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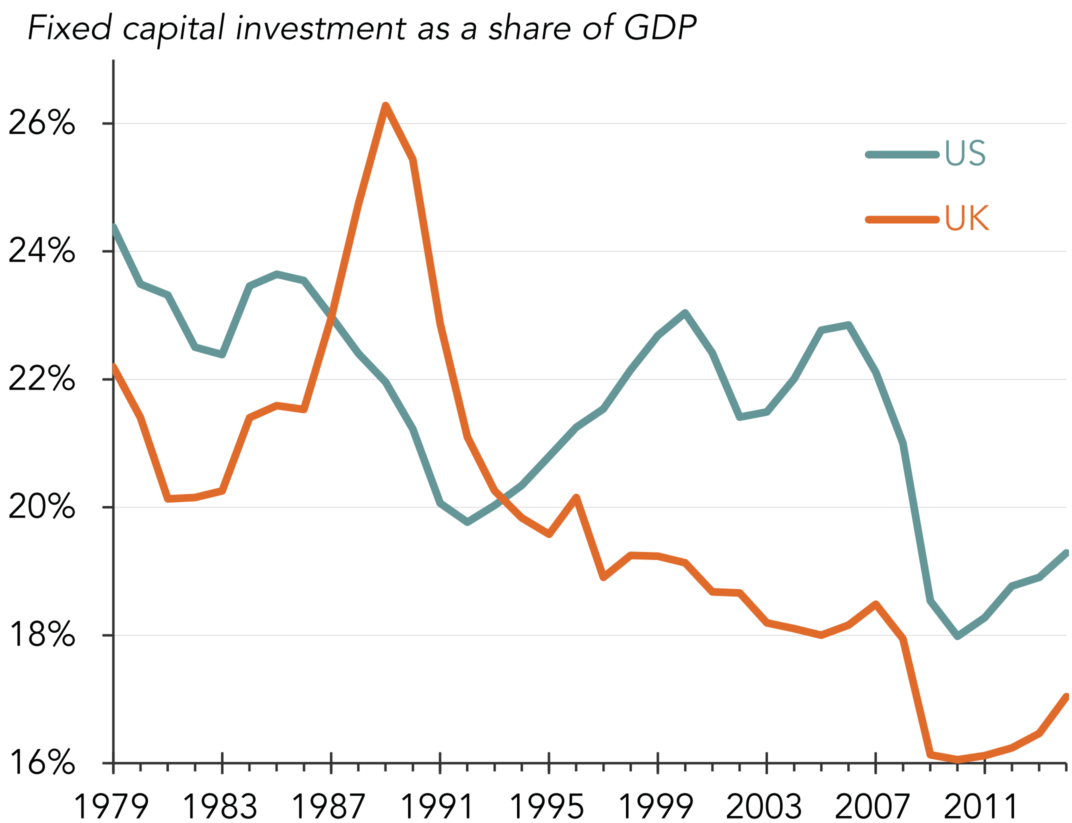
# Racing away? Correcting the damage done to wage growth by perverse management incentives

Developed economies have slowed since the financial crisis. Yet over the last two years, there have been sharp falls in unemployment in the UK and the US. Had unemployment not fallen in this way, we could blame weak growth on inadequate demand. As it is, we need to accept that the trend growth of developed economies has declined, due to two adverse changes: workforces are growing more slowly and improvements in labour productivity have stalled.

The fact that these changes occurred around the same time as the financial crisis has led many to assume, quite wrongly, that our current malaise is simply part of the aftermath.

Instead, the stagnation in real wages is largely the result of large declines in investment shown in Figure 1 that pre-date the crisis and which have damaged labour productivity. Turning around this malaise requires higher investment to get wage growth back on the agenda. To achieve this, far-reaching reform of management incentives is essential.

**Figure 1: Short sighted: the decline in investment in the UK and US, 1979-2014**




*Source: ONS; US National Income and Product Accounts, Bureau of Economic Analysis*

In contrast to the years before the financial crisis, total populations in advanced economies are now growing more rapidly than the number of working-age people. As a result, living standards are set to grow more slowly than productivity. Reversing this tendency for the dependency ratio to rise can be achieved either by lower unemployment or through more people being willing to join the labour force. Relatively little if any progress can, however, be expected on either of these fronts.

This makes the need to improve productivity all the more pressing.

A major cause of the decline in investment in recent years that has fed through more recently to falling productivity has been the change in the way senior executives are paid. The massive jump in their remuneration is largely due to the rise in incentive payments that are linked to short-term changes in profits and share prices. As such, management now has a much greater incentive than before to run companies in ways that will enhance these measures in the short term, even though the price is lower long-term investment.

Crucially, underinvestment enables companies to gain market share in the short term, as their consequent lower costs allow them to reduce their prices while maintaining the same margins and thus undercut their competitors.

