The Change in Corporate Behaviour

Andrew Smithers

Key points

- Corporate behaviour in the UK and US has changed so that the cash surplus of the business sector has become a structural rather than a cyclical phenomenon.
- This has arisen because managements are remunerated increasingly by stock options and bonuses altering perceptions of business risk and pushing profit margins up and investment down.
- A corporate surplus means that reducing the government's fiscal deficit will plunge the economy back into recession.
- The simplest rebalancing solution is to reduce the foreign sector surplus. Tackling the corporate surplus requires a fundamental change in the way managements are remunerated.

New problems require new solutions. Economic policy today in Japan, the United Kingdom and the United States is failing to produce a recovery. This is not, as is often claimed, because old solutions are being only half-heartedly employed, but because the existence of the new key problem is being ignored. The *ex-ante* savings surplus in the business sector has become structural. The implicit, though seldom stated, assumption of most Keynesians is that such surpluses are cyclical and will disappear as the animal spirits of entrepreneurs return.

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A typical example of this assumption is found in a recent article by Jonathan Portes and John Van Reenen,[1] which claims that 'the textbook prescription – followed successfully by the 1992–1997 government – [is] that the deficit cutting should follow, not precede, sustained recovery'. But the assumption that sustained recovery will duly arrive in reasonable time depends on the current savings surplus of the corporate sector being a cyclical problem. However, as the evidence clearly shows, corporate behaviour in the UK and US has changed so that the cash surplus of the business sector has become a structural phenomenon. Attempts to offset the surplus in the business sector by fiscal means alone would therefore require large semi-permanent deficits and thus provide no prospect of national debt ratios being brought under control within a reasonable time. If and when we subsequently recovered, a rise in inflationary expectations would, under these conditions, be highly likely and a more severe recession than we have today would then be needed to bring such expectations down again.

In the UK and US the cash surplus of the business sector has become a structural and not a cyclical phenomenon.

While fiscal policy is appropriate to prevent a cyclical rise in private *ex-ante* net savings from causing a slump, the change in corporate behaviour has rendered it inadequate for generating recovery. Keynes's famous quip, that in the long run we are all dead, was a way of sidestepping this important issue. Budget deficits prevent *ex-ante* savings surpluses from causing recessions, and no other solution is needed provided that the surpluses are cyclical. But if, as seems the case today, the surpluses are structural, then we are now living in the long term and other policies are vital if we are to achieve a sustainable recovery.

The historical pattern has been for the business sector to run a cash deficit. In the US this has averaged 1% of GDP since 1960, but the sector is currently running a cash surplus of over 3% of GDP. The UK shows a similar pattern, with an average deficit of 1.6% since 1987 and a current surplus of 5% of GDP.[2]

Unless one sector's changes accidentally offset another's, swings in the *ex-ante* savings of any part of the private sector will need to be offset by swings in the fiscal deficit. The business sector's net savings appear to be the most

[1] 'UK should have waited to enforce austerity', *Financial Times*, 2 August 2012.
[2] US data have been available since 1960 but UK data only since 1987.

volatile and the *ex-post* swings in this sector have been strongly correlated with government deficits in both the UK and US, as shown in Table 1.

Changes in the *ex-ante* savings balances of the business sector seem therefore to have been the major cause of the changes required in budget policy (Figures 1 and 2).

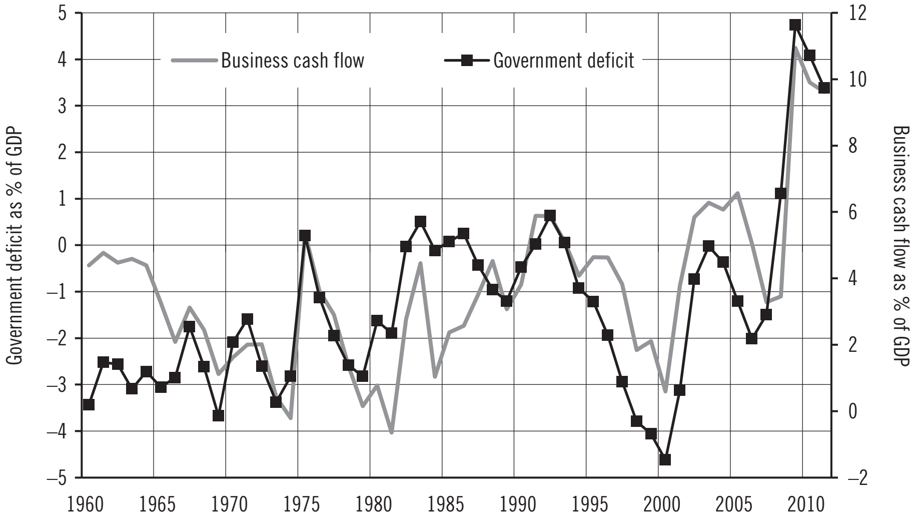
A simple equilibrium model shows that the business sector naturally runs a cash deficit. If the business share of GDP, its leverage and capital/output ratio are stable, then the net additions to the capital stock will be less than the net additions to corporate equity, and the difference will be financed by a steady growth in net business debt.

