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Reining it in

Executive pay in Australia

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Policy Brief

Summary

Although there had been disquiet for some time, the global financial crisis really focused attention on the excessive pay of many executives, both in Australia and internationally. Referring to the situation toward the end of 2008, Prime Minister Kevin Rudd acknowledged the wide-spread resentment most Australians feel toward the extravagances of executive pay; in 2009 the Federal Government, responding to the global financial crisis and public sentiment, charged the Productivity Commission with a public inquiry into excessive remuneration. The Productivity Commission's draft report, released in September 2009, highlighted the gap that exists in Australia between executive earnings and average weekly earnings.

While calls for caps on executive pay have become louder, international action has settled for linking bonuses to company performance with provision to claw these back when performance fails to meet expectations. However, these reforms do not address the pay disconnect between most Australians and executives who earn more than $1 million a year; nor does the Productivity Commission's draft report propose to do so. Even less onerous than the international reforms, it settles for merely recommending amendments to governance and some additional shareholder participation. The equity issue of 'outrageous packages' remains unaddressed, despite the Commission's own evidence of the widening gulf between the remuneration of executives and that of their employees. More is needed if greater pay equity is to be achieved.

Various policy options are available to rein in the excesses of executive pay in Australia, including:

- removing the tax concession on capital gains
- increasing the top marginal rate of income tax
- establishing an acceptable level of remuneration for executives and excluding amounts above this from qualifying as a legitimate company expense and therefore tax deductible.

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.[1]

Concern about the size of executive pay in Australia is not a new phenomenon but the recent global financial crisis has served to highlight the 'outrageous packages' that executives are receiving. And as these increase, the gulf between them and the salaries of the majority of working people widens.

The global financial crisis peaked in September 2008 with front-page stories of corporate bankruptcies and by October, the banking sector in Western countries was being recapitalised by national governments. In November, international leaders from the world's 20 largest national economies (the G-20) gathered to tackle the global financial crisis by instigating the reforms that were considered necessary to ensure that such a situation could not arise again.

A focus of the reform has been the correlation between the global financial crisis, high rates of executive pay and increasingly risky investments in a culture of 'falling risk aversion and rising irrational exuberance'.[2] But, while the issues of risk and bonuses were discussed in the business pages, it was public discontent with the perceived excesses and inequity of executive remuneration that made front-page news.

When launching the Productivity Commission inquiry into executive pay, Treasurer Wayne Swan and Assistant Treasurer Chris Bowen acknowledged that '[t]here is significant community concern about excessive pay practices', and went on to assert that the government was 'determined to ensure regulation of executive pay keeps pace with community expectations'.[3] 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.[4] In the end, the draft report did not even attempt to address the heightened expectations raised by the Prime Minister a year before. Rather than recommend that the government act to cap executive pay, the draft report simply proposes an increase in board oversight of executive remuneration and pay thresholds that trigger shareholder approval.

Prime Minister Rudd said that 'people all around the world are fed up and angry with these outrageous packages paid to financial company executives'. An 'outrage' constraint is identified by Lucian Bebchuk and Jesse Fried as one of the only limiting constraints on executive pay but quantifying it is itself limited, with comeback on a company 'sufficiently vague as to be irrefutable'.[5] The effectiveness of public outrage in curbing executive earnings is thus uncertain;

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1. K Rudd, 'Press conference at the G20 Leaders' Summit', transcript, Washington, 15 December 2008. Available at: <http://canberra.usembasy.gov/irc/us-oz/2008/11/15/pm1.html> (accessed 23 September 2009).
2. FSA (Financial Services Authority), *The Turner Review: A regulatory response to the global banking crisis*, FSA, London, March 2009, p.25. Available at: <http://www.fsa.gov.uk/pubs/other/turner_review.pdf> (accessed 18 September 2009).
3. W Swan and C Bowen, *Productivity Commission and Allan Fels to Examine Executive Remuneration*, press release, 18 March 2009. Available at: <http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/025.htm&pageID=&min=wms&Year=&DocType=0>.
4. C Kerr, 'Anthony Albanese rejects demands to cap bosses' pay', *The Australian*, 21 September 2009.
5. M Weisbach, 'Optimal Executive Compensation versus Managerial Power: A review of Lucian Bebchuk and Jesse Fried's Pay without Performance: The Unfilled Promise of Executive Compensation', *Journal of Economical Literature*, Vol. XLV, June 2007, p.423.

the effectiveness of Prime Ministerial outrage in reining them in is currently awaited with some uncertainty also. As discussed below, there may be ‘market failure’ reasons leading to the government’s wish to regulate to help protect shareholders from the excesses of executive remuneration; however, it is important to note that the original motivation for the inquiry was not to protect shareholders but to protect society from the growing inequity between the very well-paid and the majority of workers. Although the Prime Minister clearly articulated the problem, his government is yet to articulate any solution whatsoever.

Despite the Productivity Commission’s lack of support for policies that actually restrict executive excesses, its report confirms the rapid increases in remuneration, particularly during the last decade. This circumstance correlates with the shift from base salaries to incentive-based payments augmented by short- and long-term bonuses, a transition that occurred during the second half of the 1990s when executive pay began its inexorable rise. Moderate growth continued until 2007 and the emergence of the global financial crisis.

The Productivity Commission’s draft report reveals that the average pay packet among the top 20 chief executive officers (CEOs) in Australia is almost $10 million, 150 times more than average weekly earnings. Among CEOs of the next 20 companies, pay packets are about half this amount, around 75 times more than the $62,218 the average Australian worker earns in a year.[6]

Consistent with the views once held by the Prime Minister, the Australian public remains concerned with the ‘outrageous packages’ earned by some executives. Data presented below show firm community support for reducing this growing inequity by increasing the tax rate applicable to very high-income earners.

Market failure and the need for regulation

Prior to the global financial crisis, when a rapidly growing economy helped to ensure that firms were able to generate healthy financial returns, amounts paid to executives received little attention from regulators, boards or shareholders. However, when an economic downturn such as a stock market crash or a recession occurs, or when a high-profile executive receives a huge pay-out from a failing company, the issue tends to attract popular attention. This selective concern has been re-awakened in response to the global financial crisis and its magnitude has caused regulators to take heed.

