A Philosophical and Economic Inquiry into Corporate Executive Salaries
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None.

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Abstract
Over the past three decades the level of corporate executive salaries has risen dramatically, prompting community concern. This thesis is an investigation of corporate executive salaries, considered against the principles of distributive justice and economic efficiency. This will then enable the determination of whether the concerns are valid.

I commence by examining empirical evidence for relationships between corporate performance and executive salary levels in Australia and the United States. I find that there is a weak correlation between executive salary and corporate performance in Australia, and no reliable relationship evidenced in the United States. There is some evidence that high executive salary may be associated with greater risk of corporate collapse in the United States. Looking wider, there is no evidence that higher executive levels result in greater economic efficiency or returns to shareholders, in the OECD countries for which evidence is available.

Given the lack of an empirical justification for current executive salary levels, I next review the philosophical and economic theories that have been used to analyse them, to see whether it is possible to define what executive salaries should be. Philosophically the preferable approach is David Miller’s market rate theory, which justifies salary levels based on the fairness of the markets that set them. The executive salary market fails to meet Miller’s conditions for non-exploitive markets.

In economics, executive salaries have been recognised as an example of the principle-agent problem since the 1970s. The recent debate over executive salary levels has been dominated by two rival theories. Management power theory, as defined by Bebchuk and Freid, argues that executive salary levels are the result of the exploitation of positional power by executives. Alignment theory, as defined by Jensen and Murphy, argues that the principle-agent problem can be solved by incentive based contracts, and therefore executive salary levels are defensible as their free market outcome.

I conclude that management power is strongly preferable to alignment theory as an explanation of current executive salary practices and levels. Alignment theory suffers from circular reasoning and inadequate evidentiary support, despite being developed on an empirical basis. The increase in executive salary levels since the 1970s is due to increased management power. This increase can be explained by the more indirect
nature of share ownership that has evolved in parallel with institutional share funds. This has added additional layers of agency costs to share ownership, and created the potential for collusive games between share fund managers, corporate directors, and executives.

Having established that executive salary levels in Australia and the United States are not economically efficient, not ethically justifiable, and caused by systemic weaknesses in corporate governance structures, I consider the case for government regulation. I conclude that this is both necessary and appropriate, as the cost of regulation is likely to be very much less than the current losses from excessive executive salaries. Reforms need to include both direct salary caps and bonus limits on executive salaries in publicly listed corporations, as well as major overhauls to voting rules for the election of corporate directors and binding votes on remuneration. A further equally important reform is the extension of current corporate governance regimes to share funds.

I conclude on a somewhat pessimistic note, pointing out that corporate executives wield enormous political influence, making reform difficult. This is due to their ability to use corporate financial resources to influence politicians to advance their private interests. This “executive influence” theory is consistent with public choice theory first identified in the 1960s. There is now an imbalance in political power between corporate executives and all other citizens. Without reform, the misuse of corporate power by executives is likely to be a continuing problem for capitalist democracies into the future.

**Keywords**

applied ethics, compensation, distributive justice, efficiency, executive, governance, management, remuneration

**Australian and New Zealand Standard Research Classifications (ANZSRC)**

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1 Scope of Thesis and Definitions

1.1 The Good, the Bad and the Average

In recent years, instances of large salary payments to corporate executives under questionable circumstances have attracted widespread criticism. Consider the case of Phillip Green, Chief Executive Officer (CEO) and Director of Australian investment firm Babcock & Brown (B&B). He received a salary of $14.3 million in 2006, making him the second highest paid CEO in Australia. Over the four years from B&B’s listing on the Australian Stock Exchange (ASX) in 2004 to its demise in 2008, Green was paid $30 million. In addition he received performance bonuses of B&B shares, although these were not vested before the corporation collapsed. Green’s combined personal ownership of B&B shares was valued at $400 million when the stock price peaked in mid-2007\(^1\).

The outcome for other B&B shareholders was less pleasing. B&B had enjoyed rapid growth during this period, with the listed value of its shares exceeding $9 billion at its peak of $33 per share in 2007. As credit markets tightened in 2007, the B&B share price fell. By the end of 2008 it had fallen to 14 cents per share. It was placed into voluntary administration in March 2009. Over 99% of the $4 billion in funds that had been invested into B&B was lost. In 2009 the administrator recommended Green and other executives should be investigated by the Australian Securities and Investments Commission (ASIC) for possible conflicts of interest in loan deals\(^2\).

Far worse examples of excessive pay proliferated on Wall Street in the first decade of the 21\(^{st}\) Century. In 2007 Richard Fuld, CEO of investment bank Lehman Brothers, received salary and bonuses of US$51.65 million, with a total income over the five years 2002 to 2007 of US$311.88 million\(^3\). Less than a year later in September 2008 Lehman Brothers filed for bankruptcy, with more than 90% of its US$600 billion assets lost. It was the largest financial collapse in US history and precipitated what became known as the global financial crisis (GFC) of 2008/09.

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In the years prior to bankruptcy Lehman Brothers, like the other four major Wall Street investment banks, had annually paid out 40% to 50% of gross revenue as compensation to its market traders and executives⁴. Two of its last corporate actions were to transfer over US$8 billion in cash from its European offices back to New York, and then set aside US$2.5 billion to pay out bonuses to New York staff. These actions were taken after it was known the bank faced bankruptcy⁵. By contrast Lehman’s UK staff were not guaranteed to have their leave entitlements paid, even though the UK part of the business had still been profitable.

The link between Fuld’s extraordinary pay and Lehman’s disastrous collapse was more than coincidental. Corporate governance researcher Nell Minnow said in testimony to the US Congress Committee inquiring into Lehman’s collapse:

“As I have mentioned in previous testimony before this committee, there is no more reliable indicator of litigation, liability, and investment risk than pay that is not linked to performance. I think it is fair to say by any standard of measurement that this [Fuld’s] pay plan is as uncorrelated to performance as it is possible to be.”⁶

Excesses such as those listed have generated considerable hostility over the issue of rewards for corporate executives. In the wake of the Enron and “dot-com” scandals of the late 1990s Carol Loomis, Fortune Magazine reporter on CEO pay wrote simply “This Stuff is Wrong”⁷ in 2001. Almost ten years later sentiment has become even more outraged following the onset of the global financial crisis. This was particularly the case in the United States after the GFC. It emerged that some large corporations receiving taxpayer assistance to avoid bankruptcy, such as American Insurance Group (AIG), had used taxpayer funds to continue paying executives their (very large) performance bonuses, despite being effectively insolvent.

Yet there are also examples of executives who have created genuine benefits for their corporations without cheating their employees, the taxpayer, or their shareholders. When

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Charles “Chip” Goodyear became Chief Financial Officer (CFO) of BHP in 1999, Australia’s largest mining company was debt-ridden. It then merged to become BHP Billiton in 2001 and Goodyear took over as CEO in 2003. By 2007, when Goodyear retired, BHP Billiton was the largest mining company in the world, very profitable, and had eliminated most of its debts. Under Goodyear BHP Billiton’s share value had increased from $12 billion to $200 billion in nine years. It was also Australia’s largest taxpayer, contributing greatly to a parallel boom in the Australian economy. Goodyear’s salary, bonuses and departure benefits in his final year totalled A$8 million, compared to BHP Billiton’s annual profit of over A$15 billion.

An even more clear-cut example of effective executive management providing good returns to shareholders is the success of American businessman Warren Buffett. In 1967 Buffett acquired control of Berkshire Hathaway, a textiles company, and reorganised it as an insurance and investment holding company. Over the next forty-four years Berkshire Hathaway averaged returns of 20.3% to its investors, and its shares grew in price from $19 each to over $70,000 each, becoming the 18th largest corporation in the world. This success was not a result of luck or any discovery or invention. Buffett had studied an investment philosophy known as “value investing” at college and applied it in his own management decisions over the following forty years.

During this period Buffett’s personal wealth grew to over US $40 billion, making him the third richest person on earth in 2010. However this wealth accrued from his personal stake in investments and starting ownership share of the company. He lived frugally and in 2007, at the height of the corporate salary boom on Wall Street, paid himself a base salary of $100,000 per annum as CEO of Berkshire. He consciously favoured investments that provided employment in his home town of Omaha, Nebraska. In 2006 he announced his intention to give most of his wealth to charity, via the William and Melinda Gates Foundation. By any measure, Buffett’s skill as an executive has benefited his corporation, its shareholders and his community.

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11 I do not claim that Buffett is a paragon of virtue. Some of his highly profitable investments were made in tobacco companies after the harm caused by smoking was already well known.
Such extreme examples of good and ill in executive behaviour and performance illustrate
the dangers of rushing to judgement as an emotional reaction to examples of wrong doing.
They also demonstrate that we cannot reach sound general conclusions from individual
stories and anecdotal evidence. They may not be reliable indicators of the overall picture.
Every profession has instances of individuals who perform exceptionally well, while others
may behave unethically to the extent that they harm the reputation of the group as a
whole. There is a danger that, in the emotional context of a strong societal reaction
against apparent corporate greed and excess, we will rush to judgement and overreact.
As the cases of Goodyear and Buffett show, talented individual executives may greatly
benefit a corporation, and presumably the society in which it operates. Judgements about
executive salaries should be based on a broad examination of the executive labour market
and its wider consequences, and not an emotional reaction to an instance of bad practice.