Table 1: Correlation coefficients between government deficits and cash flows of other sectors, as % of GDP

	UK	US
Business	0.77	0.83
Households	0.43	0.26
Foreigners	0.30	0.30

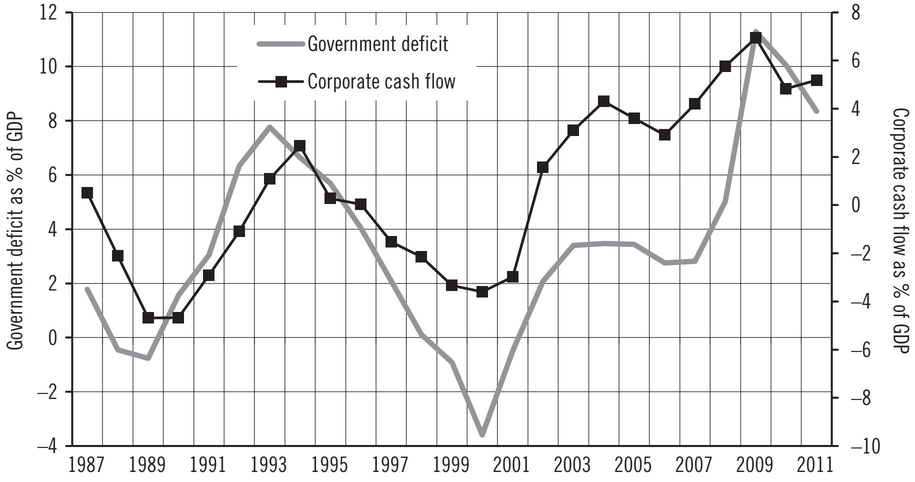
Data sources: NIPA; ONS

Figure 1: US – government deficit and business cash flow



Data source: NIPA tables 1.1.5 and 5.1

Figure 2: UK – government deficit and corporate cash flow



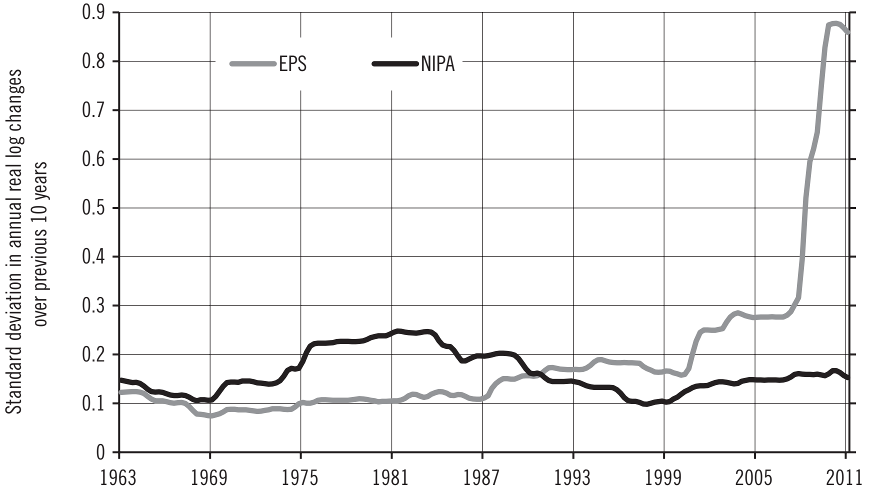
Data source: ONS

Corporate behaviour has changed in both the UK and the US in recent years. The change has taken three forms. First, the published profits of companies in the US (I don't have data for the UK) have become dramatically more volatile than those in the national accounts (Figure 3). Second, corporate investment has weakened in the US (Figure 4) and, third, profits margins have become wider (Figure 5). All these changes fit with the alteration in corporate behaviour that should be expected following the change in the way management is remunerated.

