The Report by the Institute for Public Policy Research on "Economic Justice". Comments by Andrew Smithers

Introduction.

This Report, which was published in early September 2018, received much publicity, encouraged by the fact that the Archbishop of Canterbury was shown as a co-author.

The Report makes one extremely sound and important recommendation which has been, as far as I can find, completely ignored by the press. It proposes that management bonuses should be based on improvements in productivity. In addition, however, the Report makes two recommendations, based on faulty economic assumptions, which would do damage if implemented. It proposes a large rise in the minimum wage on the grounds that this would raise productivity rather than inflation and unemployment and a large rise in corporation tax on the grounds that this was a tax on shareholders, rather than on investment.

Productivity and the Bonus Culture.

The Report correctly identifies the key problem for the UK economy as poor productivity due to weak investment "…it is investment…that is the real economic engine, driving both productivity and long-term economic growth…" It also correctly sees that the cause was a change in management behaviour "…the phenomenon known as short-termism." It therefore recommends that "…executive pay packages should be simplified and linked to ….productivity."

Had the Report or the press comment concentrated on this it would have been extremely beneficial. Sadly it proved to be another example of the press choosing to ignore the issue rather than debate it. It is also unfortunate that the Report makes other recommendations which conflict with the key one and which, if implemented, would be likely to damage rather than boost productivity.

The Minimum Wage.

The Report claims that "low wages damage productivity…when wages rise, for example, through a higher minimum wage, firms are forced to find new and more productive ways of organising and training employees in order to afford higher pay." In support of this contention the Report cites "Efficiency wage models of the labor market" by George Akerlof and Janet Yellen, who put forward the hypothesis that workers will work at less than their optimum level if they consider that their remuneration is unfair.[1] If this is correct, then labour productivity could improve without the need for any increase in capital stock if the sense of unfairness is reduced. (In models where labour quality is considered fixed, there would be an improvement in total factor productivity ("TFP") and, in models which allow for changes in labour quality, the latter would improve.) It does not, however, follow from this that a rise in the minimum wage would increase productivity.

The hypothesis is that unemployment will be higher in an economy suffering from perceived wage unfairness, and that this can be induced either by a minimum wage that is perceived to be too low or by one that is perceived to be unfairly high in that it has depressed wage differentials too much. The hypothesis is set out in the equation $e = \min(w/w^*, 1)$,[2] so that the efficiency of the workforce rises if unfairness is reduced, for example by a rise in the minimum wage, but does not improve further once the optimal level (1) is reached. On the other hand, a rise in the minimum wage beyond this point may increase the sense of unfairness due to the compression of differentials, so that the overall impact of a rise in minimum wage beyond its optimal level will reduce productivity.

In the model unemployment occurs when the market clearing wage exceeds the fair wage. The exceptionally low level of unemployment in the UK today could thus be due in part to the large rises that have occurred in recent years in the minimum wage, as these will have caused the equilibrium level of unemployment to fall (i.e. a decline in the NAIRU). But this also reduces the likelihood that any further significant rise in the minimum wage will be possible without increased unemployment.

If productivity does not rise an increase in the minimum wage is likely to be damaging. The Akerlof and Yellen model compares two equilibriums in which the only difference is in the actual wage. A rise in the minimum wage would, however, also cause either inflation to rise or profit margins to narrow. In the absence of an increase in output this would be likely to lead to some combination of lower investment, reductions in the capital stock and higher interest rates to combat a rise in the NAIRU.

[1] This is set out in Chapter 16 "The Fair Wage-Effort Hypothesis and Unemployment."