In the lead-up to the global financial crisis, the strength of the international economy appears to have instilled in the banking sector an inflated confidence which, when combined with incentive-based executive pay, led to ‘irrational exuberance’ and increased risk-taking in search of new avenues for profit.[7] High short-term profits led to the payment of generous bonuses to employees without adequate regard to the longer-term risks many were imposing on their firms. These perverse incentives further amplified excessive risk-taking, which was exacerbated by a ‘lack of due diligence in assessing credit risk’.[8] Compensation practices at large financial institutions are one factor among many that contributed to the financial crisis that began in 2007.

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6 At May 2009, the average weekly earnings for a full-time worker were $1,196.50 a week.

7 FSA (Financial Services Authority), *The Turner Review*, p.25.

8 G-20 (Group of Twenty), Working Group 1, *Enhancing Sound Regulation and Strengthening Transparency, Final Report*, 25 March 2009, p.3. Available at: <http://www.g20.org/Documents/g20_wg1_010409.pdf> (accessed 18 September 2009).

There is a widely acknowledged link between incentive-based executive pay, increased risk-taking and the global financial crisis. Indeed, the multinational Financial Stability Forum (FSF),[9] of which Australia is a member, stated explicitly that executive pay had played a role in the crisis.[10] The Productivity Commission noted in its draft report that the Australian Prudential Regulation Authority (APRA) had 'proposed a number of modifications to governance standards to reflect the principles of "sound compensation practices" for significant financial institutions' in response to FSF recommendations released in April 2009. However, a year earlier, the FSF had recommended that risky practices encouraged by executive remuneration incentives should be mitigated through a working collaboration of regulators, supervisors and companies.[11]

Similarly, after the onset of the global financial crisis, the US House of Representatives passed legislation in July 2009 requiring shareholders in public companies to vote annually on the pay of the top five executives.[12] In Europe, guidelines adopted by the European Commission have focused on designing executive pay packages so that they promote the long-term sustainability of a company.[13] APRA has proposed that a remuneration policy and a Board Remuneration Committee be mandatory requirements for the banking and insurance companies it regulates.

In September 2009, the Financial Stability Board (FSB),[14] comprised of senior representatives from national financial authorities and tasked with implementing policies to ensure global financial stability, submitted its proposals for regulating executive pay to the G-20 summit in Pittsburgh. These included linking bonuses to company performance, 'clawback' arrangements[15] in the structure of bonuses, limits on guaranteed bonuses and enhanced supervisory and board oversight of executive compensation.[16] Despite assertions to the contrary, these changes reinforce the failure of the market and of private shareholders to align the long-term interests of executives with those of company owners.

In Australia, the Productivity Commission's draft report, released the week after the G-20 summit, limited its focus in general to improved board-level governance and some increased provision for the role of shareholders. Its principal recommendation requires board members to seek re-election if a 'prescribed threshold' of shareholders votes 'no' on a remuneration report following a quarter of shareholders voting 'no' on the previous report.[17] The Commission's

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9 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'.

10 FSF (Financial Stability Forum), *FSF Principles for Sound Compensation Practices*, 2 April 2009, p.1. Available at: <http://www.financialstabilityboard.org/publications/r_0904b.pdf> (accessed 18 September 2009).

11 Productivity Commission, *Executive remuneration in Australia*, Productivity Commission discussion draft, September 2009. Available at: <http://www.pc.gov.au/projects/inquiry/executive-remuneration/draft>.

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

13 European Commission, *Commission Recommendation: Complementing Recommendations 2004/913/EC and 2005/162/EC as Regards the Regime for the Remuneration of Directors of Listed Companies,* C(2009)3177, 30 April 2009, Brussels, p.2. Available at: <http://ec.europa.eu/internal_market/company/docs/directors-remun/directorspay_290409_en.pdf> (accessed 18 September 2009).

14 Formerly the Financial Stability Forum, refer to Footnote 9.

15 Clawback arrangements permit the repayment or deferral of executive bonuses if a company's performance is determined to have fallen short of expectations.

16 FSB (Financial Stability Board), *Financial Stability Board Issues Implementation Standards on Compensation*, press release, 25 September 2009. Available at: <http://www.financialstabilityboard.org/press/pr_090925b.pdf> (accessed 30 September 2009).

17 Productivity Commission, *Executive remuneration in Australia*, p.xxxvii.

proposed reforms to executive pay in Australia have not been as far-reaching as those recommended to the G-20 by the FSB, whose goal was to ensure global economic stability. Neither the FSB nor the Productivity Commission has suggested that executive pay be capped.

It is important to note that all of the proposals discussed above are related to the need to address the market failures associated with the setting of executive compensation; not one addresses the need to ensure that the distribution of income within society is equitable. This is not to say that governments should not be concerned with market failure, rather that reversing market failure should not be the only motivation for government intervention.

Labour-market failures

The Productivity Commission's draft report identified a number of labour-market influences on rising levels of executive pay, including company demands for executives with international experience and the correlation between incentive-based remuneration and the appointment of US executives to CEO positions in Australia in the 1990s.

This situation begs several questions. First, it seems unlikely that the 'executive talent' required by some firms is so rare that salaries of more than $10 million are required to attract capable people. In 2008–09, for example, the government agency Centrelink employed 27,954 staff, operated 896 service points and was responsible for payments of $86.8 billion. Its highest-paid executive at the time received less than $490,000 a year.[18]

Second, 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 appears 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 more difficult to access and should therefore be willing to pay even higher wages. This is not the case, however, and examples of proportionally higher levels of executive pay in English-speaking countries, including Australia, indicate that it is a cultural phenomenon.

Finally, any perceived shortage of executive talent and the enormous salaries required to overcome it should act as a signal for firms to invest more in training, thereby expanding the size of the pool of capable applicants. But the recent trend towards very large executive salaries does not appear to have triggered any self-correcting investment in training. On the contrary, executive pay appears to be spiralling upwards rather than edging downwards, suggesting that either significant market failure exists and/or that some of the claims about the role of market forces in setting executive salaries are over-stated.