1.2 A Multi-Disciplinary Approach

To date the quantitative analysis of executive salary has primarily been carried out within
the field of financial accounting. This field is concerned with the analysis of business
operations and costs. It aims to provide investors with enough information about the
performance of businesses to make rational investment decisions. Hence consideration of
the level of executive salary within this field is appropriate. As we shall see, the pioneering
work on the study of executive salary was by financial accounting academics Michael C.
Jensen and William H. Mecklin in the 1970s, and by Jensen with Kevin F. Murphy since
then.

In this literature these authors argued that the efficient level of executive salary to be paid
within a corporation depended on what gave the best financial return to shareholders. If
this condition could be satisfied then under financial accounting theories it would be
rational for shareholders to pay the salary. This thesis will review this literature in order to
understand whether the levels of executive salary being paid do in fact represent rational
business decisions for shareholders.

For the broader society, the consideration of executive salary in financial accounting
literature will be insufficient to resolve public concerns. Members of a society will be
interested in the broader question of whether or not the society as a whole is better off with
a particular level of executive salary, not the individual corporation that pays it. Financial
accounting is only concerned with the performance of individual corporations and cannot answer this broader question.

The social science of economics is concerned with understanding the operations of entire industries, national and even international economies, to guide the efficient allocation of resources within each to satisfy the needs of the society. To reach rational conclusions on whether a particular level of executive salary is efficient, economic analysis may be used to determine whether the society as a whole is (materially) better off. This requires consideration of its macro-effects on social welfare, not only monetarised effects within the corporation.

The question of what level of salary within an occupation provides the best resource allocation outcomes within the society is normally considered within the sub-field of labour market economics. This thesis will examine relevant literature from that field in assessing whether the level of executive salary is rational for the society. There is a remarkable lack of economic analysis of the effects of executive salary levels, compared to the economic analysis of other occupations, such as whether a society needs more doctors, or whether teachers should be paid more. In this absence I will consider the application of standard theories in labour market economics to the executive salary market. I will also examine executive salary levels within a macro-economic framework to gain a better understanding of their overall societal impacts.

Yet while this analysis of the evidence on executive salary already spans two disciplines, it is still not sufficient to answer the broader question about the legitimacy of executive salary levels. Financial accounting theory will tell us whether executive salary levels are rational for corporations. Labour-market economics will tell us whether executive salary levels are rational for the whole economy. Macro-economics will tell us whether the society is better off in economics terms. None of these will tell us about the non-economic impacts, whether they are justifiable, or give us guidance as to whether the society should permit them. They cannot respond to Carol Loomis’ concern and indicate whether executive salaries are wrong.

While the rightness or wrongness of executive salaries may not be a question for accounting or economics to answer, it remains a significant question. When I say that the emotional reaction against current executive salary levels may be an overreaction or may
not be reliable, this is not to dismiss the reaction. Human beings react emotionally against behaviour which conflicts with their own values and ethical principles. Societies create laws or establish norms of behaviour in recognition of such commonly held values and principles. Without them, it might be argued that there is little in common to bind the society together.

Determining whether or not executive salary levels are right or wrong is a normative question. It presupposes that there are rules, or at least some common understanding within a society, for what level of reward is reasonable for undertaking an occupation. We need to understand what norms or principles are applied to such cases, and apply them to executive salaries. This is the province of applied ethics, which is concerned with the rightness or wrongness of actions. Distributive justice is the sub-discipline that is concerned with the judgements about the appropriateness of forms and levels of rewards. Therefore, a significant proportion of this thesis will be devoted to the analysis of executive salary levels using principles of distributive justice.

It should be noted that the topic of inquiry straddles three very large fields of study, accounting, economics and distributive justice with only marginal overlap between them. Each has separate professional as well as academic literature, particularly in the business and financial accounting field. It is impossible to consider all of the relevant material in one thesis. Therefore this thesis will focus on what I consider to be seminal articles that examine the theoretical issues in each case. Examination of empirical evidence will be confined to Australia and the United States up to the end of 2009.

1.3 The Relevance of Normative Analysis

Before proceeding to outline the thesis in detail, I will address further the question of the applicability of normative analysis to business decisions such as executive salary. It may be argued that the level of executive salary is purely a financial decision and should be left to business to decide. Normative questions of right and wrong are separate to business management questions under this view.

This claim is false. Ethical theories are developed to enable an analysis of the rightness or wrongness of actions in all social contexts. Business is neither specifically targeted nor excluded. It is included simply by being part of the range of activity undertaken by persons
within a society. It is no more justifiable to exclude business behaviour from ethical scrutiny than it is to exclude the military or executive branches of government from ethical scrutiny. We may debate what are the appropriate normative standards to apply to business, but it is not defensible to say that none apply to business by definition. The existence of rules for probity in business, that define acceptable behaviour in negotiations, demonstrate that accepted norms of behaviour already exist within business. Whether or not those norms are ethically justifiable is a separate question.

Moreover, the assumption that executive salary levels are purely a question of business efficiency is itself a normative view. It implies that such questions are solely a matter of consideration of financial outcomes. That is, value should be given to financial outcomes in such matters, and not to any other social impacts. Such a decision to give a weighting or value to financial measures and zero value to any other measures is itself a value or normative judgement. It would therefore be both arbitrary and logically inconsistent to exclude other normative judgements without sound reason. No such reason exists.

There has been little consideration of the underlying philosophical issues involved in the distribution of rewards within corporations, either for employees in general or to executives. This is consistent with the “classic” view of corporations as espoused by Milton Friedman. Friedman argued that the purpose of a firm is to make a profit, with all other considerations, including ethics, being secondary. Friedman used executives’ fiduciary duty to shareholders as a justification for executives making ethical considerations secondary. Under their fiduciary duty, executives were obliged to act in the shareholder’s interests, that was primarily assumed to be making a profit. Hence the executives could not substitute other considerations, including their personal ethical views, while making decisions about the corporation.

John Boatright has already demonstrated the internal contradiction in Friedman’s view. He pointed out that fiduciary duties held by corporate executives are themselves a form of moral obligation. Hence it was logically inconsistent to say that a particular class of moral obligation (fiduciary duty) trumped consideration of all other moral obligations an executive might feel compelled to act upon. There was no inherent attribute of fiduciary duties that

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gave them priority over other moral obligations. Deciding which moral obligation was most important in each case was an example of the sort of reasoning normally required in making moral judgements. Despite this logical flaw in Friedman’s argument, it clearly remains popular in business thinking\textsuperscript{14}.

I contend that the Friedman view of business ethics is not only logically flawed, but it is far too narrow a view, and is sharply inconsistent with community values. Questions of justice and fairness do matter to the majority of people, and it is legitimate to examine executive salary from this viewpoint. This has been true throughout history, with Aristotle first defining it in the fourth century BC:

“True justice means that those who have contributed to the end of the [state] should have privileges in proportion to their contribution to that end.”\textsuperscript{15}

In summary then, reaching a view on what social policy should be towards executive salary levels requires a consideration of each relevant discipline: financial accounting, economics and distributive justice. Material from each will be considered in this thesis. A final answer on whether executive salary levels are wrong and what social policy towards them may be appropriate will be principally considered from the viewpoint of philosophy and distributive justice, since these are primarily normative questions for a society. However impacts of policy proposals on business and the economy will still be considered, since these form part of the society. The point of using a philosophical framework is to ensure that non-financial issues will not be excluded from consideration.

1.4 The Relevance of Distributive Justice

Having established that normative principles are relevant to business issues such as executive salary levels, the next question is the applicability of distributive justice principles. That is, we have shown that the rightness or wrongness of executive salary levels is a normative question, that normative questions are appropriate to apply to business, and that the community is concerned about normative aspects of executive salary. The question remains: are ethical and distributive justice principles an appropriate means to use in making this inquiry? It might be argued that the philosophical conception

\textsuperscript{14} As of 2010 Friedman’s article had been cited in over 3500 publications, most in the fields of financial accounting and business management.

of distributive justice is simply an idealistic notion with no basis in people’s lived experience. We need to demonstrate that the principles of distributive justice are both ethically sound, and representative of community values. I will deal with the first question in later chapters, but here I will demonstrate the link between distributive justice principles and community values.

David Miller\textsuperscript{16} in \textit{Principles of Social Justice} (1999) surveyed evidence on social attitudes and behaviour on justice issues including income distribution. He found that, while attitudes vary slightly from culture to culture within the western world, most people did have an understanding and acceptance of concepts of social justice. Thus Miller concludes we can reject the Hayekian\textsuperscript{17} claim that “the whole notion of social justice is fundamentally misguided”. Miller found that:

“people seem to be perfectly at home with the notion of social justice itself; they are prepared to apply criteria of distributive justice to existing social arrangements, and to say in broad terms what a just society would look like (even if they are sceptical about the chances of achieving one)”\textsuperscript{18}.

I agree with David Miller on this point. Whether or not we may agree with any particular conception of social justice, we cannot, as Hayek does, dismiss it as a “mirage” imagined only by philosophers. As David Miller’s survey demonstrates, views on what social justice is exist within each society. Thus, consistently held or not, the idea of social justice exists.

