Corporate Governance Reform.

The Green Paper serves a useful purpose. It shows that the Government is aware of the dramatic change that has taken place in the amount and way that senior management are paid with the arrival of the bonus culture. It also shows that the Government is unaware how this is causing great damage to the economy. The bonus culture has caused a large fall in corporate investment which has led to extremely poor productivity.

The introduction by the Prime Minister states that "We want …companies to take better decisions for their long-term benefit and that of the economy." The Green Paper fails, however, to discuss how corporate governance affects the long-term performance either of the economy or of companies.

No serious discussion of these issues is possible until three basic points are understood:

(i) The interests of shareholders and those of the economy differ.
(ii) Companies are legal abstractions; they are not people with a single group of identifiable interests. Corporate decisions are made by managements whose interests and those of shareholders diverge. Shareholders as a group also have no identifiable interest, as the interest of different groups of shareholders diverge.
(iii) Shareholder returns are independent from the growth of the economy. They do not rise if the growth of the economy improves.

A major cause of confusion in the Green Paper arises from coyness. It is unwilling to admit that the driving force behind its production is neither the interests of shareholders nor those of the economy; it is the widespread distaste felt for the dramatic rise to the current high level of pay received by senior executives.

The Economy.

Management pay has undergone a major change in terms of both the amounts paid and the proportion that is derived from incentive payments. Incentives are designed to change behaviour, and we should not therefore be surprised by the marked change in management behaviour that has accompanied the change in the way management is paid. A key change, which has dramatically damaged the economy both in the UK and the US, has been reduction in the level of business investment.

Companies last for much longer than the terms of office that CEOs expect or usually experience. The risks run by companies have therefore a much longer time horizon than those of their leaders. Possibly the greatest single risk for companies is losing market share. This risk is reduced by high levels of investment in new equipment, which reduces the risk that other companies will, by investing more, have lower production costs. While remuneration packages vary in the detail, they all have similar effects. Very large changes in total pay result from relatively small changes in the chosen metric, all of which are related, directly or indirectly, to short-term changes in dividends and profits per share.

Money cannot be spent twice; that spent on new equipment cannot be spent on dividends or buy-backs. The former tends to be negative for bonus payments and the last two favourable. The arrival of the bonus culture has therefore shifted the decisions of management away from investment. The fall in investment has caused a dangerous decline in the rate at which productivity improves.

Shareholders.

There is a difference between the interests of the retired, who wish to spend some of their accumulated capital as well as all the money they receive from their shareholdings, and those who own shares, often indirectly, for their retirement. The former are sellers and benefit from high share prices, the latter reinvest dividends and additional savings and benefit from low share prices. This conflict has long been recognised by many economists, who have written about the problem of inter-generational inequity, which is when sustained periods of high or low prices benefit one generation at the expense of another. It is, however, almost invariably ignored in public discussion in which "the interests of shareholders" are habitually discussed as if shareholders are a homogeneous group with the same interests.

It is sometimes claimed that both groups will benefit from a rapidly growing economy on the assumption that returns on corporate equity rise with growth. They don't. We have data since 1899 for both the growth rates and the stock market returns from 17 countries and there seems to be no relationship between the two for individual countries. For example, the UK has been the slowest growing economy among the 17, but has shown an above average return to shareholders, whereas Japan, which has been the second most rapidly growing economy, has had a well below average return. This is not only what we observe, it is what we should expect. If fast growth were expected to produce higher returns to shareholders, then investors would shower capital into those economies which were expected to grow rapidly. High levels of investment should boost growth, but the efficiency of investment is also likely to fall as the amount increases, so that the greater the level the lower the return on each unit of investment is likely to be. If investors are correct in their expectations about growth, then the level of investment in rapidly growing economies is likely to be boosted to the point at which investor returns are the same whatever the growth rate of the economy. Fast growth is a boon for workers, whose real wages rise faster in rapidly growing economies, but not for investors for whom the returns on equity investment appear to be stable over the long-term and are independent of the growth rates of individual countries or the world as a whole.

Shareholders and High Pay.