The impact of income inequality on health, wellbeing and social inclusion

Market failure is defined as a situation in which the outcome of market interactions between buyers and sellers is inconsistent with the maximisation of social wellbeing. For example, even though a coal-fired power station (the seller) and an aluminium smelter (the buyer) may be happy to ignore the impact of carbon dioxide on the atmosphere, the 'external costs' associated with their private decisions may cause others grave concern.

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[18] Australian Government, Centrelink, *Centrelink Annual Report 2008-09*, Canberra, 2009, p.11 and p.200. Available at: <http://www.centrelink.gov.au/internet/internet.nsf/publications/ar0809.htm> (accessed 20 November 2009)

Although the Productivity Commission and the FSB may have expressed disquiet at the costs imposed on shareholders because of the market failures associated with executive pay, there has been virtually no discussion about the impact of ‘outrageous’ salary packages on society more generally. That is, the narrow debate around how to protect shareholders from greedy executives has largely ignored the evidence that widening income inequality imposes costs on society as a whole.

For example, the World Health Organization (WHO) has a program dedicated to understanding the social determinants of health—the underlying factors that lead to adverse health outcomes. The final report of the WHO’s Commission on Social Determinants of Health proposed three overarching recommendations, one of which was the need to tackle the inequitable distribution of income.[19]

The greater the gap between rich and poor, the worse the health outcomes for a society will be is a concept known as the Income Inequality Hypothesis.[20] A range of possible explanations for this empirical link have been suggested including:

- Societies with uneven income distributions are less likely to invest in human capital, such as education.[21]

- High levels of income inequality may erode social capital, the stock of investments, resources and networks that produce social cohesion, trust and willingness to engage in community activities.[22]

- Frustration resulting from social comparisons to others can have adverse health consequences.[23]

While the exact cause of the link between income inequality and health may be uncertain, there is strong evidence of the association nonetheless. Combined with the public desire to impose some restraint on the generosity with which boards are willing to remunerate executives, these health data suggest that government action to address egregious salary packages is socially desirable.

When too much is never enough—trends in executive pay

The greatest increases in executive remuneration packages occurred in the 1990s. The trend slowed during the next decade and underwent a noticeable reduction during the global financial crisis, which prevailed during 2007–08. However, current indications are that pay increases and large bonuses are returning. The Productivity Commission noted that there are limited data giving rise to some difficulties in putting a dollar value on equity-based incentive payments, but it did describe a pattern of rising executive remuneration in Australia.

So just how much are Australian executives paid?

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[19] World Health Organization, ‘Social determinants of health’, WHO, 2009. Available at: <http://www.who.int/social_determinants/en/> (viewed on 14 December 2009).

[20] R G Wilkinson, *Unhealthy Societies: The Afflictions of Inequality*, Routledge, London, 2009.

[21] G A Kaplan et al., ’Income inequality and mortality in the United States: analysis of mortality and potential pathways’, *British Medical Journal*, Vol. 312, 1996, pp. 999–1003.

[22] I Kawachi et al., ’Social capital, income inequality, and mortality’, *American Journal of Public Health*, Vol. 87, 1997, pp. 1491–1498.

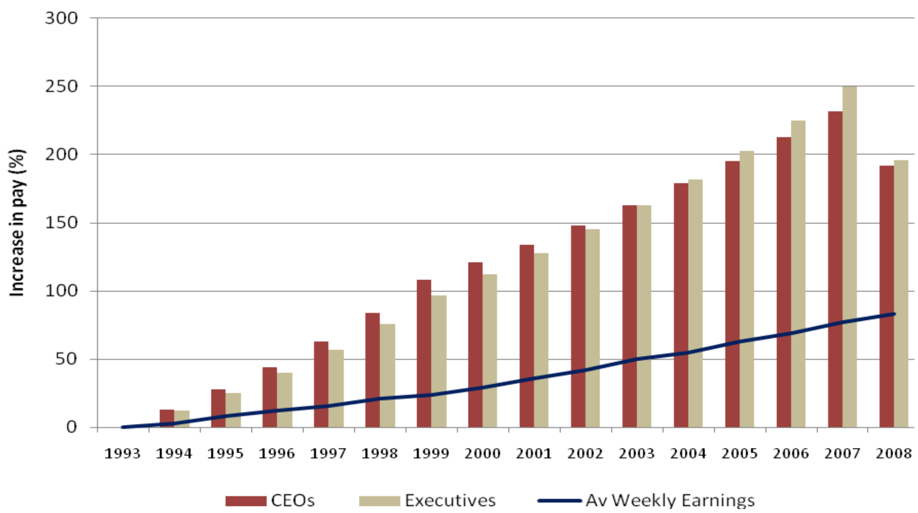
[23] W W Dressler, ’Culture and blood pressure: using consensus analysis to create a measurement’, *Cultural Anthropology Methods*, Vol. 8, 1996, pp. 6–8.

Public resentment at the steep rise in executive earnings is vindicated by the figures compiled by the Productivity Commission. Its analysis of pay packets found that from 1993 to 1999 there were increases of 16 per cent a year in real terms for the CEOs of the top 50 publically listed companies and 13 per cent a year across the top 100 companies in Australia. At the same time, the rise in average weekly earnings for full-time employees was 3.7 per cent.[24] Between 2000 and 2007, pay increases for these CEOs slowed to about six per cent a year; the increase in average weekly earnings, however, remained lower at 4.5 per cent. The following year, 2008, the emerging global financial crisis began triggering reductions in executive pay, 12 per cent across the top 100 companies.

By comparison, the increase in the pay packets of senior executives[25] employed in the top 100 public companies was 12 per cent a year in the period 1993 to 1999 and 7.4 per cent a year from 2000 to 2007. Senior executive pay decreased by 15.4 per cent in 2008.

Figure 1 compares the percentage increases in CEO and senior-executive earnings and average weekly earnings.

Figure 1: Comparison of percentage increase in pay



Source: Productivity Commission and ABS.[26,27]

Figure 1 shows that the percentage increases in executive earnings and average weekly earnings have been unequal. Interestingly, in percentage terms senior executives caught up to CEOs in 2003 and then began to move ahead. By comparison, however, average weekly earnings have failed to keep pace with increases in CEO and executive pay.