Further, there were some consistently held beliefs about distributive justice across and within cultures. These could be demonstrated through empirical evidence, both in terms of individual’s behaviour, and the justifications or principles that individuals referred to in survey responses. These beliefs also went beyond holding principles that might be in an individual’s rational self-interest to hold. They represent underlying beliefs about the nature of a just distribution of rewards.

These beliefs did not equate to a preference for income equality. Results of surveys of preferences for income distribution varied between countries and size of groups:

“most of the groups studied favoured top to bottom income ratios of between 9 to 1 [in Australia] and 12 to 1 [in the United States]. This still represented a considerable


\textsuperscript{18} David Miller (1999), Page 90.
narrowing of existing differentials as perceived by the respondents but clearly the overall pattern is substantially more inegalitarian than that presented by vignette studies, where the top-to-bottom ratio is less than 3 to 1.” ¹⁹

The highest incomes were expected by respondents to go to occupations such as lawyers or business executives. These results demonstrate that most individuals accept the notion that some individuals deserve higher income than others, based on some criteria about their work. They also show that most individuals have a view of what quantum for such differences is reasonable.

Miller (1999) concluded that community ideas of social justice were pluralistic, based on multiple criteria²⁰. These criteria are contextual in that their application singly, or in combination, depends on the circumstances, and also on the nature of the group in which they are being applied. Different societies may have different views on social justice, but there will still be an underlying notion held by the members of each society of what it is, and when criteria are relevant. Individuals have a practical understanding of these concepts, and an awareness of when it is appropriate to apply them²¹.

Concepts of desert, need and equality are widely recognised as the key criteria in deciding questions of the just distribution of rewards and obligations within society. Of these, the desert criteria are the most unambiguous, and most clearly distinct from other arguments for preferences. Desert criteria are backward-looking, based on people’s past contribution or efforts made towards an outcome²². It may be difficult to distinguish rewards for desert from those given as incentives for future efforts. The preference for desert criteria over equality tended to be stronger in larger groups, or where the degree of internal group cohesiveness was lower²³.

Need is also an important criteria to most people, as long as genuine need is distinguished from wants or desires. That is, need is determined by the circumstances an individual finds themselves in, not their expressed claims of need. This is true both in small groups,

²⁰ David Miller (1999), Pages 78-79.
²¹ David Miller (1999), Pages 87.
²² David Miller (1999), Page 90.
²³ David Miller (1999), Pages 64-65.
and across societies as a whole. At the societal level, there is a strong preference for need to be reflected in minimum levels of income or support for all individuals.\(^{24}\)

Equality is also important to the majority of persons, but it needs to be carefully defined. Most people want equality of treatment and opportunity for all. This does not equate to a preference for identical rewards for all. A purely egalitarian approach to distribution of rewards is the preference of some but not the majority. Most people consider that differences in factors such as effort, difficulty, qualifications and risk between occupations should be taken into account in their relative rewards. They do not seriously expect all jobs to have equal incomes, although Miller did find that most would expect income differences to be smaller than at present, and not the present differences or larger, if all labour markets were fair.\(^{25}\)

Given the prevailing attitudes Miller reported, we can consider how they relate to corporate executives. For executives, consideration of reward practices against measures of equality is almost a "straw-man" criticism. Current levels of executive reward are so much greater than average incomes that they could not be justified under any conception of egalitarianism. Likewise questions of need maybe disregarded in the case of corporate executives, since their rewards are already higher than the norm, and much higher than any definition of poverty or the minimum income levels needed for survival in any society.

This leaves the question of whether executive rewards are deserved. This is squarely within the field of study of distributive justice theories of desert. Therefore this thesis examines executive rewards from the viewpoint of desert theories. That is, we will consider whether it can be shown that executives deserve the level of rewards they receive. If it is possible to construct a distributive justice theory that might justify executive rewards, desert theories seem to offer the best chance. Whether this is possible or not, desert theories are reflective of broader social attitudes and thus represent the sort of justification that needs to be met for executive rewards to be socially acceptable.

\(^{24}\) David Miller (1999), Page 91.
\(^{25}\) David Miller (1999), Page 71.
Jarred Harris\textsuperscript{26} has considered the question of executive rewards from the viewpoint of three other theories of distributive justice, namely Rawl’s difference principle and conception of justice as fairness, Sen and Nussbaum’s capability theory, and Nozick’s libertarian theory. Harris makes clear that executive rewards practice did not satisfy these theories either. Rawl’s difference principle is that increased rewards should only be allocated in such a way that the least well off are (also) made better off. We will see in reviewing empirical evidence in Chapter Two that this is not the case for higher executive rewards. With regard to the principles of justice as fairness, Harris considers equality of opportunity and the process for determining rewards for executives. In both cases current practice in selecting executives and their rewards is shown to fail to meet relevant criteria.

Sen and Nussbaum’s capability theory focuses on whether the freedoms and capabilities of individuals relevant to an action are enhanced by it. For executive rewards, Harris considers that this equates to deciding whether the freedoms and capabilities of the stakeholders in a corporation are increased by rewarding the executive more. He concludes that this requirement is difficult to quantify and prove, and likely not to be met.

This application of Sen and Nussbaum is debateable, since it depends on the definition of the group affected by the executive reward. If the group affected was extended to the whole community, and it could be shown that the reward did lead to an increase in social welfare, then it might be possible to satisfy Sen and Nussbaum’s conception of distributive justice. With a wider definition of stakeholders the theory would more closely resemble contribution-based desert theory, although an increase in income would be insufficient to satisfy it, unless there was also a genuine increase in human freedom and capability.

Nozick’s libertarian theory very narrowly defines distributive justice to property ownership and the justice of its acquisition and transfer. He states no view on the justice of any particular pattern of allocation of rewards, other than the means by which they were obtained. In Harris’s view this means that executive compensation must satisfy a “value proposition” that it results in a gain in value for the other parties of the transaction i.e. the shareholders. Again, Nozick does not allow an overall conclusion to be reached for

executive rewards. This would depend on examining the process and level of executive rewards in each individual case.

I broadly agree with Harris’ conclusions, however in my view they do not answer the central questions of this thesis. None of these theories closely match the commonly held attitudes to justice described by David Miller. Nor do they match the economic theory and rhetoric commonly used to analyse and justify executive rewards. In my view this is the most urgent task facing a review of executive rewards from the point of view of distributive justice and economics. There is a need to engage with the views held by the community, and the theories in use within the professional groups that set executive rewards. I do not propose to examine these other philosophical theories further in this thesis. I consider that desert theories as defined by David Miller represent the best analytical tool with which to consider the fairness of executive rewards.

1.5 Does it Matter?

Finally, before launching into an examination of such a complex topic, I need to address the question of whether it matters. That is, can we establish that executive salaries are a sufficiently important question of distributive justice to warrant examining it closely? Arguments about the reasonableness of executive salaries have been raised since well before their growth trend started in the early 1980s. After over 25 years of debate for seemingly no change in trend, cynics might say that nothing has changed, or will change, and there is no point in further debating the topic. Critics of distributive justice and/or defenders of high executive rewards could also argue that such behaviour is simply an inevitable aspect of the corporate executive labour market. Further, arguments about equity are irrelevant and some degree of self-serving behaviour occurs in every field, while most executives take their responsibilities seriously and only seek their earned reward.

This view is false. Although the trend of real increases in executive rewards has been ongoing for over 25 years, this does not mean that the situation is static. In real terms the Australian or US CEO of the early 21st Century is rewarded five to ten times more than their counterpart CEO was in the late 1970s. Executive rewards have continued climbing higher every year, at a rate outstripping growth in both corporate profits and economic growth in general. They now represent a considerable cost to shareholders.
This trend will be discussed in greater detail in Chapter Two, but I will briefly outline the situation here. In Australia in 2007/08, the CEOs of Australia’s top 300 corporations had an average total income of $2.9 million per annum, with a median income of $1.7 million per annum. The average total incomes for non-CEO executives were $1.1 million and the median total income was $600,000 per annum. This represented an income 45 times the national average income for top 300 CEOs and ten times the national average for other executives. Comparing to other highly paid professions, the average executive received 3.3 times the income of the Prime Minister, 2.75 times the income of a High Court Judge, and 2.3 times the income of a University Vice-Chancellor.

In the United States the contrast is even more dramatic. In 2007/08, the CEOs of America’s top 500 corporations were paid an average of $12.8 million US, or 457 times the national average income. Perhaps more remarkably, this average income was 32 times the US President’s salary, and 74 times the salary of the average doctor. While a few individuals such as musicians or sporting stars might earn more than the average CEO, the average income for musicians and professional sportspeople as a group is much less. There is no other occupational group with an average income comparable to executives.

Prior to the 1980s executive compensation represented a cost to shareholders of perhaps 1% to 2% of corporate profits. Paying executives slightly more to motivate better corporate performance might be understandable in that context. In the thirty years since then the scale of executive rewards has grown to the point where they now represent a loss to shareholders of over 10% of corporate profits annually. Shareholders would wish to be sure of a corresponding increase in profits for such a cost to be worth incurring.