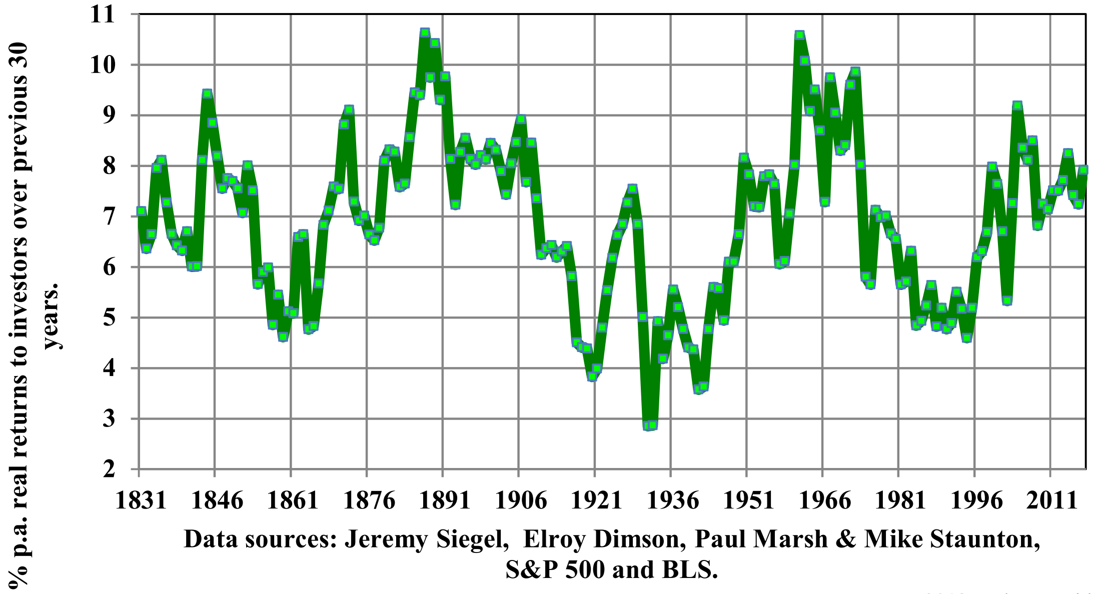
[2] Efficiency is represented by e, the actual wage by w and the fair wage by w*. Efficiency rises until the fair wage equals the actual wage but no higher and unemployment occurs when the market clearing wage exceeds the fair wage.

Corporation Tax.

The report calls for an increase in corporation tax on the grounds that "Broadly speaking, taxes on profits fall on shareholders…."

The real return on corporate equity ("RoE") to shareholders has been mean reverting around 6% since 1801 (Chart 1). For the first 115 years there was no corporation tax and, since then, it has been at a significant but widely fluctuating level. The impact of corporation tax cannot therefore fall on shareholders.

Chart 1. US: Real Equity Returns over 30 Years.



Data sources: Jeremy Siegel, Elroy Dimson, Paul Marsh & Mike Staunton, S&P 500 and BLS.