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24 ABS, (Australian Bureau of Statistics), 'Table 2. Average Weekly Earnings, Australia (Dollars)—Seasonally Adjusted', in *Average Weekly Earnings, Australia, August 2009*, Cat. 6302.0, Canberra, 2009. Available at: http://www.ausstats.abs.gov.au/ausstats/ABS@Archive.nsf/0/3952A0872859276DCA2575BC00213F00/$File/6302002.xls#A594106L.

25 Figure calculated on the average pay of the top five non-CEO company executives.

26 Productivity Commission, *Executive Remuneration in Australia.*

27 ABS, (Australian Bureau of Statistics), 'Table 2. Average Weekly Earnings, Australia (Dollars)—Seasonally Adjusted'.

Productivity Commission figures reveal that executive pay increased by 250 per cent between 1993 and 2007 but figures submitted to the Commission's inquiry by Egan Associates 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. A comparison of increases in executive pay and 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
Senior executives	$250,000	$1.4 million
Average annual wage	$31,075	$62,218
Ratio of CEO to senior executives	2 to 1	2.3 to1
Ratio of CEO to the average annual wage	15.3 to 1	51.4 to 1

Sources: Egan Associates' submission to the Productivity Commission Public Inquiry into Executive Remuneration; ABS Cat. No. 6302.0.[28,29]

The data from Egan Associates tell a story of ballooning executive pay packets and gradually rising 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 but, while the ratio between CEOs and executives remained relatively constant over time, the gap between executives and the average wage widened out by a factor of more than 50 times.

Executive pay in the public sector

Executive pay in the public sector is not as excessive as it can be in the private sector, but there are differences between senior executives and senior officers within the public service. In Australia, the Remuneration Tribunal sets pay rates for senior offices such as the judiciary, defence chiefs and parliamentarians, and has noted that in the eight years to 2006 the salaries for senior executives increased by between five and six per cent per annum.[30] While not as audacious as those in the private sector, these increases nevertheless exceed 'adjustments determined by the Tribunal over the same period' for senior officers. The Tribunal referred to:

> … the decline in remuneration relativities of senior public offices compared to movements, over an extended period, in SES remuneration. This decline in remuneration relativities is of particular relevance to Secretaries ...[31]

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28 Egan Associates, *Submission to Productivity Commission Enquiry on director and executive remuneration in Australia*, September 2009. Available at: <http://www.pc.gov.au/__data/assets/pdf_file/0004/91408/sub105.pdf>.

29 ABS, (Australian Bureau of Statistics), 'Table 2. Average Weekly Earnings, Australia (Dollars)—Seasonally Adjusted'.

30 Remuneration Tribunal, *2008 Review of Remuneration for Holders of Public Office: Statement*, 2008, p.1. Available at: <http://www.remtribunal.gov.au/determinationsReports/byYear/2008/2008%20Review%20of%20Remuneration%20for%20Holders%20of%20Public%20Office.pdf>, (accessed 20 November 2009).

31 Remuneration Tribunal, *Annual Report 2007-2008*, Commonwealth of Australia, 2008, pp.1–2. Available at: <http://www.remtribunal.gov.au/publications/Annual%20Report%202007-08.pdf>, (accessed 20 November 2009).

After taking into account advice from the Remuneration Tribunal responsible for developing rates of pay for the secretaries of Commonwealth departments, the Prime Minister set the pay schedule for departmental secretaries in October 2009. The secretaries of the Departments of Defence, Prime Minister and Cabinet and Treasury will receive a total package of $503,220 per annum; all other secretaries will receive $470,790 per annum.[32] By comparison, the Prime Minister is paid $372,704 before expenses.[33] All these remuneration packages are considerably less than the $1 million plus received by many executives in the private sector.

A review of executive salaries published by the *Australian Financial Review* in November 2009 included an assessment of the base pay, benefits and short- and long-term bonuses received by the 100 highest-paid executives in Australia and found that their average pay packet was almost $5.4 million. The lowest-paid executives in the top 100 received more than $2.5 million and among executives not in the top 100, over 180 were paid more than $1.25 million.[34]

It is important to note that while the heads of public sector departments are well paid by community standards and poorly paid by private sector standards, they are still willing and able to manage extremely large organisations. For example, Centrelink employs 27,954 staff and the Australian Taxation Office employs 22,429 non-senior executive staff. These are very large organisations operating in highly complex areas of service delivery; the executives running them are subject to much higher, and much more public, levels of scrutiny than those running large private companies. For example, not only are members of opposition political parties employed full time to find fault with the performance of a department, but millions of ‘customers’ are also exceedingly willing to vent any frustration directly towards those charged with finding fault. Furthermore, through processes such as Senate Estimates, it is likely that any failures of management will be televised nationally.

Finally, the ability of some senior public servants to receive significant increases in remuneration when they depart the highly regulated salary structures of the public sector suggests that talented people are willing and able to work for much lower salaries than those offered in the private sector. For example, the former chief of staff to Queensland premier Anna Bligh saw his salary rise from $211,000 to $450,000 a year when he left to work for the National Broadband Network.[35]

Are Australian executives overpaid?

The Productivity Commission used an analysis of CEO remuneration across companies with a market capitalisation of between $5 million and $30 billion to compare executive pay packets in Australia with those paid internationally. In the US, the average executive payment was A$7.36 million and in the UK, A$5.56 million. But, suggesting that Australia is more closely aligned with Europe than the US and the UK, in Germany the figure was A$4.41 million, in France A$4.04 million and in Australia $3.45 million.[36] However, the Productivity Commission

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32 Commonwealth of Australia, ‘Determination under Section 61: Secretaries' remuneration and other conditions’, *Public Service Act 1999*, October 2009, p. 12. Available at: <http://www.pmc.gov.au/accountability/docs/pm_determination.pdf> (accessed 20 November 2009).