If current executive pay practices and levels remain in place in the long term, they will have a significant effect on retirement savings in Australia and the United States. Under

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28 The Prime Minister’s salary was $330,000 in 2007. The High Court Chief Justice salary $398,930 in 2007. Source: Australian Government Remuneration Tribunal
current executive salary levels individuals with retirement funds invested in shares are likely to have their retirement benefits reduced by 15% to 20% over 35 years of full time work, compared to returns if the cost of executive rewards had remained equal to 1% of corporate profits as in the 1970s. This has the potential to undermine the retirement income policies of most western nations. The threat of too high executive pay to superannuation (retirement) fund performance in Australia was identified by Pauline Vamos, Chief Executive of the Association of Superannuation Funds of Australia, in 2009\textsuperscript{32}. The potential loss in retirement benefit from executive pay for a worker saving $5000 per year over 35 years is shown in Figure 1.1\textsuperscript{33}.

![Diagram showing accumulation of value over years comparing 35-year pension and reduced executive profits share.]

\textbf{Figure 1.1 Potential Losses in Retirement Savings from Executive Pay}

Further, executive pay practices may be creating additional indirect losses to shareholders, by encouraging excessive risk taking. While this is not a case of deliberately transferring wealth from shareholders to executives, the losses to shareholders may be even greater than from excessive pay. Nobel Economics Laureates


\textsuperscript{33}The chart assumes a worker on average wages, receiving legally required superannuation, an 8% real rate of return on investment, and executive pay equalling 10% of net profits as per Bebchuck.
Joseph Stiglitz and Paul Krugman have both suggested that the form of executive salaries was one motivating factor behind the high-risk investment strategies that led to the global financial crisis (GFC) of 2008/09. The GFC reduced the value of stockmarkets by more than a third throughout the western world and was estimated to have cost over two trillion dollars.

The growth trend in executive incomes extending over three decades is not normal for labour markets. We would expect any labour market to begin some form of correction (i.e. return to a long run equilibrium price level) before such a long period of time had elapsed. For example, the demand for accountants boomed in the 1980s following financial market deregulation, while the demand for computer professionals grew dramatically in the 1990s during the “dot com boom”. Yet in both cases those labour markets adjusted later, as the supply of graduates trained in accountancy and computer science increased to match demand. Labour markets are notoriously “downwards sticky” in that individuals are usually reluctant to accept a cut in personal income. Nevertheless, those labour markets reached equilibrium again at a lower labour price within less than a decade.

The executive labour market has shown little sign of reaching an equilibrium level or of undergoing any form of price correction. This is despite an increase in the supply of business graduates in the Australian and United States labour markets to the point where they might now be regarded as over-supplied. In a competitive labour market this should have resulted in a correction to the cost of executive labour. This is contrary to all relevant economic theory for labour markets and markets in general. A deeper examination of the mechanisms at work does seem necessary to understand what is occurring. Moreover the trend in executive rewards has created tangible costs, both economic and social.

Clearly, there is a need to examine the broader economic impacts of executive salaries, and not simply their effect on the profitability of an individual corporation. Recently,

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36 The cost was estimated at US$2.3 Trillion by the International Monetary Fund in its October 2009 Global Financial Stability Report.
studies of Australia superannuation fund returns suggest that these concerns are already being realised. For the period records were available, from 1997 to 2010, Australian super fund returns averaged less than 4% per annum, barely exceeding inflation\(^39\). Whilst it is not suggested that executive salary levels are the sole cause of this poor performance, it highlights that any issue that affects the long-term performance of shares and superannuation funds is of national economic significance.

1.6 Terminology and Definitions

Modern corporate culture has spawned a bewildering array of terms for corporate structures, positions, roles, and forms of payments. In some cases a multiplicity of terms relate to essentially the same concept, while in others the concepts themselves appear deliberately confusing. Payments to executives are often defined in opaque terms that a reasonable person might be forgiven for suspecting are invented primarily to conceal the true extent of payment from easy calculation. In this thesis I will assume certain key terms to have the meanings defined here.

The term “corporation” is taken to apply to any privately owned business structure in a capitalist economy that has the purpose of providing goods or services for profit. For this purpose it applies equally to individual firms or large groups consisting of many subsidiary companies both nationally and internationally. The key structural characteristics are that corporations are owned by a group of individuals able to sell their share of ownership if they desire, and that they have a defined power structure controlled by high-ranking employees. They are typically controlled by a corporate board elected by shareholders and including the most senior (executive) members of the employees reporting to it.

The term “shareholder” is taken to represent individuals holding (owning) shares in the ownership of a corporation. Note that there is a legal debate over whether shareholders are the legal owners of a corporation. Some argue that instead they own a share of the stock, or a security over a corporation\(^40\). Also there are many different classes of share ownership in some corporations, with varying combinations of ownership, voting rights and rights to profits. However its details are beyond the scope of this thesis and does not alter the status of shareholders from the point of view of rewards. In ethical terms,


shareholders are the providers of the capital required to create the corporation, and are reasonably entitled to a return on their investment. Hence for purposes of this thesis, shareholders will be regarded as sharing the ownership of a corporation and entitled to share in the profits.

The term “executive” is meant to refer to an occupier of any high level position within a corporation who has, or shares, some form of decision-making authority over the corporation. Common titles for these positions at present are Chief Executive Officer (CEO), Chief Financial Officer (CFO), Chief Operating Officer (COO), Chief Technical Officer (CTO), Chief Information Officer (CIO), and Chief Communications Officer (CCO). Other examples include titles substituting terms such as “Vice President”, “Director” or “Executive” in place of the word “chief”. Examples of executives by this definition also include Managing Directors or members of Corporate Boards with executive powers (Executive Directors).

The term “rewards” will be taken to include all forms of contractually entitled payments or benefits received by executives for the performance of their corporate role. This includes salary, bonuses, severance and retirement benefits, and other accumulated benefits such as options to purchase shares at a concessional price. In this context I am not concerned with whether the payments are received by cash, or share options or in the present or future. The question is the total amount and present value of rewards received, and whether it is justified.

In many cases I will primarily consider evidence on payments made to CEOs when discussing executive rewards more generally. There are two reasons for this. Firstly, the lack of consistency in titles and structures in firms below this level makes lower level comparisons difficult. Secondly, the large amount of data available for CEO pay makes them convenient to use as a proxy for executive wage trends generally. While CEO rewards will generally be higher than those of other executives, data shows they act as a reasonable proxy for the trend in executive rewards generally. Wherever possible empirical evidence has been drawn from government or official sources such as the Organisation for Economic Cooperation and Development (OECD), World Bank and the International Monetary Fund (IMF).
1.7 Structure of Thesis

I will commence in Chapter Two by examining an overview of the empirical evidence for trends in executive rewards in Australia and the United States. The Australian and US markets have been selected because the relevant data is published and most easily accessible to the author. Australian and US executive labour market trends are also considered to be representative of other English speaking countries such as Canada, New Zealand and the United Kingdom. Data from other nation's executive labour markets will be compared where relevant and available.

The examination will commence with a review of the cited evidence for relationships between executive rewards and corporate performance at the micro (individual firm) level, as practiced in financial accounting literature. I will show that, while these relationships are commonly quoted to defend the effectiveness of accounting models of executive salary, they do not meet normal standards of statistical reliability applied in other fields of science. Next I will proceed to review the macro (national) level economic evidence of relationships between executive rewards and economic performance. This should be a key factor in justifying high executive salary from a societal and public policy perspective. I will show that such evidence as exists is either inconclusive or recommends lower executive salary levels. I will conclude with evidence on two aspects not usually quantified by financial papers on rewards, the relationship between executive rewards and corporate risk, and a comparison with norms for variation in salary levels in other group practices.

In Chapter Three I will examine philosophical theories of distributive justice. The general question of reward for individuals in groups has received little attention in the philosophical literature. I will sketch a philosophical framework by which we may judge claims about the fairness of executive rewards and economic theories used to justify them.

Chapters Four, and Five contain a review of the primary economic theories used to explain and in some cases justify executive rewards, namely management power and alignment theories. Although both of these theories are defined in terms of agency costs, they represent explanations of executive rewards that depend on non-market and market causes respectively. In this respect, executive reward theories are at the intersection of the economic debate over efficient markets hypothesis, and the question of whether self-regulating markets are possible. I argue that the available evidence from executive labour markets in Australia and the United States leads to a clear preference between these two
economic theories. Further developments in the causal explanations of both theories are recommended. Other economic theories such as the economics of superstars are briefly discussed in Chapter Six. These are peripheral to the arguments in this thesis but help to clarify some aspects of executive rewards.

Having developed a philosophical framework and completed a review of the economic theories, we are left with the question of policy recommendations. Chapter Seven looks at the weaknesses identified in economic explanations of executive rewards and asks whether, in ideal circumstances, one of the economic theories could be implemented in a more effective fashion than has occurred to date. This leads to conclusions on the nature of structural and regulatory changes required to reform the executive labour markets in Australia and the United States.

Chapter Eight continues with some specific policy recommendations on the types of changes required to have a better functioning executive labour market. This will not detail specific legal or accounting rules, but focuses on areas where practice may be improved, and some means by which this may be achieved. This is discussed broadly, including changes to executive labour market practice, changes to corporate governance, and structural changes to corporations themselves. Changes are recommended to both corporate practices, and practices of associated bodies that are found to causally impact on executive rewards.

