THE AUSTRALIAN

We need new rules to help rein in executive pay club

ADAM CREIGHTON THE AUSTRALIAN 12:00AM April 10, 2017

It is difficult to get a man to understand something when his salary depends on his not understanding it. American author Upton Sinclair's famous remark perhaps rings truer nowhere more than in executive pay, where self-serving and specious arguments are - bandied about to justify the outrageous.

Six weeks ago I offered to run Australia Post for $560,000 a year, a mere 10 per cent of what the former chief executive, Ahmed Fahour, was paid last year. I've not heard from the board, who are no doubt engaged in an intense global search for someone willing to accept a few million dollars a year to run the state-owned postage giant.

How can it be so hard? Clearly, technical knowledge is irrelevant: Fahour spent his career in banking before his 2010 appointment, so presumably the only skills that matter are "soft" ones: basic maths, English (written and spoken), a work ethic, integrity and a desire to do a good job, for instance. These combinations are in large supply, but the managerial cartel will not let others make bids to do such jobs. The outcome might be embarrassing.

Danielle Roche, an Australian gold medallist in hockey, finds herself in a similar position, having reportedly offered to do the job of chief executive of the Australian Olympic Committee for free. The pulsating "market for talent" dictates that the incumbent John Coates needs more than $700,000 a year to fulfil, apparently, what was once a voluntary position.

"Executive recruiters are seldom aware of evidence-based procedures for selecting managers," says J. Scott Armstrong, a professor of forecasting at Wharton, who famously challenged former US vice-president Al Gore in 2007 to a $10,000 bet that global temperature wouldn't rise. "Having obtained bids owners should then employ evidence-based selection procedures and also very importantly, do not meet the candidate," he recommends, suggesting recruiters too often hire executives based on irrelevant characteristics such as interview performance, age, looks, voice, golfing prowess, and connection.

In the film *Moneyball*, based on a book by the brilliant Michael Lewis, a baseball team succeeds on a limited budget only when it - decides to select players based on objective evidence, he notes.

The market for executives and the level of pay is highly dysfunctional, propped up by the largesse that is possible only when spending other people's money, in this case that of remote shareholders.

A few days ago in the US it emerged that the Coca-Cola chief executive's pay increased about 20 per cent to $US17 million ($22.6m) in 2016 despite the fact the company's share price, profits and revenue all fell.

So-called performance pay, which spread like wildfire in the payment of executives in the 1990s, has been questionably beneficial outside the boardroom.

Last year the Nobel prize in economics went to Oliver Hart and Bengt Holmstrom, whose research spelt out how to optimally design contracts for best performance. Luigi Zingales, a brilliant finance professor at the University of Chicago, tells me their insights have been abused. Pay contracts are only optimal when irrelevant variables outside the control of the chief executive are stripped. "When I was a board member (of Telecom Italia) I found enormous resistance to this because managers like to be compensated for luck, and because they know when times are bad, job contracts won't be rewritten," he says.

Commonwealth Bank chief executive Ian Narev, made $12.3m last year, partly for achieving "customer satisfaction targets", a nebulous concept that would certainly flout this principle.

Giving managers short-term incentives hooked to share prices or other variables (STIs, as they are known) distracts them from making decisions in the long-term interests of their company. STIs encourage neglect of important factors that can't easily be quantified. An STI plan might have got a fourth law of motion from Sir Isaac Newton or a 10th symphony from Beethoven, but they would have been shoddy by comparison. Bank of England governor Mark Carney recently noted that banks' misconduct fines (where so-called performance pay is used most commonly) had exceeded $US320 billion since the financial crisis, which suggests such mechanisms have stoked a serious morality deficit among some of the highest paid workers.

Does anyone seriously claim that western economies are more innovative and dynamic now than they were before the 1990s, when "performance pay" spread? It's an argument that is comprehensively demolished by Nobel prize-winner Edmund Phelps — a strong proponent of genuine capitalism — in his insightful 2013 book *Mass Flourishing*, which chronicles how a sclerotic corporatism has sapped the dynamism that used to underpin our economies.

"The question here is whether the heightened aspirations for money or wealth help account for the economic decline that was clearly under way in America by the early 1970s: the slower growth, higher unemployment and lower job satisfaction, as well as the massive fiscal stimuli, dereliction of regulators, and the speculative manias. The answer is yes. Wealth seeking competes with innovation seeking," he writes, suggesting Reagan tax cuts in the 1980s had unleashed a money frenzy that had come at the expensive of genuine risk-taking and innovation.

Companies with limited liability aren't natural; they are creations of government, which should write their governance rules in a way that best promotes prosperity. No one is suggesting top managers shouldn't get paid well, nor that government should micromanage corporate pay. There are no perfect solutions but the current framework is not working. The two-strikes rule that attempts to give shareholders a say on pay has been a toothless failure. Lecturing voters on the need to lift productivity growth while permitting elite managers to extract huge rents that ultimately push up prices will only fuel further populist movements.

"If you do not like the market-based approach [letting people make bids], why not try the democratic approach and let employees vote for their executives?" says Armstrong.

Perhaps votes on remuneration proposals could be based on "one shareholder-one vote".

A 100 per cent marginal income tax on payments from limited liability companies to employees for amounts above, say, $2m would help ensure the companies' revenue went to dividends or investment rather than the managerial class.

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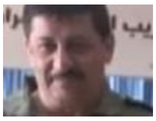

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