33 S Benson, ‘Premier Nathan Rees' pay rise means he is paid more than Prime Minister Kevin Rudd’, *The Daily Telegraph*, 30 October 2009. Available at: <http://www.dailytelegraph.com.au/money/money-matters/nathan-rees-youre-just-not-worth-all-that-money/story-fn300aev-1225792602020> (accessed 20 November 2009).

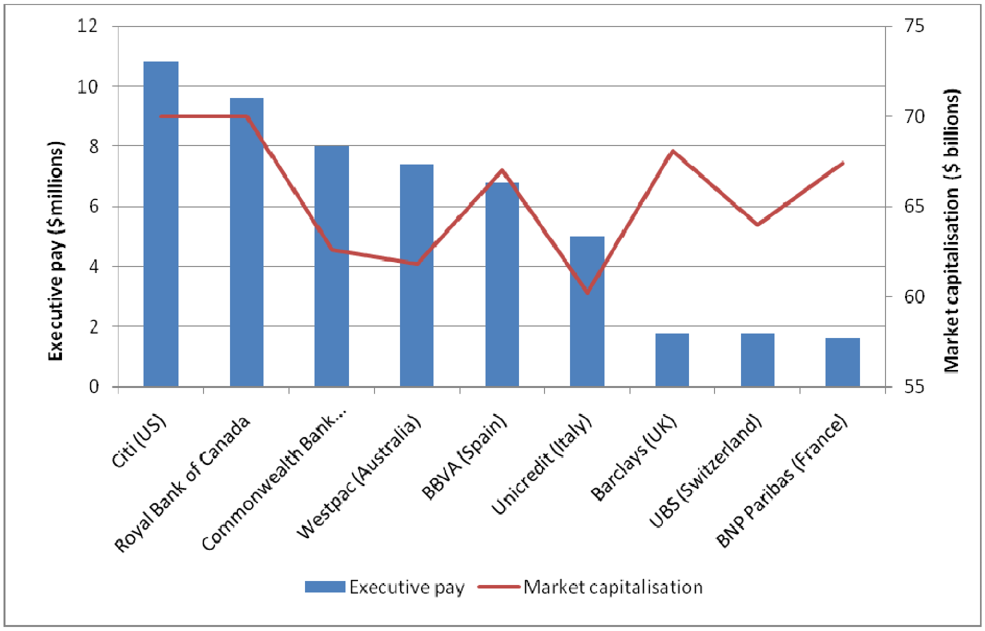
34 ‘Salary Review 2009’, *The Australian Financial Review*, 11 November 2009, pp.S8–S9.

35 E Chalmers, ‘New post is worth $450,000 for Kaiser’, *The Courier Mail*, 18 November 2009. Available at: http://www.news.com.au/couriermail/story/0,23739,26368842-952,00.html.

36 Productivity Commission, *Executive remuneration in Australia*, p.xix.

acknowledges that in the Australian finance sector, and comparing banks of similar size, executive remuneration is closer to the high levels paid in the US whereas European banks pay significantly less to their executives. Figure 2 illustrates the disparities between executive pay and market capitalisation.

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



Source: Reuters.com.[37]

Figure 2 reveals that the CEOs of Australian banks do much better than their European counterparts. The nearest comparable example is UniCredit (Italy), which has a slightly lower market capitalisation than the Australian examples but pays its executives $2.5 million less than if they were doing the same job at Westpac. Alternatively, the amount of executive pay is similar at BBVA (Spain) but the market capitalisation is around of $4.5 billion more. The competitive examples from the UK, France and Switzerland illustrate the disproportionate levels of executive compensation in the Australian banking sector.

Recent reports from overseas indicate that bonuses and pay increases are now returning following the global financial crisis. In the US, investment bank Goldman Sachs is reported to have set aside close to $17 billion or 47 per cent of its profits for paying bonuses, which are the company's largest expense.[38]

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[37] Reuters.com, 'Graphic: Banking compensation', 23 September 2009. Available at: <http://blogs.reuters.com/from-reuterscom/2009/09/23/graphic-banking-compensation/> (accessed 8 October 2009).

[38] P Ryan, 'Goldman profits, but home defaults surge', *ABC News,* 16 October 2009. Available at: <http://www.abc.net.au/news/stories/2009/10/16/2716193.htm> (accessed 16 October 2009).

How executives are paid?

Until the mid 1990s, executive packages in Australia were largely comprised of a base salary and some allowances, with bonuses usually accounting for less than a tenth of the total.[39] Since that time, however, bonuses as a proportion of executive pay have increased, a circumstance attributed to the new practices introduced by the appointment of US executives in the early part of the decade. This pivotal point has been recognised by both the Productivity Commission and Professor Ross Garnaut in his book, *The Great Crash of 2008,* written with David Llewellyn-Smith.[40]

Recently, Leighton Holdings CEO Mr Wal King acknowledged that Australian executives have benefited from the adoption of US-style pay packages, the legacy of short-stay US executives. Mr King said, '[Y]ou 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'.[41]

When former Qantas CEO Geoff Dixon finished up, 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,[42] a total of $10.5 million and almost 170 times what the average Australian worker earns in a year.

The Productivity Commission has identified the following trends in the structure of executive remuneration in the top 300 companies listed on the Australian Stock Exchange during the five years from 2003–04 to 2007–08. There has been:[43]

- 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.

With a fixed salary (including superannuation) as a base, executive pay can be enhanced by bonuses 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 their company. Short-term bonuses tend to be cash payments; long-term bonuses usually involve shares. Guaranteed bonuses are used to lure executives to a company, a practice that has contributed to the spiralling increases in executive pay. Multinational reforms designed to encourage a longer-term focus by executives have concentrated on deferring bonuses and, if

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39 Productivity Commission, *Executive remuneration in Australia*, p.51.

40 R Garnaut and D Llewellyn-Smith, *The Great Crash of 2008*, Melbourne University Press, Melbourne, 2009.

41 W King, 'Wal King defends big pay packet', *Radio National PM*, 5 November 2009. Available at: <http://www.abc.net.au/pm/content/2009/s2734533.htm> (accessed 6 November 2009).

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

43 Productivity Commission, *Executive remuneration in Australia*, p.51.

justified, ‘clawing back’ bonus payments where company performance is significantly below expectations.