I conclude with some reflections on the significance of the executive rewards problem as it stands now. I argue that current practice is a symptom of broader weaknesses in the political - economic relationship between corporations and democratic governments. These have far reaching implications for the functioning of democracy. As I intend to demonstrate, I consider that executive rewards are problematic, and they are symptomatic of deeper problems in the conception of corporations and their stakeholders in most English-speaking countries, including but not limited to Australia and the United States.
2 Empirical Evidence on Executive Reward Trends

Empirical evidence on the level of rewards for corporate executives and their relationship to the performance of corporations and the economy is relevant to arguments on both financial (business) and economic (societal) efficiency. Later it will also be relevant to consideration of the distributive justice or fairness of such rewards, when we are considering the desert bases of these executives.

In this chapter I will briefly describe some of the trends in executive rewards in the past two decades for Australia and the United States. I will then review literature on comparisons between executive rewards and the performance of corporations, to see whether higher rewards for executives generate a higher return on investment for shareholders in individual corporations. I will also report my own comparison of data on executive rewards and investment risk, which has rarely been addressed in financial literature. This will enable us to form a view on whether current executive salary trends are rational as investment decisions for shareholders. Next I will report a comparison of executive rewards with national economic performance. This will enable us to form a view on whether current trends are economically rational for each society.

2.1 Evidence and Proof

Statistical analysis plays a significant role in the arguments for and against associations between executive salary and corporate performance. I will therefore give a brief introduction to the methods of proof and statistics most commonly used in economic and financial analysis here before looking at the evidence itself.

In any form of scientific inquiry, seeking confirming evidence is not a sound means to prove an argument. Following Karl Popper’s philosophy of falsifiability\(^\text{41}\), it is more usual to define a hypothesis, then test to see if there is any disproving evidence against the hypothesis, before adopting it. That is, we only accept a hypothesis as “proven” if we cannot find sufficient evidence to disprove it. Even then, the hypothesis is not proven absolutely, but we assume it is likely to be correct.

In this context, statisticians often include multiple variables in an analysis, including other plausible causes of a phenomena besides the hypothesis being tested. Thus we are able to ensure that the hypothesised variable provides the best explanation of the phenomena being studied, amongst the range of possible causal variables. This approach is known in economics as “positive economics”, being introduced by Paul Samuelson and first defined by Milton Friedman42.

Relationships between data may be analysed and measured in the form of correlation coefficients ($R^2$), which measure the degree of similarity between variables as a number ranging from +1 to -1. A correlation coefficient or $R^2$ value of +1 represents perfect agreement between two datasets, an $R^2$ value of 0 indicates there is no relationship, and an $R^2$ value of -1 represents that the datasets are exactly the inverse of each other. As well as checking the strength of $R^2$ values, statisticians also perform various tests on the reliability of relationships, based on the sample size tested. A relationship which passes a statistical test for reliability is said to be “statistically significant”.

Correlation between data does not prove causation. An $R^2$ coefficient of $+0.9$ or better would normally be taken as strong evidence, but not proof, of a significant relationship between two variables. Smaller $R^2$ values may indicate that both are related to some other factor, or that the degree of influence of one variable over the other is small. They are then said to have limited “explanatory power”. While a high $R^2$ value does not prove causation, a low $R^2$ value indicates that any causal relationship between the variables is either unlikely or inconsequential.

Irrespective of the strength of any correlation between data, the context also needs to be considered. There are many different types of statistical models than can be fitted to data. It is important to check that an appropriate model is used. Typically, statisticians produce “scatter plots” of data to check if there is any visually obvious pattern in the data. It is also important not to include too many variables in an analysis, as this may result in spurious relationships being “detected. The larger the number of variables that are included in a statistical model, the easier it becomes to match to data to some variable, regardless of whether or not an actual relationship exists between them.

As Milton Friedman indicated, the ultimate test of the quality of any statistical model of the relationship between data is its predictive accuracy. That is, if we say some variable X is related to Y, then if our model is accurate, given a new value Y2, we should be able to predict the corresponding value X2 with reasonable reliability.

2.2 Methodological Difficulties
There are two categories of methodological difficulty with empirical analysis of executive rewards and performance. The first is practical – there needs to be suitable data collected over a long enough time for trends to be detected. Despite recent laws on reporting executive salary, obtaining comparable data remains difficult. Accounting standards vary and reporting methods are often inconsistent in treatment of current income, bonuses for past performance, and the valuation of future shares options. Complex payment methods and obscure terminology have been used by corporations to camouflage the full extent of executive’s rewards from shareholders. Non-reporting of share bonuses that are to be vested at a future date is a notorious example. A typical structure for executive salary packages in Australia is shown in Figure 2.1.

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Figure 2.1 Structure of Executive Rewards

Reporting laws themselves have changed over time, generally becoming tighter, such as the Sarbanes Oxley Act (2002) in the United States and the CLERP 9 (2004) reforms to corporate law in Australia. This increases the amount of data but makes time comparisons more difficult.

Significant amounts of data on executive rewards are held by private organisations, typically business consulting firms that provide advice on executive remuneration. These include several of the world’s largest accounting firms, such as Deloitte’s, and specialist remuneration consultants such as Mercer and Towers Watson. These databases are not freely available for external review. Remuneration advisors are not subject to the same disclosure rules as auditors.

Despite this limitation private sources often hold the most comprehensive datasets available. For example, the 2008-09 Australian Productivity Commission inquiry into executive remuneration utilised data from Egan Associates. Data on executive rewards for public listed Australian and United States corporations is published by the financial press such as Australian Financial Review, Fortune Magazine, and Forbes Magazine. These are based on information supplied for stock exchange reporting requirements for public corporations. This leaves large gaps in data for executives below board level and for unlisted private corporations.

The second practical difficulty is in the nature of the data, especially its granularity. Executives comprise a small fraction of the workforce of a corporation, and so the number of sample points in an industry will be small, especially in Australia. The samples would be larger if we could consider the trends for rewards of all executive positions, but in the past the research focus was often on CEO pay, and time series data is often limited to them. If a comparison is to be made of executive rewards or corporate performance within a single industry, there may be less than a dozen comparators. This makes reaching statistically reliable conclusions difficult in the United States and impossible in Australia.

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44 Productivity Commission Inquiry into Executive Remuneration”, Australian Productivity Commission, Canberra, Australia, 4 January 2010. Figure 7, Page 26.
Overall then, despite large and growing volumes of data on executive rewards, there is a
dearth of accessible databases reported through peer-reviewed processes. Compared to
other areas of social science research there is no central agency with agreed standards
and definitions for executive reward data. Accounting conventions and corporate reporting
requirements vary between jurisdictions and over time. This has been highlighted by
Jensen and Murphy (1990) in the United States, and the Australian Productivity
Commission in Australia\textsuperscript{46}. There is enormous scope for disagreement in empirical
studies. The answer to questions such as “are executive rewards rising faster than
corporate profits?” can vary depending on the database used.

For these reasons only publicly available data sources have been used for my own
analysis. Wherever possible, data published by government bodies such as the Australian
Productivity Commission, US Federal Reserve and OECD have been used. Where private
sources of data have been required, peer-reviewed publications have been used to source
it, and preference has been given to databases maintained over longer periods of time. I
will identify where data constrains our ability to reach strong conclusions.

\section{2.3 Trends in Executive Rewards}

\subsection{2.3.1 Australia}

An extensive review of trends in executive rewards was recently published by the
Australian Productivity Commission (APC) in its Inquiry into Executive Remuneration in
Australia\textsuperscript{47}. This examined trends in total executive rewards, including pay and other
bonuses, in the past two decades, from 1993 to 2009. It also reviewed previous
publications reporting on executive reward trends back to the early 1980s. Although
consistent data sets are lacking for the reasons discussed previously, there is an
unmistakeable rising trend in total rewards to executives. These rose up to 300\% during
this period, reaching a peak in 2007, then falling in the wake of the financial crisis of 2008-
09. This trend is shown for Australian CEO pay from a range of databases at Australia’s
largest 50 to 100 firms in Figure 2.2.

\textsuperscript{46} Michael C. Jensen, and Kevin J. Murphy, “Performance Pay and Top-Management Incentives”,

\textsuperscript{47} Australian Productivity Commission, “Productivity Commission Inquiry into Executive
Remuneration”, Canberra, Australia, 4 January 2010. See Chapter 3 and Appendix D for data on
executive reward trends.
Within this overall trend of rapid growth, a number of related trends are apparent. The ratio of CEO rewards to other executive rewards remained constant, indicating that trends in CEO rewards are representative of overall trends in executive rewards. The growth trend in executive rewards was much faster than inflation and growth in other worker’s wages. It closely matched the growth trend in stock market valuations during this period, which was dramatic.