Corporate behaviour does not appear to have changed in other G5 countries. While I can find no suitable data for Germany, profit margins for non-financial companies in both France and Japan have shown declining trends. Attempts to explain the rising trends in the UK and the US need therefore to be specific to those countries. This fits with the change in corporate incentives and behaviour, which appears to be a purely Anglophone issue. It also means that changes in technology or the impact of globalisation, which apply to all G5 countries, cannot account for the rise in UK and US profit margins.

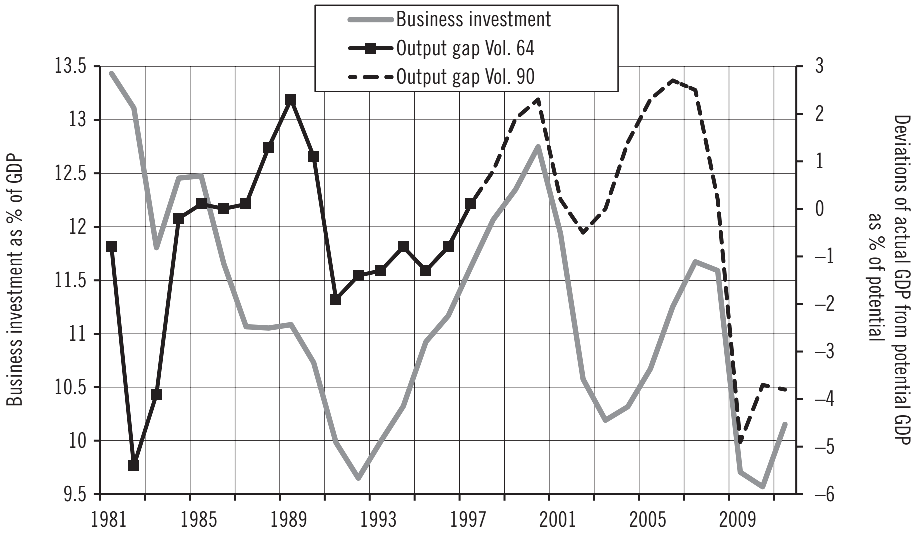
Since the future is unknowable, management decisions involve risk, with different types of decision involving different types of risk. Decisions to invest in new capital equipment reduce the risks that a

Figure 3: US – volatility of NIPA profits after tax with EPS of the S&P500



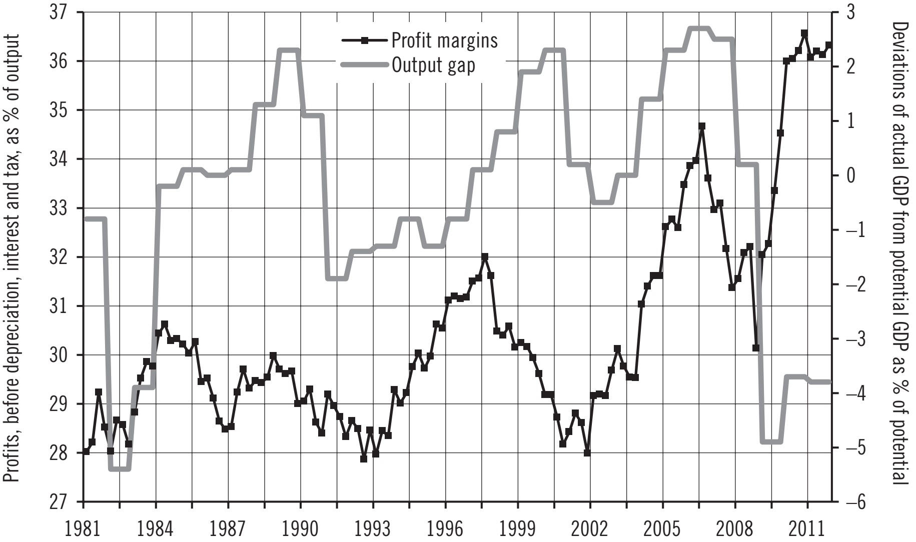
Data sources: NIPA table 1.14 and Robert Shiller's website