As discussed above, while it may be in the interests of shareholders to better align the long-run profitability of a firm with the salary packages of its executives, the societal interest in executive remuneration and its impact on equity and social cohesion is much broader than shareholder perceptions of ‘value for money’. It is interesting to note that the Productivity Commission confined its focus to shareholders rather than to society; its recommendations addressed problems faced by shareholders while largely ignoring the costs ‘outrageous’ salary packages impose on society more generally. The UK Government, on the other hand, has recently announced that an additional 50 per cent payroll tax will be levied on bonus payments of more than £25,000. As payroll tax is not a tax-deductible expense, this means that there is a direct and significant cost to shareholders associated with any such payments. Although the UK Government has announced that this is a temporary measure only, it has also foreshadowed that it is likely to stay in place until other regulatory measures designed to reduce excessive bonuses take effect.[44]

Termination payments

Termination payments (or golden handshakes) have been subject to public scrutiny because they are seen as a reward for failure when an executive is compensated for early termination, often because of poor performance. The reported size of termination payments for leading executives has not helped this perception. On departing Telstra, former CEO Mr Sol Trujillo received $3 million in termination payments over and above a base salary of $13.4 million.[45]

High rates of executive pay (and apparent reward for failure) are not restricted to the private sector, however. 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’s recording a loss of more than $5 billion or 13.7 per cent in the same year.[46]

The Australian Government announced changes to the Corporations Act in March 2009 that affected termination payments in the following ways:[47]

- the threshold at which shareholders must approve a termination payment was reduced to one year’s base salary
- approval requirements were extended to all executives listed in a company’s remuneration report
- the definition of a termination payment was broadened.

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44 Chancellor of the Exchequer, *Securing the recovery: growth and opportunity*, *Pre-Budget Report December 2009*, presented to Parliament by Command of Her Majesty, HM Treasury, December 2009, pp.43–44. Available at: <http://www.hm-treasury.gov.uk/prebud_pbr09_repindex.htm>.

45 P Ryan, ‘Swan cracks down on “golden handshakes”’, *ABC News*, 18 March 2009. Available at: <http://www.abc.net.au/news/stories/2009/03/18/2519570.htm> (accessed 15 October 2009).

46 D Rood, ‘Million-dollar public servant presided over lost billions’, *The Age*, 16 October 2009. Available at: <http://www.theage.com.au/national/milliondollar-public-servant-presided-over-lost-billions-20091015-gz62.html> (accessed 16 October 2009).

47 W Swan and N Sherry, *Action on golden handshakes*, joint media release, 18 March 2009. Available at: http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/024.htm&pageID=&min=wms&Year=&DocType=0.

These changes are not retrospective. In contrast, the FSB has recommended that existing termination clauses in executive contracts be re-examined.

How can executive pay be reined in?

The G-20 met in Washington at the height of the global financial crisis, a summit of panicking world leaders calling for immediate action to end executive pay packages 'which reward excessive short-term returns or risk-taking'.[48] This action, the summit declared, could be pursued through voluntary measures or regulatory means, so long as the desired outcome was achieved.

The deliberations of the G-20 Summit in Washington resulted in proposals for reining in executive pay that focus largely on the payment of bonuses because incentives, and in particular short-term incentives, are viewed as the primary motivator behind risky business and investment decisions—a contributing factor to the global financial crisis. The objective of these suggested reforms has been to increase the accountability of executives with regard to their decisions by aligning their own long-term interests with those of shareholders.

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, for example company profits and shareholder losses. Regulation, the FSA contends, is further justified because the market is unlikely to address the externalities resulting from the effects of executive pay packages.[49] However, it also recognises that the extent to which government policy can change executive pay practices is limited, stating that changes to capital, accounting and liquidity and associated market responses could be more effective in curtailing levels of executive pay than regulation.[50]

In Australia, APRA acknowledges that it can directly influence the boards of the financial institutions it regulates but has stated that it 'does not intend to focus on the levels of [pay] paid to executives'.[51] Instead, its proposals attempt to ensure that companies themselves address the issue by extending governance standards at board level and requiring boards to establish a remuneration policy and a Board Remuneration Committee.[52] These reforms are aligned with the principles set out by the FSB, which stipulate that independent and effective boards oversee executive pay policies and practices.

In its draft report, the Productivity Commission has similarly recommended that board governance of executive pay be strengthened and, in addition, it has proposed a marginal increase in the role of shareholders where board decisions on executive pay are concerned. But by abandoning the issue to the prerogative of companies, regulators' attempts to improve the

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48 G-20 (Group of Twenty), *Declaration: Summit on Financial Markets and the World Economy*, [Washington], 15 November 2008, p.3. Available at: <http://www.g20.org/Documents/g20_summit_declaration.pdf> (accessed 18 September 2009).

49 FSA (Financial Services Authority), *Reforming remuneration practices in financial services*, Consultation Paper 09/10, March 2009, p.13. Available at: <http://www.fsa.gov.uk/pubs/cp/cp09_10.pdf> (accessed 18 September 2009).

50 FSA (Financial Services Authority), *The Turner Review*, p.81.

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

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

situation are not addressing the whole problem; the government too has a part to play by regulating companies and the market to prevent another global financial crisis. The role for government is to ensure that the widening gap between executive earnings and average weekly earnings is addressed but whether that role includes the protection of shareholders from a decrease in dividends due to the pay packets of executives is less evident.

Policy solutions

The Productivity Commission's draft response has alleviated neither the size nor the inequity of executive remuneration; internationally, reforms have largely ignored the inequity. However, reining in executive pay and reducing the incentive for executives to take unjustified risks with other people's money are not mutually exclusive tasks, and public concern at executive excess and the international focus on economic stability can be addressed simultaneously.

The following sub-sections outline some of the principal ways in which governments, if they so choose, can reduce the generosity of executive remuneration.

Fixing the market failures

The global financial crisis demonstrates the extent to which the market failed to control its own excesses and those of its executives, who were encouraged to take ever greater risks because of the bonus-based incentive structures within their pay packages.