There was a shift during this period from executive reward packages that mainly consisted of salary, to rewards packages that comprised a large component of performance bonuses, usually linked to share prices. This made executives during this period beneficiaries of an enormous personal financial windfall. Their own incomes increased correspondingly as share prices rose. A comparison of Australian CEO rewards and ASX 200 share market capitalisation over this period is shown in Figure 2.3.
Figure 2.3  Australian CEO Rewards Compared to ASX 200 Index

The distribution of executive rewards was highly skewed. Growth in rewards was much higher at large corporations than for executives and CEOs of smaller companies. Executive rewards had grown into the millions at Australia’s 100 largest corporations by 2008, whereas the average for executives at Australia’s 2000 public companies was several hundred thousand dollars per annum. This corresponded to executives earning 110 times average income at the largest 20 companies, compared with four times the average income for the smaller half of the sample. Executive rewards tend to be proportional to the value of the corporation, not its profit or return to shareholders. This suggests that the executives at large companies had much greater ability to extract large performance bonuses than at small firms.

Executive rewards in Australia were comparable with those of executives at similar sized corporations in other western countries. Generally, executive rewards in the United States and United Kingdom were significantly larger than for similar sized corporations in other countries. Executive rewards in Australian corporations were more comparable to those at similar sized corporations in European countries. A comparison of international CEO rewards in 2008 is shown in Figure 2.4.

49 APC Inquiry (2010), Figure 6, Page 23.
Figure 2.4 International CEO Total Rewards in 2008 ($M AUS)\textsuperscript{50}

These findings confirmed earlier work by Shields\textsuperscript{51} and others. In general, over the past two decades executive rewards have risen rapidly in Australia, though not as rapidly as in the United States or the United Kingdom. Executive rewards rose faster than average wages, inflation, corporate earnings and returns to shareholders. They more closely matched increases in share prices. These share price increases were across the board, and related to increased retirement savings via share markets. Hence Australian executives were in the fortunate position that their incomes became closely linked to share prices, precisely at the time when the latter increased dramatically.

2.3.2 United States
The situation in the United States is more complex. More data is available over a longer time period than in Australia. Conversely there has been no independent inquiry into executive rewards to consistently evaluate all the data. The government data source is US Bureau of Labor income surveys. For chief executives this data is for 300,000 persons self-reporting as chief executives, whether they own their own business, or are the CEO of a major corporation. The income data does not include bonuses. The average income listed for CEOs was $167,000 US as of 2009\textsuperscript{52}. This is far less than CEO incomes reported to stock exchanges.

\textsuperscript{50} APC Inquiry (2010), Figure 4
Piketty and Saez\textsuperscript{53} have undertaken an extensive study of incomes in the United States as part of their research into income inequality. Their data includes executive incomes, based on annual compensation surveys by Forbes Magazine for CEOs of the top 500 corporations. Some critics have argued against their use of IRS data including capital gains. I do not consider that criticism significant and in any case, as their analysis has used consistent datasets, I consider it adequate for this purpose to establish trends in executive rewards.

Real growth in US executive rewards has been occurring since the 1970s according to Piketty and Saez. Like the Australian data, it has shown a more rapid rise in executive rewards from the 1990s onwards. A graph of average CEO rewards for top 500 firms, together with average wages, is shown in Figure 2.5 (all incomes are converted to 1999 dollars).

![Graph: US CEO Pay Versus Average Wages 1970 – 2003\textsuperscript{54}](image)

**Figure 2.5** US CEO Pay Versus Average Wages 1970 – 2003\textsuperscript{54}

The quantum of growth in US executive rewards is much greater than in Australia, reaching tens of millions of dollars per annum for CEOs by the middle of the decade. Total compensation for CEOs at major US corporations equalled 275 times average wages by


2007. The growth in rewards for other executives was not as high as for CEOs, but was comparable in pattern. The resulting ratio of US executive rewards to average wages is much higher than in Australia, exceeding 167 times average wages by 2003. US executives are now paid six times more than their peers of the early 1980s in real terms. In this respect the executive labour market has grown more rapidly in the United States than in Australia.

The primary reason for the dramatic rise in US executive rewards during this period was the increase in performance-based bonus payments to executives. From the 1980s onwards, performance based share options had tended to be paid in addition to base salaries. Performance bonuses now represent up to ten times the base salary for US executives. As share values grew in the 1990s this greatly increased executive rewards. This effect is illustrated in Figure 2.6, which compares average pay for US production workers to average CEO pay from 1970 to 1996. Executive pay is shown with performance bonuses (red line) and without (blue line). The difference demonstrates the increase in bonuses during the 1990s.

![Figure 2.6 Ratio of CEO Pay to Worker Pay 1970-1996](image)

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In 2002 the Sarbanes-Oxley Act was introduced in the United States to force more complete disclosure of all forms of executive rewards. It was hoped that this would increase transparency and reduce the rate of increase in executive rewards. However the latter objective has not been realised, with executive rewards continuing to rise in the following decade. They reached a peak in 2007 before falling 3.4% in 2008 and 0.9% in 2009\textsuperscript{58} to an average of $7 million US. Declines in US executive rewards during the financial crisis were less than in Australia, despite the fact that the crisis has been far more severe in the United States than in Australia. This decline proved only temporary. In 2010 CEO salaries of Fortune 500 corporations rose 12% in the United States, and exceeded their 2007 levels in the finance industry\textsuperscript{59}.

2.4 Executive Rewards and Performance – Corporate Level

We have seen that executive rewards have been increasing and the degree of inequality with other incomes has been increasing in Australia and especially the United States. I will now consider the return on executive rewards for shareholders, by comparing executive rewards to corporate performance. This will partly answer the financial question of whether it has been a rational investment of shareholder funds to pay increased levels of salary to corporate executives. Following this I will consider executive rewards and risk for shareholders, which will complete the financial assessment of executive rewards and performance.

2.4.1 Australian Evidence

The APC Inquiry (2010) considered the relationship between executive rewards and corporate performance in Australia. Defining corporate performance is a complex question. There may be many non-financial measures of performance not reported in markets, but which are important to measuring the effectiveness of an individual executive. Examples include staff turnover, safety, and regulatory compliance. The APC Inquiry used the ASX200 Accumulation Index to measure financial performance. This includes share dividends and capital (share price) growth for the top 200 companies, giving total financial returns to shareholders. Statistical comparisons were then made between executive salary and corporate performance.

\textsuperscript{58} Joann S. Lublin, “CEOs See Pay Fall Again.” \textit{Wall Street Journal}, April 1, 2010.

From the APC inquiry data, overall growth in Australian executive rewards in the period 1993 – 2008 was found to closely match growth in the ASX200 accumulation index. The correlation between the ASX200 accumulation index and average CEO rewards was reported by the APC to be very close, with a correlation coefficient of 0.88 for the top 50 corporations, and 0.83 for the top 200 corporations. No test correlations with other variables were reported. No measures of statistical significance were reported, although as this result is for the complete ASX200 dataset, it is presumed to be significant. This suggests that executive rewards are closely related to financial performance at the aggregate level in Australia, assuming the ASX200 accumulation index is a reliable indicator of performance. However, in the absence of any testing against independent variables, this does not constitute proof of a causal relationship.

The situation changes for the worse when the analysis is undertaken at the individual corporation level. Analysis at this level is difficult, as executives may leave a firm during the analysis period, and there is uncertainty over how to treat bonuses that may be received (vested) years after they are earned. Conclusions of different researchers have varied. Doucouliagos, Haman and Askary (2007), Merhebi et al (2006) and O’Neill and Iob (1999) all concluded that there is a positive correlation between Australian corporate performance and executive rewards. Conversely Izan, Sidhu and Taylor (1998), Shields (2005) and Capezio (2008) all concluded that there was not a statistically significant relationship, with Shields concluding that any relationship that was present was negative.

The APC inquiry compared CEO rewards with three measures of corporate performance – total shareholder return (dividends paid to shareholders plus growth in share capital value), profit growth and return on equity (share dividends as a percentage of share value). Total shareholder returns would have been influenced by the rising overall share market in this time period, due to their including share prices in the measure.

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60 APC Inquiry (2010), Page 73.
Findings were mixed with positive correlations between executive rewards and profit growth and return on equity, but negative correlations between executive rewards and total shareholder returns. Correlation coefficients were low ($R^2 = 0.1$ to $0.46$), suggesting that at best these variables explained less than half of the variation in executive rewards. Again no tests against independent variables were reported. Also correlations varied depending on whether the relationship was measured in the short term or the long term, with short term results highly variable depending on share-price volatility. Overall then, the Australian executive labour market appears to be reasonably correlated with corporate performance at the macro level, but not at the micro level (individual firms).

2.4.2 United States Evidence

It is possible to reach more definite conclusions on the relationship between executive rewards and corporate performance in the United States. This is due to the availability of much longer time-series databases, and the larger number of corporations enabling more robust sample sizes to be used. Interestingly, the answer has varied considerably over time. There have been many studies into this issue, but I will confine discussions to those most commonly cited.

Studies into the relationship between executive rewards and corporate performance in the United States up to the 1980s had found that there was no relationship between them. The data for these early studies was drawn from the late 1970s and early 1980s, when in real terms US executive rewards were ten times less than for the decade post 2000. Even so, researchers then found that the highest rewards for executives were correlated with corporation size, not corporate performance as measured by profitability and return to shareholders.