Because companies usually have long life spans, we might expect them to take a more considered approach. However, chief executives can rationally expect only to be in office for a few years. The change in incentives has therefore shifted the balance of decisions away from the longer-term interests of companies to the shorter-term interests of management. The result has been a sharp decline in investment, an increased drive for higher margins and a preference for adding labour rather than capital equipment in response to rising demand. These preferences naturally results in weak labour productivity.

*To shift from an economy characterised by low investment and stagnant productivity, we must alter the incentives that have produced it*

Since 1990, investment in the UK has fallen from 26 per cent to 17 per cent of GDP (Figure 1); productivity has also stopped rising since the crisis. Indeed, measured over the previous three years, it has been persistently negative since 2010 and even over the past five years has risen by only 0.2 per cent per annum. To shift from an economy characterised by low investment and stagnant productivity, we must alter the incentives that have produced it.

## Boosting investment by changing incentives

The first step is to recognise this underlying problem and accept that bold action is needed. The challenge is to alter incentives from those that damage the economy to those that help it, with persuasion likely to prove a better means of achieving this than proscription. Linking bonuses to increases in productivity fits this mould, with tax incentives offering an effective route in.

Shareholders want some benefit in return for bonuses. Improved incentives will therefore involve adding to profit criteria rather than replacing them. The added requirement should be that productivity must be enhanced by, say, one per cent per annum to allow bonuses to be paid. Persuasion could take the form that bonuses, without the productivity requirement, would not be an allowable expense for corporation tax and would be subject to, say, an exceptional 80 per cent tax in the hands of the recipient.

Companies would therefore need to publish their output and the hours worked by their employees. Because output is simply the sum of employment costs and profits, measured before depreciation, interest and tax, these data are already known to companies and the need to publish them would involve almost no added expense.

## The scope for raising labour's share of GDP

A change in these incentive structures should also raise typical wages. This can be achieved in three ways: by leaving the current distribution of earnings unchanged while improving productivity; by increasing the labour share of output; or by reducing the disparity between senior management and other employees' remuneration.

In the US, corporate output is currently split 61 per cent to wages and 39 per cent to profits, compared to the post-war averages of 68 per cent and 32 per cent. (Output equals profit, broadly defined, plus employment costs, so that wages plus profits are equal to 100 per cent of output.) If current management incentives were moderated, we might reasonably expect some rise in US wages coming from an increase in the labour share of output. For example, a return to the post-war average level would itself allow a 12 per cent rise in real wages, without any change in output.

The same may be true in the UK, but profit margin data is not nearly as good here so we have no way of knowing for sure. One reason for pessimism in the UK is the relationship between real wages and the exchange rate. A decline in the real exchange rate produces a fall in real wages and it is through the resulting fall in production costs that devaluations improve a country's competitive position. The UK currently runs large current account and fiscal deficits and it is improbable that the latter can fall significantly unless the former moves with it. The fiscal deficit might be significantly reduced by a compensating adjustment in the private sector from being a small lender to a large net borrower but this appears unlikely. Household balance sheets are still very highly leveraged today and household savings are low.

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The fiscal deficit might instead be helped by a rise in business investment but this too appears unlikely without the sort of reforms proposed here. Instead, moving towards fiscal balance is likely to require an improvement in the trade deficit.

Achieving this points to the need for a lower real value for sterling. It thus seems unlikely that we can hope for much improvement in the labour share of output in the UK. But we can reasonably expect that better management incentives will mitigate the decline in real wages that would otherwise accompany a fall in sterling.

### The fallout from reforming management incentives

My suggestions for the reform of management incentives can perhaps be improved upon. Others may have better solutions and I will welcome them but the inevitable resistance such ideas will provoke should not scare us off the change which is required. Linking bonuses to productivity will naturally have its critics.

One potential objection is that it will restrict business unnecessarily. My aim is to end, by tax persuasion, the damage to the economy that is currently being done by business, which is decidedly necessary. This is very similar to preventing the damage done by allowing monopolies to flourish. Competition is the essence of capitalism and is of course disliked by businessmen, who seek to avoid it whenever they can. We are right to preserve competition, which handcuffs businessmen by thwarting their ability to rent gouge, and we would be equally correct to avoid the damage done by perverse incentives.

*Changing incentives should help reverse the rise in top management remuneration relative to other employees*

Others may argue that my proposals would cause us to lose talent abroad. That is an outcome with which I am entirely comfortable. If talented businessmen leave our shores because they are less able to damage the economy, we should congratulate ourselves and sympathise with their new homes where they will be employing these destructive talents.

Improving productivity is the overwhelming requirement for stronger wage growth. The key is to change the incentives which currently encourage low investment and low productivity. This should also contribute to mitigating the downward push on real wages that will accompany a competitive sterling exchange rate. Changing incentives should help reverse the rise in top management remuneration relative to other employees, which appears to have brought no benefit to shareholders. Together, these outcomes should help to move the UK economy onto a prosperous and stable path, both economically and politically.