The FSB has proposed to the G-20 that executive pay should be based on a full risk assessment of the organisation, reducing the incentive for executives to take excessive risks by aligning bonuses to risk-adjusted profit. It further recommends that executive payments be deferred so as to reflect actual company performance over time. It must be remembered, however, that these proposed standards relate only to 'significant financial institutions'.[53]

Other FSB recommendations include:

- linking bonuses to company performance
- increasing a proportion of the deferred (minimum three years) bonus relative to seniority and/or responsibility, starting at 40 per cent and rising to more than 60 per cent
- paying at least half of every bonus in shares linked to a share retention policy
- vesting cash bonuses over time and clawing them back in instances where future company performance declines
- restricting guaranteed bonuses to new staff and limiting the practice
- re-examining termination clauses and payments.

While these reforms are intended to shift executive focus from a short- to long-term perspective, they also involve an increase in company regulation and supervision. In his new book on the global financial crisis, Professor Garnaut has highlighted the process of 'regulatory capture' in which those who supervise the regulation of an industry succumb to the views of those they regulate, most often through the transfer of employees from the private sector to the regulator.[54]

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

[54] Garnaut and Llewellyn-Smith, *The Great Crash of 2008*, p.75.

The emphasis on shares as bonuses is a market-friendly form of regulation and supervision and is possibly indicative of ‘regulatory capture’. There are, however, several drawbacks to providing shares as bonuses.

The Productivity Commission has noted that shares offer little in the way of consistent incentives to executives (being ‘akin to a lottery’) and can have large cost implications for companies,[55] but it remains advantageous for Australian executives to receive them because shares are subject to a concessional rate of capital gains tax. Capital gains are taxed at half the top marginal tax rate resulting in an effective top tax rate of 24.3 per cent on proceeds from shares sold after a year. 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’.[56] Given the tax advantages available to executives by exchanging salary for shares or options, it seems naively optimistic to assume that companies or executives will work very hard to reduce their reliance on such practices unless the underlying advantage of tax concessions is removed.

The link between risk and executive pay was canvassed by the International Monetary Fund’s Executive Board at a seminar in June 2009 where the roles of tax and different forms of pay available to executives were examined. The seminar noted that tax treatments ‘may have contributed to greater risk-taking and short-termism’ and concluded that ‘it is important that taxation not encourage the use of inappropriate compensation arrangements’.[57]

The proposed FSB standards tackle incentives that encourage risk-taking through increased use of shares and deferred divestment, but this approach does not take into account the tax advantages that remain available to executives. The rationale for tax concessions on capital gains runs contrary to this goal as it is intended to encourage risk-taking, thereby undermining international reforms to encourage more prudent management by executives.[58] To ensure that reforms designed by the FSB are effective in Australia, the concession on capital gains should be removed.

Directly capping executive pay

United efforts by the G-20 to reform executive remuneration have revealed that capping is not the preferred option of most developed countries. There are exceptions, however. The French President, Nicolas Sarkozy, advocated capping executive pay in the lead-up to the September meeting of G-20 members 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’.[59] Nevertheless, the argument for capping executive pay has remained off the G-20 agenda in spite of its public appeal.

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55 Productivity Commission, *Executive remuneration in Australia*, p.xxiii.

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

57 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*, Washington D C, 16 June 2009. Available at: <http://www.imf.org/external/np/sec/pn/2009/pn0976.htm> (accessed 22 September 2009).

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

59 Great Britain, House of Commons, Treasury Committee, *Banking Crisis: reforming corporate governance and pay in the City*, Ninth report of session 2008–09 together with formal minutes, The Stationery Office, London, 15 May 2009, p.22. Available at:

In Australia, despite enthusiasm for addressing the 'outrageous' levels of executive remuneration, the Prime Minister has indicated that the government does not advocate pay caps.[60] The Productivity Commission is of a similar view, instead placing an emphasis on the role of company remuneration boards and policies. The draft report states that it is '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'.[61]

There is no doubt that the introduction of a cap to executive remuneration could help rein in the 'outrageous' packages the Prime Minister was once concerned with, but there is also no doubt that defining and enforcing such a cap would be both controversial and difficult.

Labour-market reform

In its draft report, the Productivity Commission described how the market forces of supply and demand determine executive remuneration, with additional negotiation directing bonuses and tax implications influencing an executive's final pay packet. Ironically, it is possible for prudent, risk-averse boards to play a role in driving up executive salaries by creating remuneration structures that subsequently serve to encourage excessive risk-taking. Consider the following hypothetical example.

The board of a company has narrowed down the number of candidates for a new executive position to two people, both of whom appear to be equally suitable. One is currently being paid $500,000, the other $2 million. The board is likely to be perceived as taking less risk by choosing the second candidate even though it will have to pay more, with the rationale being that the 'labour market' has already determined the executive's market value. Therefore, employing the better-paid candidate suggests that the board's decision is supported by the market whereas employing the cheaper candidate suggests that 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'. If, however, the board takes the 'riskier' decision of employing the lower-paid executive who subsequently turns out to be a poor performer, the mistake is more likely to be perceived as solely the board's.

The Productivity Commission makes a related point in its report.

> 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.[62]

The dynamics of the labour market have contributed to the rise in executive pay; indeed, as companies will offer ever higher remuneration to lure 'good' people, executive market value will increase even before hiring is concluded. Amidst the large executive pay hikes of the 1990s, this phenomenon was described as the 'virtuous circle'.[63]

<http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf> (accessed 18 September 2009).

60 K Rudd, 'Press conference at the G20 Leaders' Conference'.

61 Productivity Commission, *Executive remuneration in Australia*, p.xxv

62 Productivity Commission, *Executive remuneration in Australia*, p.xviii

63 I Ries, 'The fat-cat gap is growing', *The Australian Financial Review*, 5 December 1996, p.52.

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 at only half the top marginal income tax rate. The tax concessions enjoyed by executives who receive large share bonuses can be extraordinary when compared to the tax payable by an executive poorly advised to take their entire remuneration in cash.