This view was challenged by Jensen and Murphy in the 1980s. They sought to measure corporate performance by total return to shareholders, including change in share

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price and dividends to shareholders, rather than corporate profits. This shift implicitly assumes Fama’s efficient market hypothesis\textsuperscript{70}, whereby share markets would accurately price shares based on a corporation’s performance. I will discuss these assumptions further later. Using this approach and tracking individual executives across firms, Murphy found a positive but weak correlation between executive rewards and performance. The correlation coefficient quoted ($R^2 = 0.312$ for “cross sectional” data)\textsuperscript{71} was low. A higher correlation was achieved in the long term ($R^2 = 0.880$) by comparing executive salary against the share index. This relationship was also reported to be statistically significant. Comparative tests of correlations against other executive position incomes were reported as dummy variables. No test of the predictive accuracy of the model was made or scatter plots reported.

Aside from the very low degree of explanatory power demonstrated in Murphy’s analysis, I consider the methodological approach very problematic. Comparing executive salary against share price assumes both that the executives were responsible for the corporation’s performance and the share price accurately reflected that performance. It also means that results were influenced by the overall rising trend in share prices. The much stronger correlation in the long term may have been due to that effect.

No attempt was made to test correlations against alternative causes. The process of testing a range of measures of corporate performance against a range of measures of executive income (salary, bonuses, share options and total income) hints at searching for confirming evidence, rather than testing whether the hypothesis was falsifiable. Finally, I consider that the statistical significance Murphy reported was likely to be an artefact of the large number of data points analysed (data on 461 executives for 17 years) combined with the inclusion of share prices, rather than any inherent reliability in the relationship. To clarify the point, nothing in Murphy’s analysis disproves an alternative hypothesis that executive salary was a function of corporation size as measured by share price, which was the finding of previous analysis by Ciscel and Carrol (1980) and others.


\textsuperscript{71} Kevin J. Murphy (1985), page 30.
A later study by Jensen and Murphy (1990)\textsuperscript{72} found that the correlation was more significant if measured between relative changes in CEO wealth and shareholder wealth (share price) rather than absolute performance as measured by the total of share price and dividends. This established the so-called “Jensen-Murphy Statistic” that CEO wealth increased by $3.25 for every $1000 increase in shareholder wealth. This enabled a numerical value of performance incentives for executives to be quantified. The relationship between observed executive rewards and corporate performance was reported as statistically significant but the correlation coefficient (R\textsuperscript{2}=0.0144)\textsuperscript{73} was very low. In my view this correlation is so small as to disprove that a relationship existed, and it should have been grounds for Jensen and Murphy to abandon their hypothesis at this point.

Murphy (1999)\textsuperscript{74} did further analysis of the corresponding data for the subsequent decade. The “sensitivity” of CEO pay to shareholder wealth had increased, meaning that CEO wealth now increased by $4.36 to $7.69 (average $6.03) for every $1000 increase in shareholder wealth, which Murphy regarded as evidence of increasing alignment of interests. The correlation coefficients measuring the strength of the relationship between US executive rewards and corporate performance defined in this manner were declining, even relative to the low levels observed in the 1980s. Depending on the industry measured, correlation coefficient (R\textsuperscript{2}) values varied from a low of 0.0034 to a high of 0.0078, about half the R\textsuperscript{2} values measured in the 1980s. Again, in my view claiming that such tiny correlations represented any form of statistical proof was false. Further, the continued change in the reported value of the pay-performance sensitivity statistic Jensen and Murphy had established meant that it had not demonstrated any predictive reliability. Linking executive salary and corporate performance together was therefore not statistically sound.

Further US research has been done by others since 2000. Daines, Nair and Kornhauser (2005)\textsuperscript{75} hypothesised that a continuation of good performance of a firm relative to its rivals or change in poor performance was due to CEO “skill”. They showed that there were

\textsuperscript{73} Michael C. Jensen and Kevin J. Murphy (1990), page 40.
instances when CEOs paid higher than average did display high “skill” (i.e. good relative performance) and other instances where CEOs paid higher than average did not display such skill. I consider that defining “high skill” for the CEO in this way made it a proxy for CEO performance, and this research still makes the assumption that correlation between CEO performance and corporate performance implies causation. Nevertheless in defining CEO skill by change in a corporation’s performance relative to its peers, this approach is more sophisticated than Jensen and Murphy’s. Daines, Nair and Kornhauser also tested for other possible causal variables, including aspects of corporate governance.

Overall Daines, Nair and Kornhauser found a low correlation ($R^2 = 0.32$) between CEO pay and skill (firm’s relative performance). They found that highly paid CEOs displayed high skill in small firms, when the pay was performance based, and when there was a single large shareholder. Where any one of these factors was absent high pay did not guarantee a highly skilled CEO. This suggests that it is possible that high CEO pay may be rational for shareholders in these cases of exceptional performance. Conversely, it shows that high CEO pay does not in itself guarantee high performance, and other governance factors are more likely causes.

Bebchuk and Grinstein (2005)\(^76\) analysed CEO and top five executive pay for all S&P1500 (largest 1500) firms in the United States from 1993 to 2003. They compared CEO and executive pay to a range of measures of corporate performance, including size and sales, profit, dividends, ROA (return on assets or ratio of income to asset value) and stock (share) price. Statistically significant correlations were obtained between executive pay and all the variables except ROA. However overall, changes in firm performance and size could only explain 66% of the 166% increase in executive pay that occurred in this period. That is, an overall rising trend in executive pay was occurring in which only a minority of the rise could be linked to measures of corporate performance. The correlation coefficients for Bebchuk and Grinstein’s model was 0.56 for CEOs and 0.74 for top five executives, much higher than Jensen and Murphy had achieved with most of their analyses.

In my view Bebchuk and Grinstein’s analysis gives further weight to the conclusion that executive rewards in the United States are not closely correlated to corporate

Any relationship that does exist is small and, while it may be statistically significant over a large sample, this is merely evidence that executive rewards and corporate performance are both auto-correlated with other factors, such as firm size and the overall rising trend in share market prices.

Overall, the empirical studies indicate that, assuming differences in comparative performance between firms are due to the executive, the salaries paid to executives in the United States are less closely linked to corporate performance than in Australia. That is, higher rewards for US executives are not primarily linked to corporate performance, but to other factors, such as (weaknesses in) corporate governance. Highly paid executives have achieved comparatively better corporate performance in some cases, but these are not the majority, and those outcomes do not occur unless corporate governance arrangements are also sound.

This lack of a strong link between executive salary and corporate performance has now been the case in the United States for more than three decades. The problem appears to have worsened as corporate rewards grew rapidly in the 1990s. The United States executive labour market is both more expensive than the Australian executive labour market, and less linked to corporate performance, at both the macro level and at the level of individual corporations. High executive salaries appear to represent a poor investment of shareholder’s funds in this context. Popular criticism of the level of executive rewards in the United States is therefore justified from a financial perspective.\(^77\)

### 2.4.3 Evidence on Executive Influence – Corporate Performance Studies

A major criticism of empirical analysis into the relationship between executive rewards and corporate performance is that it assumes cause and effect. That is, since the studies only consider the relationships between executive rewards and corporate performance, and not relationships between corporate performance and other possible causes, they effectively assume that executives are the cause of corporate performance. This is assuming precisely the point which is trying to be proven. This leaves the question of to what degree executives do influence corporate performance unanswered.

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\(^77\) Even some business leaders have voiced concern, notably US Federal Reserve Bank President William McDonough in a speech on September 11, 2002, who described United States CEOs as "terribly overpaid".
In reality a CEO’s ability to influence corporate performance will vary depending on their degree of control over the organization. Adams, Almeida and Ferreira (2005)\textsuperscript{78} have shown that firms with structures giving greater power to the CEO have more variable performance than other firms, both for better or worse. This suggests that the CEO role is influential. However if we wish to use performance measures to define executive rewards, it would be logical to quantify the degree to which it is the determining factor.

Wasserman, Anand and Nohria (2001)\textsuperscript{79} analysed differential corporate performance in each US industry group. They found that, assuming CEOs were responsible for the differential performance change between firms in the same industry that occurred during their period of control, their influence was at best 21\% of performance improvements (in the Communications Equipment industry) and at worst 2\% of performance improvements (in the meat products industry). In this way Wasserman concluded that on average 14\% of the gains in performance made by US corporations could be linked to decisions made by their executives. In my view this claim is still vulnerable to the criticism that it assumes causation between CEO performance and corporate performance, only over a narrower range of criteria. The conclusions on the degree of influence of CEOs over corporate performance are therefore a best case, assuming this causation is true.

Assuming for purposes of this analysis that this is the case, then rational shareholders who paid executives solely on the basis of performance would not wish the quantum of executive rewards to rise above this proportion of corporate profits. That is, rational shareholders would not wish the quantum of executive rewards to rise above 2\% to 21\% of profits, depending on industry. Bebchuk and Grinstein showed that by 2003, average rewards for the CEO and top five executives (not counting other lower level executives) were already averaging 10\% of corporate net income (of which profits would be a proportion)\textsuperscript{80}. If Wasserman, Anand and Nohria are correct, some of these shareholders would appear to be paying executives more than any additional return they are likely to generate for their corporation.