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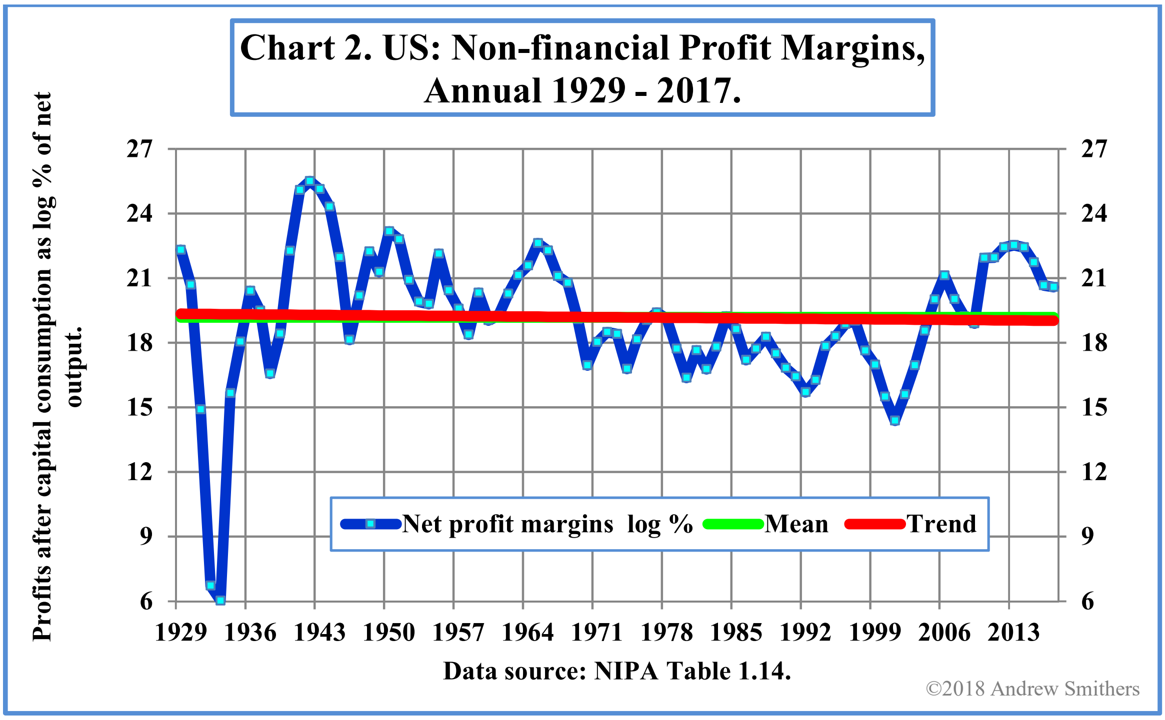
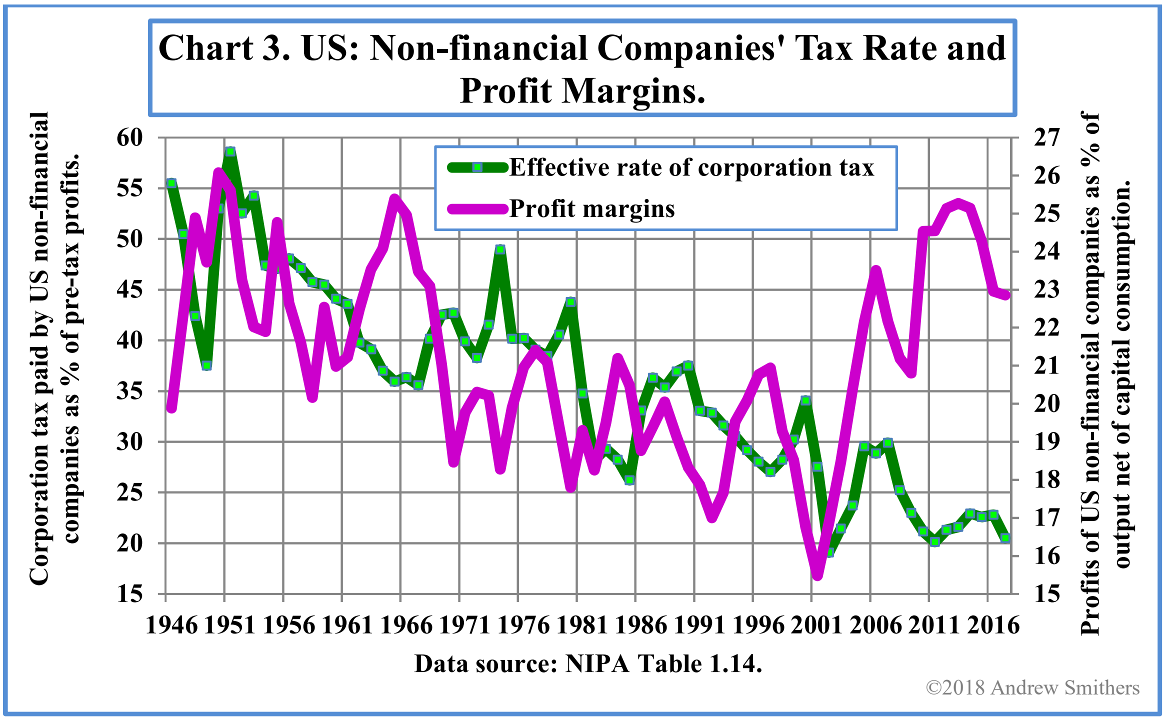
As the cost of corporation tax does not fall on shareholders it must therefore either fall on consumers or on investment. We have data on US profit margins since 1929, though unfortunately not on those for the UK, and over this period they appear to have been mean reverting (Chart 2) and their swings appear unrelated to changes in the effective rate of corporation tax (Chart 3). Corporation tax is therefore borne by neither shareholders nor consumers.





As the burden of corporation tax falls on neither consumers nor shareholders, it must fall on investment. RoE is determined by profit margins, leverage, interest rates, corporation tax and the capital/output ratio. If profit margins are stable the profitability of capital will, in the absence of changes in leverage and interest rates, fall if corporation tax rises. In order to match the required c.6% hurdle rate for RoE, investment and the value of the capital stock will fall. We should therefore expect a