Consider, for example, an executive with a $2 million base salary who receives an additional $10 million worth of capital gain from share-based performance bonuses. If the executive has held on to the shares for more than 12 months before selling them, the tax payable on the $10 million capital gain is literally half what would be payable on a cash bonus of the same amount. Specifically, while the income tax payable on a $10 million cash bonus would be $4.85 million, the tax payable on a share-based capital gain of the same size would be equal to $2.425 million. It is sometimes argued that because shares may go down as well as up in value, executives are assuming a higher degree of risk by taking their remuneration in the form of shares but when the generous tax treatment of those shares is taken into account, the 'risk' is much smaller than it might otherwise appear.

Removing this tax advantage would reinforce proposed global reforms by addressing both the conflation of incentives with risk and the size of executive pay packets and would not require any further regulation unlike suggestions from the FSB and Productivity Commission. This approach would reduce the advantage of large bonuses over negotiated base salaries and, therefore, some of the increasing gap between executive remuneration and average earnings. It would also result inevitably in executives demanding higher salaries and the net increase in the tax base would permit a degree of redistribution. This is a straightforward option and while it would not cap executive pay, it would achieve greater equity and remove one of the biggest financial incentives for executives to seek remuneration packages dominated by large, share-based bonuses.

Increase the top marginal income tax rate

Currently, the top marginal income tax rate is considerably lower than the 75 per cent in place at the beginning of the 1950s, which reduced to over 60 per cent in the 1980s and to 50 per cent only at the end of the decade. As it has decreased further, there has been a proportional increase in the amount of income tax incurred by lower-paid Australian workers.[64] If the top marginal tax rate were to be set back to 50 per cent, it would not be an unprecedented rate of taxation and would also address the inequitable increases in the proportion of income tax paid by Australians on lower incomes.

A majority of Australians surveyed by The Australia Institute indicated that they were in favour of a new top tax bracket for very high-income earners. When asked if they would approve of raising the top income tax rate from 45 per cent to 50 per cent, a clear majority (70 per cent) said that they would support an increase for people earning more than $1 million a year. Table 2 shows the demographic breakdown of respondents in favour of raising the income tax rate.

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[64] S Reinhardt and L Steel, *A brief history of Australia's tax system*, paper presented to the 22nd APEC Finance Ministers' Technical Working Group Meeting, Vietnam, Australian Treasury, 15 June 2006, pp.14–15. Available at: <http://www.treasury.gov.au/documents/1156/PDF/01_Brief_History.pdf> (accessed on 20 November 2009).

Table 2: Support for raising the income tax rate for million-dollar earners to 50 per cent

	Gender		Age			Income[a]		
	Male	Female	18-34 years	35-54 years	55+ years	<$60,000	>$60,000	All
	Percentage							
Yes	70.0	69.0	66.2	64.9	77.5	74.5	61.7	69.5
No	30.0	31.0	33.8	35.1	22.5	25.5	38.3	30.5
Total	100	100	100	100	100	100	100	100

Base = 718. Based on the question: 'If the top income tax rate for people earning more than $1 million per year were raised from 45% to 50%, would you support this?' Includes only those who answered this question (respondents who said they were unsure have been excluded).

[a] Annual household income before tax. Table excludes respondents who did not indicate their income.

Increasing the top marginal tax rate is a policy option that would not require any new regulation and would act as a simple and effective means of redressing rising income inequality in Australia.

Abolish the tax deductibility of remuneration over a threshold

When determining the profit and, in turn, the tax liability of a company, the total amount of allowable expenses is deducted from the total amount of revenue for the period in question. While defining 'income' and 'expenses' is literally an industry in itself, one straightforward way to discourage firms from paying what the Prime Minister labelled in November 2008 as 'outrageous' salary packages would be to deem incomes over a given threshold as a non-deductible expense for the calculation of taxable profit.

For example, if the threshold for 'reasonable remuneration' were to be set at $1 million a year and a firm wished to pay an employee $20 million a year, the firm would be unable to deduct the $19 million difference between the salary package and the threshold when calculating its taxable profit. In effect, this would convert the $19 million from a legitimate, tax-deductible business expense of the company into a $19 million gift from its shareholders to its executive. While the executive would still be required to pay tax on the full $20 million they received, the firm would also have to pay the full company tax rate on the $19 million that was above the threshold.[65]

Although the increase in tax revenue would be small, such a change would be likely to ensure that shareholders, including institutional shareholders, would subject claims concerning the benefit to shareholders of high executive salaries to significantly greater scrutiny.

Conclusion

At the outset of the global financial crisis, the Prime Minister reflected the public mood when he expressed concern at the 'outrageous packages' paid to some executives and the consequent

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[65] The acceptability limit might be determined through a combination of a fixed rate plus a (possibly non-linear) variable component based on the market capitalisation of the company concerned. Although market capitalisation itself can vary, the extent of this variability would be addressed in most instances by applying a 12-month average. Alternatively, the acceptability limit could reflect increases in the public sector and be determined by the Remuneration Tribunal or an equivalent independent statutory authority.

corrosive effect that such packages have on the stability of the financial system. In an effort to convert his rhetoric into reality, he announced that the Productivity Commission would hold an inquiry. Unfortunately, the draft report of that inquiry entirely neglected to consider the community's concern with the equity of, and responsibility for, excessive executive remuneration, focusing instead on the need to ensure that shareholders receive value for money from the managers of the companies they own. While there is no doubt that the government has some role to play in ensuring that private companies are well-managed, there is also no doubt that it has a major role in ensuring that Australian society is equitable and inclusive. Unfortunately, the Productivity Commission has not taken this view.

However, if the government were to express a greater degree of concern with equity and inclusion than the Productivity Commission, there are a number of equitable and efficient ways in which executive remuneration can both be curtailed and taxed more equitably at the same time. It is particularly important to address the existing distortions in the taxation system that provide a strong incentive for companies to structure executive remuneration around large share bonuses rather than cash payments, despite the stated concern of both the Prime Minister and the Productivity Commission. These tax-induced, share-bonus remuneration packages in turn provide executives with strong financial incentives to maximise the short-run share price rather than the long-run profitability of their enterprises.

The excesses of executive pay can be reined in through targeted policy reforms:

- 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.

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