Figure 4: US – business investment and the output gap



Data sources: NIPA table 1.1.5 and OECD Economic Outlook Vols. 64 and 90

Figure 5: US – output gap and profit margins



Data sources: OECD and NIPA table 1.14

company will lose market share, either because it will otherwise be unable to meet rising demand or because its labour costs per unit of output will rise relative to those of its competitors. However, neither the benefits of capital spending nor the risks of under-investment show up quickly. Pricing decisions have diametrically different risks. Holding up profit margins in weak markets or pushing them up in any conditions increases the long-term risks of losing market share, but protects short-term profits and thus has low short-term risks for managements' remuneration.

There has been a huge change in the way US and UK managements are remunerated.

A change in the incentives given to managements will change their willingness to take risks, and the balance between the long-term and short-term risks. In recent years there has been a huge change in the way US and UK managements are remunerated. Basic salaries have ceased to constitute the major part of executives' incomes, and stock options and bonuses have come to dominate. According to Frydman and Jenter (2010), basic salaries in 2008 were only 16% of total executive pay. The non-salary part of the total pay is highly volatile and depends on short-term changes, particularly in share prices, earnings per share and sometimes returns on corporate equity. As the measures are short-term ones and the jobs of senior executives change frequently, the change in remuneration has altered their perception of their business risks, and increased the difference between the risks for shareholders and the risks for management. The long-term risks inherent in high profit margins and low capital investment have become much less important, and the costs to management of short-term falls in profit margins have become much greater. As the target levels for share prices and earnings per share are habitually ‘rebased’ in the event of changes in management and sharp falls in profits, managements naturally favour volatility of profits and share prices.

The change in accounting practice from ‘marked to cost’ to ‘marked to market’ has greatly increased the differences between profits as published by companies and those shown in the national accounts, which basically remain ‘marked to cost’. The change has also sharply increased the ability of management to put, if only temporarily, a favourable or an unfavourable interpretation on current profits. In so far as management can influence the level of published profits, relative to their economic level, the change in the way management is paid is likely to result in their increased volatility. Profit margins and investment have historically fluctuated with cyclical changes in the economy; the change in management incentives will naturally tend to push up profit margins and push down investment, relative to the impact that would previously have occurred from the cyclical position of the economy.

The expected pattern is that observed. Figure 3 shows that the volatility of earnings per share, as published by US listed companies in the S&P 500 Index, used to be very similar to the volatility of profits after tax of US companies as shown in the national accounts, but have in recent years become more than four times more volatile.

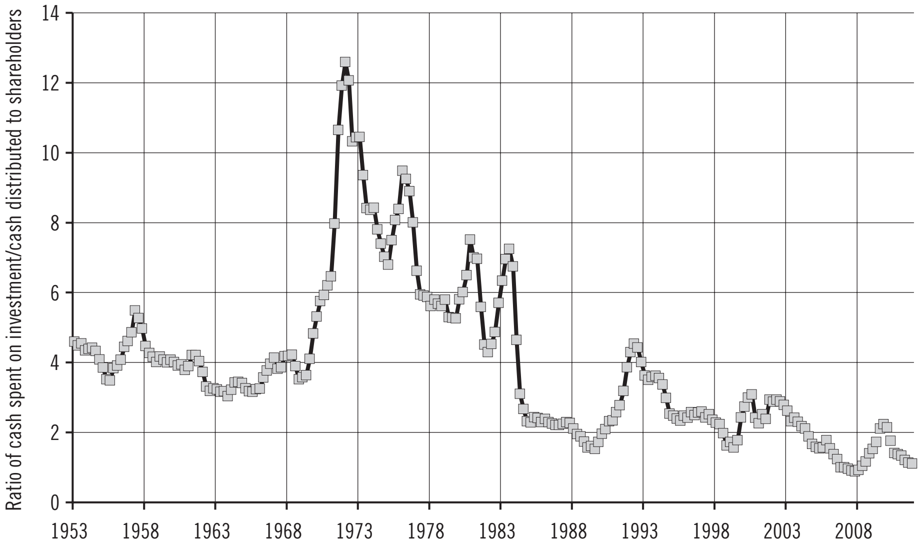
The impact of the change in management remuneration on investment and pricing is also as expected. Figure 4 shows that business investment has not only fluctuated with the cyclical state of the economy, as estimated by the OECD, but has been on a strongly declining trend, and Figure 5 shows that profit margins have both moved with the cycle and have had a rising trend.