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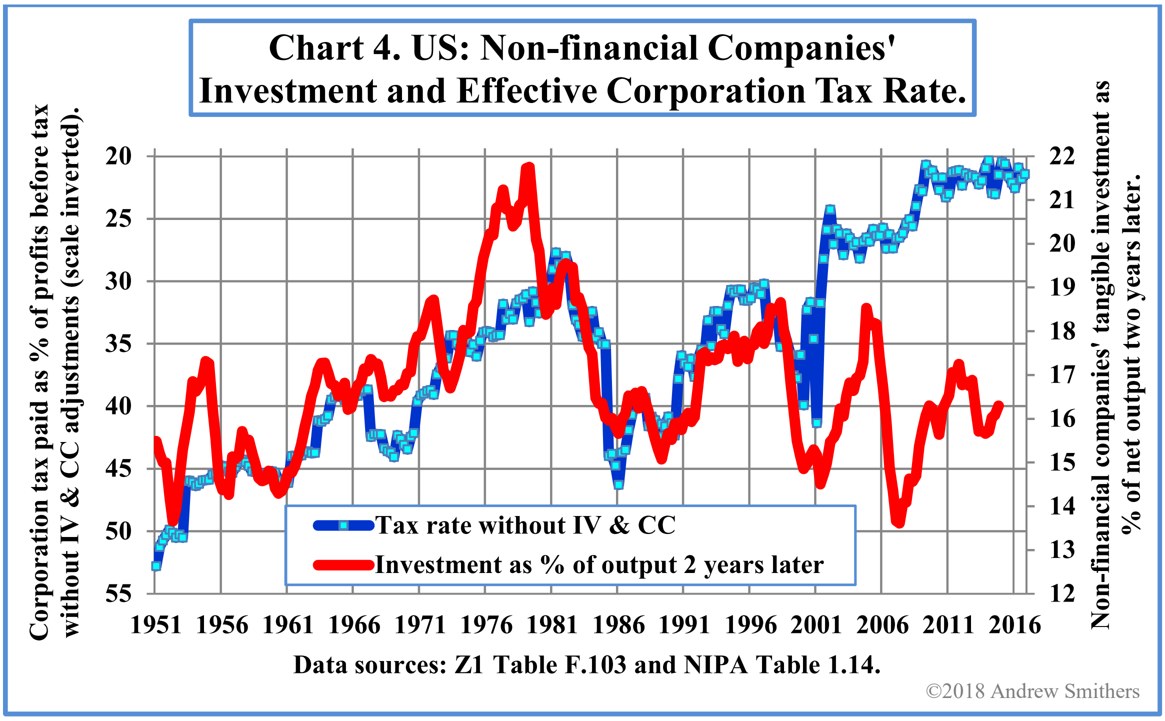
strong correlation between investment and corporation tax and, as Chart 4 shows, this has been the case, although the relationship appears to have changed after 2000.[3]

The Report is therefore wrong to assume that corporation tax is borne by shareholders and, prior to 2000, would have been wrong to assume that investment does not respond to changes in corporation tax. Since 2000 there appears to have been a change and it may therefore be the case that an increase in corporation tax would not under current conditions have an adverse impact on investment.



The change in behaviour shown in Chart 4, which is confirmed by the change in the relationship between investment and RoE shown in Chart 5, follows the change in management remuneration which occurred in the US between 1992 and 2000 (Chart 6) and which has been followed in the UK (Chart 7).

[3] From Q4 1951 to Q4 2000 the R^2 correlation was 0.60 between the rate of tax and the level of corporate investment two years later.

