compensation consultant, who defends this upward momentum nonetheless. "Some call it the ratchet effect, I call it a market effect. It's competitive and talent can move." (*The Economist* 2016).

However, there is a long history of views to the effect that the incentive structure facing managers, mediated via company boards, does not align with the interests of shareholders. Boards are not at arm's length from the CEO and nor are board interests necessarily aligned with shareholders. Indeed, rather than CEO's conforming to the board's interpretation of shareholder wishes there is a view that directors face strong incentives to support the CEO. Apart from the financial benefits in which everyone helps set each other's payments and fees, there are strong social, friendship and loyalty concerns (Bebchuk and Fried 2004). While that is the strong view in the US it is even more relevant in Australia where the pool of managers and board members is so much smaller and it is much more likely that people know each other personally.

It needs to be stressed that the concerns of the managerial power view are not new; they go back at least to the concerns raised by Berle and Means in 1932 and can be traced back to Adam Smith in 1776 (Weinbach 2007). So long as we have large uncompetitive companies with the potential to earn super profits there are going to be a class of predators that seek to predate on the predators.

The Productivity Commission makes the important point that executive pay tends to be associated with the size of the company. That view is consistent with both the market view and the managerial power theory. However, the implication is that the problems associated with executive pay are going to be so much worse in an economy that is riddled with monopolies, duopolies and oligopolies.

A final point is that recent research has shown the size and complexity of the modern firm make it impossible for the board to monitor it. As one set of researchers report:

We are pessimistic about the possibility of boards being able to effectively monitor managers on an ongoing basis in many circumstances. ... Given the size and complexity of many modern firms, we believe some firms may effectively be 'too big to monitor', and that successful monitoring by boards may be highly unlikely in many large public firms. It might be time to concede that our conception of boards as all-encompassing monitors is doubtful ... Consequently, we believe that future research and theorizing needs to ... look to other corporate governance mechanisms to secure monitoring (Bovis et al cited in Taylor 2016)

On that view we would have to express serious concern that policies based on the market view can succeed.

Policies?

We have referred to the apparent success of the 'two strikes' policy in addressing excessive managerial pay. The two strikes policy would be suggested almost irrespective of one's view of the underlying mechanisms in the managerial labour market. Under the market view the two strikes rule increases the involvement of the owners of capital with the setting of remuneration and so improves the market mechanism. However, an implication of the managerial power theory is that managerial power can only be addressed by increasing the countervailing power of those who 'lose' whatever the management 'wins'. The two strikes rule thus becomes a powerful tool for addressing management power.

The Productivity Commission views are too narrow in the sense that we all have an interest in the distribution of income and CEO pay is an important part of that. The PC recommendations reflect the view that shareholders need to align CEO remuneration with the objectives of shareholders which is assumed to be maximising long term value. Unless there is an appropriate financial incentive then CEOs cannot be expected to act in the interests of shareholders. CEOs are viewed as purely motivated by financial considerations and so the financial incentives need to be appropriately structured. Richard Denniss once observed that the same people when they drop their children at a crèche or go to the doctor would be horrified if they thought that childcare workers and doctors were only motivated by money. There are similarly a host of professions where the practitioners are expected to imbibe the values of their professions and seek perform at the highest standards according to those values no matter how their salary package is structured. Indeed, imagine the CEO of a bank telling the board that the failure to manage fraud was due to the failure of the incentive package to embrace that performance indicator.

In the words of one observer:

It is very clear that while boards spend hours preparing the remuneration pages in the annual reports they are not being not being tough enough with their CEOs and are paying top dollars for second-grade performances when measured against global counterparts (Gottliebsen 2012).

Having addressed the major 'market imperfections', the market view would suggest that policy should leave things well alone. Baker and Denniss (2010) rejected that view and advocated additional policies. They suggested:

Removing the concession on capital gains tax would go some way towards mitigating the link between incentive and risk (the focus of international reform)

without requiring any further regulation. However, this option does not address the flaws in the labour market that result in rising executive pay.

Increasing the top marginal income tax rate would address pay inequity to some extent.

Setting an acceptability level for executive pay could dissuade companies from fostering spiralling increases by limiting the portion of an executive's salary that could be claimed as a deductible company expense.

Those policies are still worth pursuing and we offer the following additional comment.