Another way of looking at this is to compare the allocation of cash generated from operations between money spent with longer-term or shorter-term considerations in mind. Capital investment by corporations reduces longer-term risks and thus shows the emphasis given by management to the longer term, while cash paid out to shareholders in the form of either dividends or buy-backs shows the emphasis placed by management on the shorter term. Figure 6 shows the ratio of money spent on reducing longer-term risks compared with that spent on reducing short-term ones. The falling ratio thus shows how the shorter-term considerations have increasingly dominated management decisions.

Figures 7 and 8 show that there have been similar changes in the UK: as business investment has fallen, profit margins have risen, relative to the level of the output gap; though the cyclical pattern with regard to investment is less clear for the UK than it is in the case of the US.

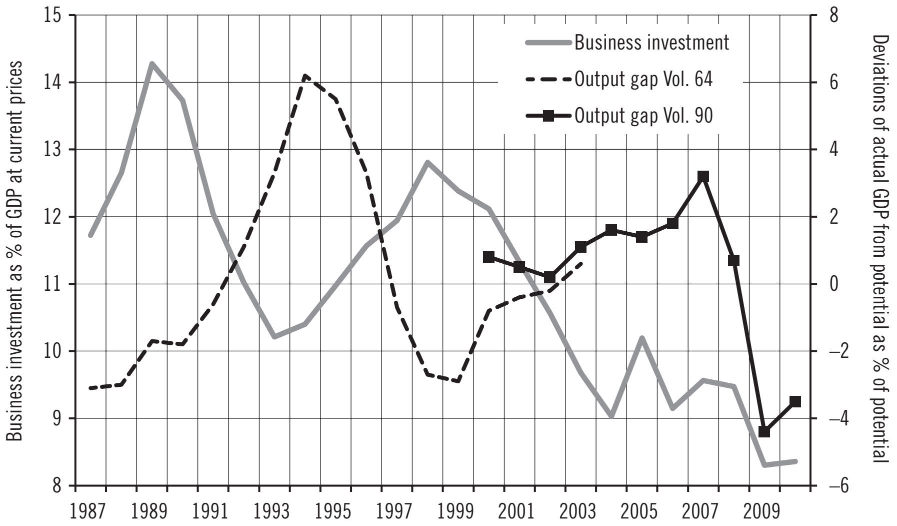
I am not alone in seeing the change in the way that managements are now being rewarded as damaging the economy. In December 2011 the Federal Reserve Bank of New York published a paper by John Donaldson,

