Getting the economy going

Invest in management incentives and secular stagnation

The last financial crisis, like those which followed the 1929 crash in the US and 1989 crash in Japan, was caused by excess debt, with the trigger provided by falling real asset prices such as shares and property. Exploring key practical issues to prevent a repetition of the crisis including how to reduce debt for governments, households and business, and the ways to rebalance economies, both internally and with regard to their external balances.

A key problem that I identify in my new book arises from the revolution that has occurred in both the amount and the way corporate managements are paid in the UK and the US.

The big change is a fairly recent one having occurred over the past 15 to 20 years. Not only has management pay shot up but, from being mainly based on basic salary, the bulk now consists of bonuses and similar extras which depend on increases in earnings per share, return on equity or share prices.

Between 1992 and 2008 US CEO bonuses and similar extras rose from $1.3 million to $5.0 million, measured at constant prices and increased from 57 per cent of basic salary to 83 per cent.

This huge change in incentives has naturally enough produced a major change in management behaviour. It has had a profound effect on the economies of the UK and the US, but one that has been totally ignored by the vast majority of economists.

To understand how the change in incentives has affected behaviour, it is important to consider the risks that companies run and the very different risks that are run by senior management.

Among the various risks run by companies, a serious loss of market share is probably the most damaging over the longer term.

As market share falls, a company has to spread its overheads over a level of sales which is shrinking relative to that of its competitors, and it has increased difficulty in matching their expenditure on advertising, research, marketing and sales.

Market share can be lost through uncompetitive pricing, insufficient improvement in the quality of the product and a failure to keep costs falling as fast as those of its competitors. The routes to improving market share are therefore to keep pricing competitive and to invest in new plant and equipment.

Reducing the longer term risks thus comes at short-term cost in terms of having lower profits than would be likely with a more aggressive pricing policy and in terms of earnings per share, or return on equity, by spending money on new equipment rather than buy-backs.

The change in management remuneration has not changed these longer term risks but it has changed the willingness of management to take them. This is because the key risks to those running businesses which they do not own is that they will fail to receive vast rewards during the relatively short period of time during which they are likely to be in command.

Management has therefore been given a massively increased incentive to take long-term risks for the companies they manage in order to achieve sharp rises in their companies' earnings per share and return on equity.

They will therefore take increased risks by pushing up profit margins to higher levels than they would previously have thought safe and by preferring to spend cash on share buy-backs rather than on new plant and equipment.

They will also benefit if published profits become highly volatile. As bonuses and the value of options depend on the increase in earnings per share, the lower the starting point, the easier it will be to generate a rise.

New management want profits to be heavily depressed before the terms of their bonuses and options are agreed, and those managers who survive a downturn in profits will be able to argue, with great conviction, that their targets must be lowered, for who can be suitably incentivised by unachievable targets?

The change in management remuneration is thus likely to result in lower levels of investment, wider profit margins and more volatile profits than would have been found under previous arrangements.

We should expect this change to be found in publicly quoted companies rather than more widely and this is exactly what we do find. The evidence shows that quoted companies invest only half as much as unquoted ones, despite being of equal importance in the economy.

Profit margins in the US are at record high levels. This cannot be explained away as the result of a rip-roaring economy, as the economy is generally assumed to be operating well below its potential.

So far this century the gross profits of non-financial companies have risen as a proportion of their output by nearly 10 percentage points, while the amount of unused capacity of labour and capital has increased by six percentage points of GDP, as calculated by the OECD in their measure of the output gap. Investment has also responded as expected to the change in management remuneration.

A marked feature of the 21st Century has been the decline in investment. Business investment has fallen by 2.5 percentage points of GDP, despite the rise in profit margins to record high levels.

The profits that quoted companies publish have also become much more volatile, although there has been little change in the volatility of profits shown in the national accounts.

From 1952 to 2000 the volatility of profits after tax shown in the national accounts and the volatility of the earnings per share data on the S&P 500 were virtually the same.

However, since 2000 the earnings per share published by the companies included in the S&P 500 index has been four and a half times more volatile than those in the national accounts.

As investment is depressed and profit margins boosted, companies run large cash surpluses and these have to be offset by large fiscal deficits to avoid the UK and the US falling back into recession. (Cash surpluses in business are highly correlated with fiscal deficits).

Companies are paying out record amounts of their cash flow to shareholders, either through dividends or share buy-backs and are investing at record low levels. These buy-backs are running at around three per cent of GDP in both the UK and the US and pushing up debt levels. Academic work has shown that this behaviour is what we should expect in the light of the change in management incentives.

One result of the failure of economists to understand the way the economy has changed is that economic forecasts have been habitually wrong in ways that would not have occurred had they allowed for the change in management behaviour.

Not only has business investment been persistently lower than the Federal Reserve and the Bank of England expected, but productivity has been worse. Business can expand output by using more labour or more capital.

When the cost of capital is pushed down by low interest rates and high equity prices, this would normally boost expenditure on new equipment. But the more money that is used for investment, the less is available for buy-backs, so although the cost of capital to companies has fallen, the perceived cost of capital to management has risen.

The result is that companies on both sides of the Atlantic prefer to employ more labour rather than more capital when they find that demand for their products has grown. (In terms of economic theory, the high perceived cost of capital changes the coefficient of substitution in favour of employing labour rather than capital.)

Labour productivity, measured by GDP per hour worked, rose from Q1 1992 to Q1 2010 at 2.3 per cent p.a. in the UK and at 1.7 per cent p.a. in the US. Since then it has fallen slightly in the UK and risen by only 0.56 per cent p.a. in the US.

Recently there has been much written about 'secular stagnation', by Lawrence Summers among others, but these articles are marked by a complete failure to recognise the key cause of this stagnation. The result is that he and others like him simply advocate the same policies that have failed so far.

The change in management behaviour means that the economy does not respond as it used to do to the boost given by high fiscal deficits and low interest rates. If we are to get the economy moving again, economists must remove their heads from the sand and recognise that things have changed and policy must change with it.

The key to preventing secular stagnation and producing a sustainable recovery without an ever increasing level of national debt is the realisation that the change in management remuneration lies at the heart of our troubles.

There are many ways in which this could be changed, but the first essential is for the issue to be publicly debated and thereby understood.

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By Andrew Smithers