Capital gains tax and top marginal rate

Both of these policies still seem relevant in today's context. On the top marginal income tax rate Piketty (2014) notes that in the US after WWII the top marginal tax rate on personal income was 90 per cent and, as the occupying power the same rate was imposed on Germany and Japan. Piketty notes the high rates then was part of the 'civilisation package' but it had the side effect of discouraging the grab for excessively high incomes since it just was not worth it to get a high income if most of it was to be taxed away. Of course, there is no evidence that the high post-war income taxes ever meant there was a shortage of CEOs!

Caps

In 1993 the Clinton administration limited the tax deductibility of executive pay to \$1 million unless it was performance related. According to some the policy 'did more harm than good. It caused companies to come up with sham performance criteria that work on paper but really are not pay for performance' (Hall 2009). However we think it should be possible to design guidelines that can be monitored by the ATO. We think there is a strong case for such a cap beyond which the company would have to pay out of after-tax profit. Limiting the deductibility of CEO pay is one approach but another is to increase the company tax rate for companies that exceeded a certain limit as suggested by Meyerson (2017). California voted for differential company taxes that would punish companies with high CEO pay compared with their other employees (Meyerson 2014).

There is of course another view that suggests CEO pay should be subject to some maximum, just as pay generally is subject to a minimum wage.

Independent management of the performance pay

Some of the literature refers to the problems with performance pay and how it has become corrupted. An option to address that is to set up a mechanism that would pay performance fees on the basis of objective criteria that are managed outside the company concerned. Hence company XYZ would have a well specified performance contract which is administered by, let us call it the Performance Pay Regulator (PPR). Performance pay might be set at a maximum of four times the capped salary. At the end of the financial year company XYZ would submit its performance indicators to the PPR which would then decide on the bonus to be paid.

Conclusion

In the lead up to the global financial crisis there was a confluence of skyrocketing CEO pay and a financial system that looked more and more precarious. For many observers the two trends were inextricably linked. Soon after the crisis The Australia Institute published a paper on executive pay (Baker and Denniss 2010). That paper has stood the test of time in that its findings remain relevant and, unfortunately, the excessive CEO pays have persisted. The tenth anniversary of the collapse of Bear Stearns is an appropriate time to revisit that paper and update some of the empirical and analytical findings.

The present update attempts to do those things. On the latest figures the corporate sector in Australia declared an average taxable income of \$719,000. Average companies cannot pay the sorts of salaries we are concerned about. To reach those sorts of incomes we need an economy such as the Australian economy that is dominated by very big businesses and uncompetitive markets, such as banking which is dominated by four big banks.

Baker and Denniss document how CEOs remuneration in Australia increased massively and went from 15 times as much as the average worker in 1993 to 250 times in 2007. Here we update that perspective by presenting respectively the behaviour of the CEOs of two big banks relative to average weekly earnings together with other CEO data for the top 100 ASX companies. All of these show that CEO pay remains excessive but is no longer accelerating as it did up to around 2007. Baker and Denniss had to deal with data that stopped just around the time that CEO pay seemed to peak. At about the same time the government had introduced the 'two strike' rule which required a spill of all a company's board positions in the event that the remuneration report was rejected twice in a row by the annual general meeting.

While it is hard to be definitive it does seem that the two strike rule has frozen excessive CEO pay at or a bit below its peak. There is evidence that similar 'say on pay' provisions in other countries have had a similar effect. Just after the Baker and Denniss paper a Productivity Commission report was published which regarded the 'two strikes' rule as sufficient to address externalities in the market for CEOs.

By and large one's stance on further action on executive pay depends on whether CEO pay is regarded as having a market solution or whether it reflects a non-market exercise in managerial power. (It may also reflect the position one takes on executive pay as part of the general worsening in the distribution of income and the need to

improve the income distribution—questions Baker and Dennis answered in the affirmative.) Those two contrasting views are spelt out and evaluated. However, it should be stressed that it is possible to hold the market view as determining CEO pay and incentives but nevertheless believe the market is perverse and characterised by myopic behaviour.

Having considered the above we conclude by suggesting that Baker and Dennis's policy prescriptions remain valid. A major contribution was their suggestion of denying tax deductions for pay above a certain amount. The Clinton administration tried that with a cap of \$1 million on non-performance related pay. There was criticism that the arrangement was gamed. Here it is suggested that there might be a cap on both performance pay and base salary with a maximum 4:1 ratio. The performance component would be administered by an objective body outside the corporation itself.

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