Large pay packets to senior executives are not made at the expense of shareholders. The incentives that drive management to reduce investment also drive them to push up profit margins. Most companies, with the marked exception of producers of oil and other raw materials, have considerable short-term monopoly power as their customers cannot usually switch to another supplier without considerable difficulty. Companies are deterred from exploiting this to their maximum short-term advantage because the more they do so, the greater will be the risk that their customers seek out alternative sources of supply. The longer term interests of the company in preserving its market share are thus at odds with the wish to maximise short-term profits. Modern management incentive plans increase the reward for taking the short-term benefit from aggressive pricing at the cost of increasing the long-term risk that customers will seek out alternative suppliers. We should therefore expect the change in management remuneration to push up profit margins and it has. In the US where long-term data on margins are available, they are exceptionally high. High profit margins benefit rather than hurt shareholders.

The bonus culture damages the economy rather than shareholders. The damage is thus similar to that done by an increase in monopoly power. Preventing the harm done by either the bonus culture or a reduction in competition is thus a concern for the government regulation and is not amenable to changes in corporate governance.

Fairness.

The huge rise in senior management remuneration has caused popular discontent with the bonus culture, as it is seen to be unfair. The existence of the Green Paper, though not its content, shows that the government is loath to ignore this. It could be addressed either by preventing high pay or by demonstrating that it is in the interests of the economy. The former is unlikely to be practical and if attempted would produce an outcry. If the issue of fairness is to be addressed, it must be done by showing that high pay rewards the economy.

Linking High Pay to the Economy.

The challenge for the government is thus to change incentives from those that hurt the economy to those that help it. They could try to enforce such a change or seek to encourage it. The choice is between proscription or persuasion, either by passing laws which would make it illegal to have "unsatisfactory" remuneration structures, or by encouraging companies to have satisfactory ones through the incentives of publicity and tax. Persuasion is likely to be much the more effective than proscription. It has the additional advantage of being more easily adapted to the particular circumstances of individual companies and less likely, therefore, to meet reasoned opposition based on the probability that any change will have unanticipated impacts. The government needs to change bonus systems so that they encourage rather than discourage companies to improve productivity, and the tax system could readily be adapted to achieve this. For example, the competition authorities could be given the power to approve bonus systems for companies over a certain size. Competition authorities are the appropriate people to judge these schemes because the damage done to the economy through perverse incentives is similar to the damage done by inadequate levels of competition.

Bonus systems that are approved by the competition authorities should require that bonuses and other salary add-ons should only be awarded if the company improved its productivity by a given amount, such as 1% each year. Companies need not have their remuneration schemes accepted, but should be encouraged to seek approval through tax incentives. Without the authorities' stamp of approval, incentive payments should not be a deductible expense for corporation tax. It would probably be even more effective if unapproved bonuses were liable to a higher than usual rate of income tax.

Achieving the productivity target should not be the only metric for calculating incentive payments. They should be an addition to the profit targets that are currently used. Shareholders want some benefit, or at least the appearance of it, in return for the bonuses their companies pay to management and approved incentive schemes should therefore involve adding to profit criteria rather than replacing them. This approach should, among its other benefits, ease the political difficulty of reform.

A major advantage of introducing a productivity target into company schemes is that the additional cost to companies would be minimal because they already have the information they need to calculate productivity, even though this is not usually published. The need to publish productivity data would itself be a major advantage of my proposal, as the current failure to do so is both the result and the cause of misinformation. Productivity is the output that a country or a company produces per hour worked. The rate at which productivity improves is the single most important factor in determining the future prosperity of a country. It is also a matter of vital importance to individual companies. Companies have to pay wages which are competitive with those offered by other companies and which are therefore determined nationally. For the economy as a whole, wages increase over time in line with the rate at which productivity improves and the wages paid by individual companies are thus determined by the rate at which they rise nationally. Companies cannot avoid paying higher wages if they are rising generally in the economy. Companies whose productivity lags will thus face a major problem. They will either have to raise their prices faster than they rise generally, and consequently be at risk to being undercut by competitors, or will find their profits falling.

Despite its importance, most managements and shareholders are completely in the dark about the levels and changes in productivity of the companies they run or own. Shareholders and investment banks can only analyse published data. The questions they pose are thus restricted to these data and there is a natural tendency for managements to assume that these are therefore the vital issues. The failure to publish output and productivity data has the effect of making them seem trivial. The requirement to publish should therefore have a beneficial effect on the attitude of managements and shareholders by alerting them to the importance of improving productivity.

Andrew Smithers
London
December 2016