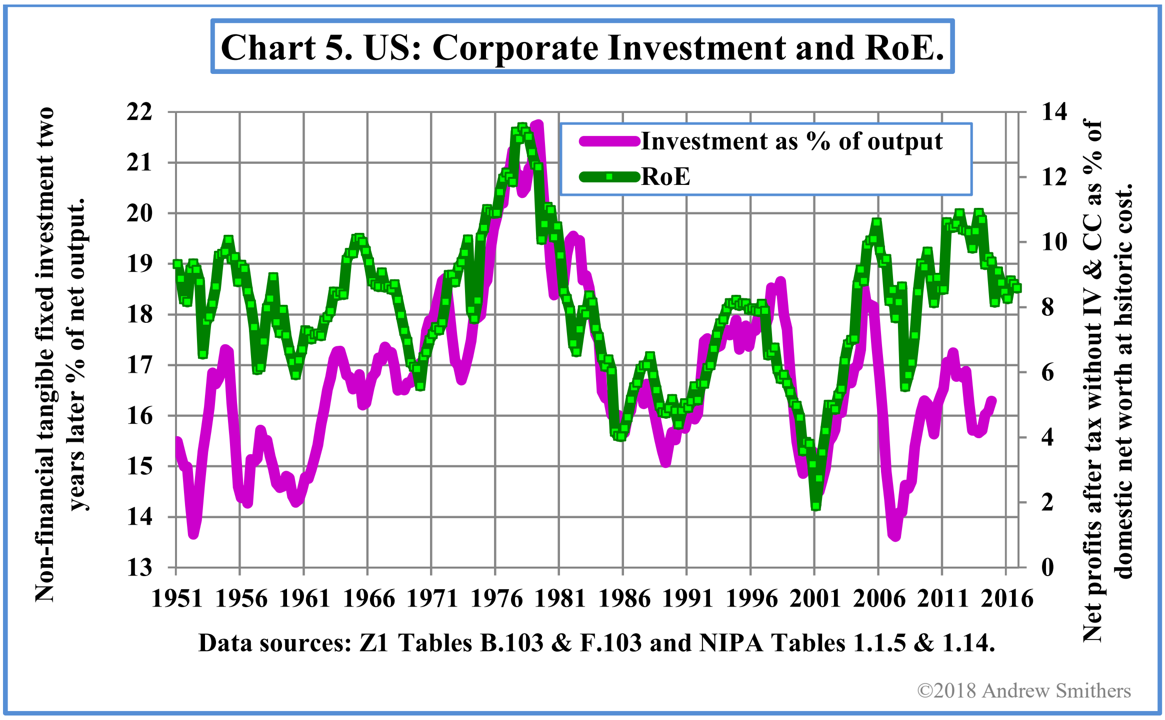


Chart 5. US: Corporate Investment and RoE.
Investment as % of output
RoE
Non-financial tangible fixed investment two years later % of net output.
Net profits after tax without IV & CC as % of domestic net worth at hsitoric cost.
22
21
20
19
18
17
16
15
14
13
14
12
10
8
6
4
2
0
1951 1956 1961 1966 1971 1976 1981 1986 1991 1996 2001 2006 2011 2016
Data sources: Z1 Tables B.103 & F.103 and NIPA Tables 1.1.5 & 1.14.
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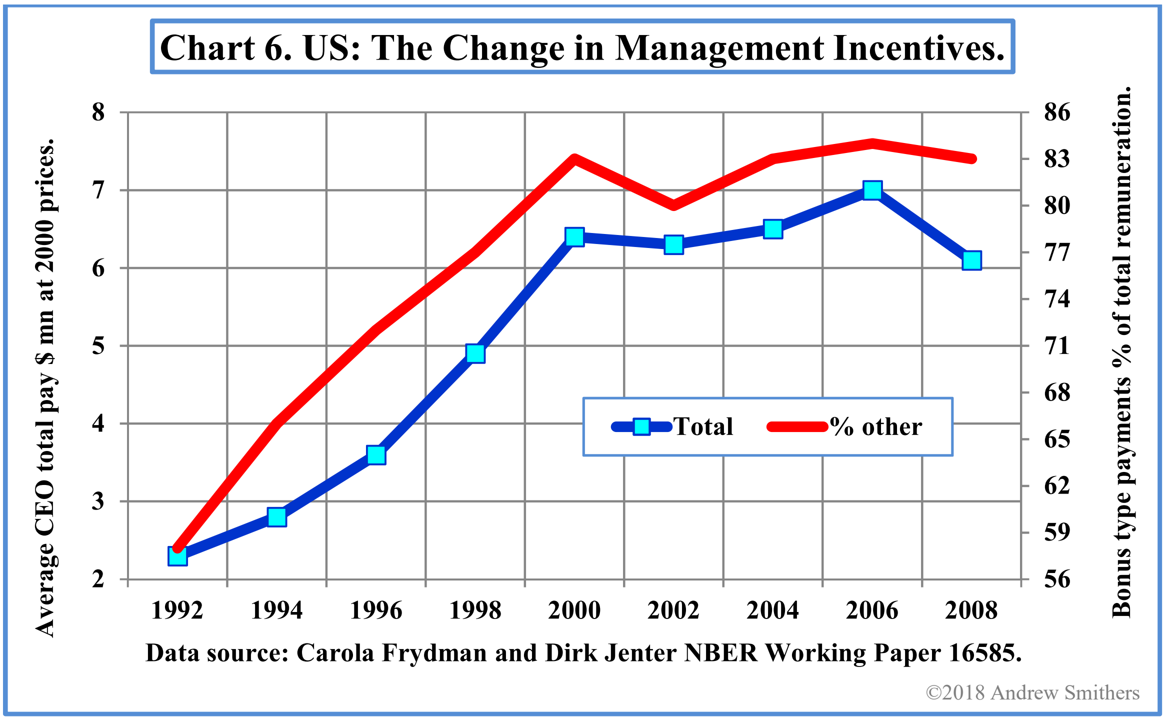