Figure 6: US non-financial companies – management horizon, long-term vs short



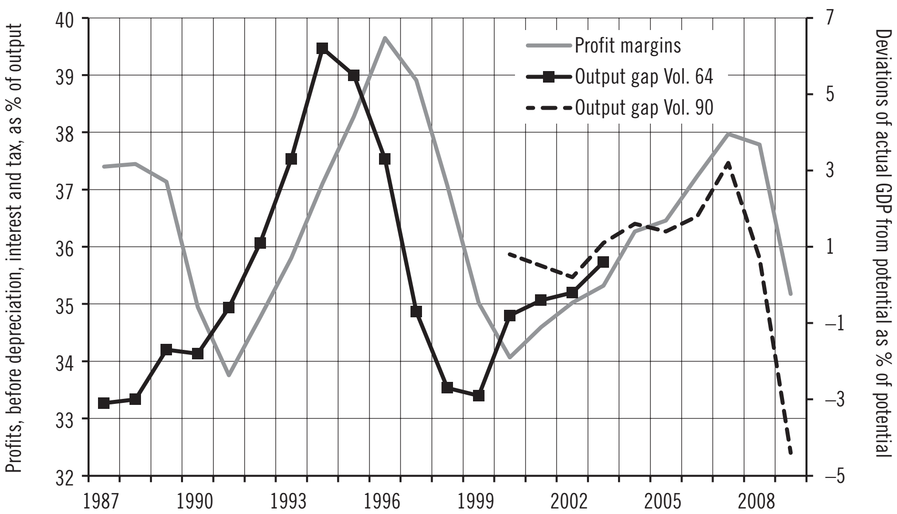
Data source: Z1 table F.102

Figure 7: UK – business investment and the output gap



Data sources: ONS and OECD Economic Outlook Vols. 64 and 90

Figure 8: UK – profit margins and the output gap



Data sources: ONS Blue Book 2011 tables 3.3.2 and 4.1.2; OECD Economic Outlook Vols. 64 and 90

Natalia Gershun and Marc Giannoni, which set out a theoretical model of the way the change in management remuneration was likely to cause serious damage to the economy.[3]

The policy of waiting for sustained recovery before cutting back on the fiscal deficit may have been successful in the 1990s, but will not be today when the behaviour of companies has changed with the change in managements' incentives. New policies are required. In order to bring down the fiscal deficit without pushing the UK economy into deep recession, the new policies must address the fiscal deficit's twin causes, rather than simply assuming that the problems will disappear of their own accord. The two sectors whose savings surpluses need to be offset by large fiscal deficits are those in the corporate and foreign sectors.

The policy of waiting for sustained recovery before cutting back on the fiscal deficit will not be successful as in the 1990s.

The surplus in the foreign sector is the easier of the two problems to tackle and simply involves intervention in the foreign exchange market to depress sterling – at least to a lower level than it would have been in the absence of intervention. The resulting additions to the foreign exchange reserves will be matched by a lower savings surplus of the foreign sector compared with that which would otherwise have been the case. Over the past decade the foreign exchange reserves of China have risen by US$3 trillion, and those of Brazil, India and Russia combined by a further US$1 trillion. It cannot make sense for the UK, which has a larger fiscal deficit problem than the 'BRICS', to eschew similar action. Currency intervention cannot be an acceptable policy for those without large fiscal deficits and unacceptable for those with them.

If the world has an *ex-ante* private-sector savings surplus and needs a larger fiscal deficit to offset it, then the additional load cannot sensibly fall on those who have already borne the policy burden. Furthermore, those who should ease their fiscal policies will be less eager to do so if they are the only countries that are apparently permitted the relatively

[3] John B. Donaldson, Natalia Gershun and Marc Giannoni, *Some Unpleasant General Equilibrium Implications for Executive Incentive Compensation Contracts*, published in December 2011 by the Federal Reserve Bank of New York as Staff Report No. 531.

easy option of offsetting any weakness in domestic demand by currency intervention.

In the 1930s, sterling was devalued, with the result that the UK performed much better than France, which maintained its exchange rate. It is said that when the former Labour Chancellor, Philip Snowden, saw the success of this policy he remarked that 'Nobody told us that we could do that.' Economists should be telling the present UK government that they can almost certainly stimulate demand by increasing our foreign exchange reserves and, if they wish to be re-elected, they must start doing so soon.

Happily, intervention in the foreign exchange market is likely to cause the real exchange rate to be lower than it otherwise would have been, and thus should not only stimulate a reduction in the current account deficit but also an increase in business investment. Foreign trade is 70% goods and 30% services, whereas output for domestic demand is not more than 20% goods. A fall in the trade deficit is thus likely to increase the importance of goods in total output and, as the produced capital/output ratio of goods production is much higher than that for services, a fall in the external trade deficit should be accompanied by a rise in business investment and thus a fall in the sector's net savings.

A more fundamental approach to reducing the corporate sector's structural savings surplus is more difficult. A major improvement requires a major change in the way management is remunerated. In my view this will require the development of a new 'best practice' contract under which pay should be aligned with the national interest and not against it, as it is with current bonus practices. For example, this could be achieved by making increases in output and investment, in addition to improvements in earnings per share or the return on equity, a necessary condition for the payment of bonuses. This is a complicated and difficult issue, and is unlikely to be implemented unless the present problem of perverse incentives is understood. It is clear that this is not yet the case and the first requirement is that we should have a public debate on the subject. I hope this paper will help stimulate discussion of this key problem.

References

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