Chart 6. US: The Change in Management Incentives.
Total
% other
Average CEO total pay $ mn at 2000 prices.
Bonus type payments % of total remuneration.
8
7
6
5
4
3
2
86
83
80
77
74
71
68
65
62
59
56
1992 1994 1996 1998 2000 2002 2004 2006 2008
Data source: Carola Frydman and Dirk Jenter NBER Working Paper 16585.
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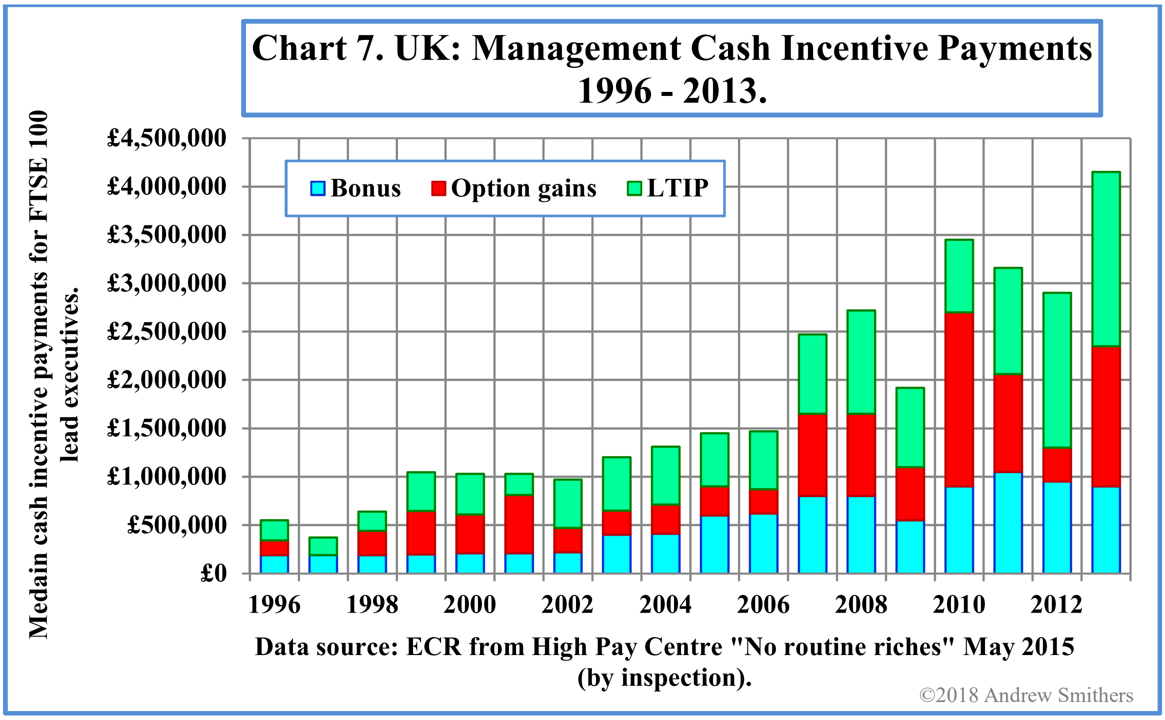

It appears that the breakdown in the relationship between the rate of corporation tax, RoE and corporate investment was the result of the change in management incentives induced by the bonus culture. So long as these incentives remain in place, the reduction in investment that results from a rise in corporation tax may be small but, if the Report's proposal to link bonuses to productivity were introduced, a rise in corporation tax would be likely to neutralise the benefit. The Report's proposals to change management incentives and to raise corporation tax are therefore inconsistent. The first should be accepted and the second rejected.

The Cost of Ignoring the Impact of the Bonus Culture.

Poor productivity is the key problem facing the UK and the US. Its cause is low investment induced by the perverse incentives of the bonus culture. This connection is ignored in the press and without debate we are unlikely to see a change. The response to the Report underlines this. Another recent example is in an article by Lawrence Summers in the Financial Times which claims that "The idea that a myopic market forces companies to forgo highly attractive investment opportunities is unsupported either by logic or evidence." I wrote to the Financial Times correcting this mistake, which is shown by Charts 4 and 5, but the paper chose not to publish my letter and allowed the error to go uncorrected.

Andrew Smithers
London October 2018