\textsuperscript{80} Lucian Bebchuk, and Yaniv Grinstein, (2005), Page 297.
Other likely causes of changes in share prices can be identified during the period that was analysed. In *The Roaring Nineties (2003)*\(^{81}\) Joseph Stiglitz identified several external causes for the boom in share market prices that occurred during the 1990s. These included increased globalisation of trade, market deregulation, greatly increased investment of retirement savings into share markets, and even accounting fraud. This trend of increased share market prices greatly increased the wealth of existing shareholders. In parallel, this period saw the wide use of performance bonuses paid to executives in the form of share options. This meant that the value of executive wealth would inevitably rise as the value of their share options rose with the market.

### 2.5 Corporate Risk and Executive Reward

A major criticism of the previous empirical analyses of executive rewards and corporate performance is that most only looked at narrow definitions of corporate performance. There was no reported consideration of whether effects on other measures of corporate performance were associated with the level or type of executive rewards. One economic factor not considered is the impact of performance bonuses on corporate risk taking. One of the potential consequences of large performance components in executive rewards is that they may encourage executives to adopt high-risk corporate strategies, in order to achieve their bonuses. If so, this may be to the long-term harm of shareholders. This would represent a form of moral hazard as defined by Arrow\(^{82}\), where the moral hazard occurs because the executive takes the risk but the potential loss accrues to the shareholder.

In the long term risks should be apparent in the financial outcome for a corporation. In the short term it may be difficult to determine whether a corporation’s results have been achieved through effective performance or taking on excessive risks. The occurrence of catastrophic risks that may cause the corporation to become insolvent should be evident in statistics for corporate collapse. Corporate bankruptcies are usually infrequent for large corporations and so it is difficult to obtain a statistically significant sample. However the global financial crisis of 2008 – 2009 provides a unique opportunity to study this relationship, due to the large number of corporate collapses that occurred in this period.

To test whether there is any relationship between high executive pay and risk to corporations a comparison has been made between executive rewards immediately prior to the financial crisis and subsequent corporate performance in Australia and the United States. Executive rewards have been measured by CEO total rewards in 2006 and two tests have been made:

(1) test if there is a higher than average occurrence of subsequent failure in corporations with highly paid CEOs in 2006, and

(2) test if major corporate collapses that occurred in 2007-08 involved CEOs that had previously been in the highest paid group in 2006. (This previous period was chosen as many of the CEO’s that were responsible for corporations that collapsed in 2008 left office during that year.)

2.5.1 Australian Data

An analysis has been carried out of Australian CEOs, their pay and risk of corporate failure. In Australia’s case the 2008-09 global recession did not lead to a local recession but a lack of credit in early 2009 saw some failures in corporations with high debt. Three large non-bank investment firms (ABC Learning, Allco Finance, and Babcock and Brown) and 27 smaller corporations collapsed in 2008. The large collapses, their CEO and pre-collapse (2006/07 or 2007/08) income are recorded in Table 2.1.

<table>
<thead>
<tr>
<th>Corporation</th>
<th>CEO</th>
<th>Firm Rank</th>
<th>Pay Rank</th>
<th>2006/07 Pay</th>
<th>2008/09 Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC Learning</td>
<td>E Groves</td>
<td>NA</td>
<td>158</td>
<td>$1.6M</td>
<td>Bankruptcy</td>
</tr>
<tr>
<td>Allco Financial</td>
<td>D Coe*</td>
<td>NA</td>
<td>130(3)</td>
<td>$2M($26M)</td>
<td>Bankruptcy</td>
</tr>
<tr>
<td>Babcock&amp;Brown</td>
<td>P Green</td>
<td>100</td>
<td>2</td>
<td>$17M</td>
<td>Bankruptcy</td>
</tr>
</tbody>
</table>

* Paid $26M (3rd) in 2007/08. Source: Australian Financial Review

The number of major corporate collapses in Australia in 2008 is too small to develop reliable statistics for them. Nevertheless, the previous pay for CEOs of two of the three collapsed companies was significantly higher than, the average total pay for CEOs of Australian top 100 corporations in 2005/06 and 2006/07 ($5.5 million). In all three cases,

the CEO pay was ranked higher compared to peers of similar sized corporations. High CEO pay relative to size of company and CEO pay at market peers appears to be a marker for increased likelihood of collapse in Australia, although a reliable correlation cannot be established.

The reverse relationship can also be tested. The ten highest paid Australian CEOs in 2006, their corporation and its subsequent performance are shown in Table 2.2. Only one of them was CEO of a company that subsequently collapsed. There does not appear to be a relationship between high CEO pay and risk of collapse in Australia.

Table 2.2   Highest Paid Australian CEOs and Subsequent Results

<table>
<thead>
<tr>
<th>Rank</th>
<th>CEO</th>
<th>2006 Pay</th>
<th>Corporation</th>
<th>2008 Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>R Murdoch</td>
<td>$38M US</td>
<td>Newscorp</td>
<td>Profitable</td>
</tr>
<tr>
<td>2</td>
<td>A Moss</td>
<td>$34M</td>
<td>Macquarie</td>
<td>Profitable*</td>
</tr>
<tr>
<td>3</td>
<td>P Green</td>
<td>$17M</td>
<td>Babcock&amp;Brown</td>
<td>Bankrupt</td>
</tr>
<tr>
<td>4</td>
<td>G Gailey</td>
<td>$17M</td>
<td>Zinifex</td>
<td>Profitable</td>
</tr>
<tr>
<td>5</td>
<td>F Lowy</td>
<td>$14M</td>
<td>Westfield</td>
<td>Profitable</td>
</tr>
<tr>
<td>6</td>
<td>W King</td>
<td>$14M</td>
<td>Leighton</td>
<td>Profitable</td>
</tr>
<tr>
<td>7</td>
<td>P Little</td>
<td>$13M</td>
<td>Toll Holdings</td>
<td>Profitable</td>
</tr>
<tr>
<td>8</td>
<td>D Turner</td>
<td>$13M</td>
<td>Brambles</td>
<td>Profitable</td>
</tr>
<tr>
<td>9</td>
<td>G Clarke</td>
<td>$12M</td>
<td>Lend Lease</td>
<td>Profitable</td>
</tr>
<tr>
<td>10</td>
<td>S Trujillo</td>
<td>$12M</td>
<td>Telstra</td>
<td>Profitable*</td>
</tr>
</tbody>
</table>

* Remained profitable although profits and share price fell heavily.

Source: Australian Financial Review\(^{85}\).

2.5.2 United States Data

There were a large number of corporate failures in the United States in 2007/08, especially in the finance industry. Some 25 large banks became bankrupt, and additional banks became insolvent and required assistance to prevent bankruptcy. Most of the larger failed firms were either taken over, forced to sell in a merger, or “bailed-out” with the assistance of Federal government financial support. The question arises as to whether there was any pattern in prior executive rewards for the failed firms. The largest failed firms (within the

S&P 500), their 2008 ranking based on industry returns to shareholders\textsuperscript{86} and 2006 CEO pay and pay ranking\textsuperscript{87} (within the S&P 500) are listed in Table 2.3.

<table>
<thead>
<tr>
<th>Corporation</th>
<th>2006 CEO</th>
<th>Firm Rank</th>
<th>2006 CEO Pay Rank</th>
<th>Pay</th>
<th>2008 Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lehman Bros</td>
<td>R. Fuld</td>
<td>106</td>
<td>5</td>
<td>$122M</td>
<td>Bankruptcy</td>
</tr>
<tr>
<td>Countrywide</td>
<td>A. Mozilo</td>
<td>90</td>
<td>10</td>
<td>$69M</td>
<td>Forced Sale</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>J. Mack</td>
<td>30</td>
<td>32</td>
<td>$31M</td>
<td>Govt bailout</td>
</tr>
<tr>
<td>Bear Stearns</td>
<td>J. Cayne</td>
<td>202</td>
<td>36</td>
<td>$28M</td>
<td>90% Loss</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>S. O’Neal</td>
<td>34</td>
<td>49</td>
<td>$22M</td>
<td>60% loss</td>
</tr>
<tr>
<td>Citigroup</td>
<td>C. Prince</td>
<td>8</td>
<td>59</td>
<td>$20M</td>
<td>Govt bailout</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>H. Paulson</td>
<td>41</td>
<td>81</td>
<td>$16M</td>
<td>Govt bailout</td>
</tr>
<tr>
<td>IndyMac</td>
<td>M. Perry</td>
<td>722</td>
<td>84</td>
<td>$16M</td>
<td>Bankruptcy</td>
</tr>
<tr>
<td>Washington Mtl</td>
<td>K. Killinger</td>
<td>99</td>
<td>99</td>
<td>$14M</td>
<td>100% loss</td>
</tr>
<tr>
<td>Wachovia</td>
<td>G. Thompson</td>
<td>57</td>
<td>112</td>
<td>$13M</td>
<td>65% loss</td>
</tr>
<tr>
<td>AIG</td>
<td>M. Sullivan</td>
<td>9</td>
<td>130</td>
<td>$11M</td>
<td>Govt takeover</td>
</tr>
<tr>
<td>Fannie Mae</td>
<td>D. Mudd</td>
<td>53</td>
<td>202</td>
<td>$9M</td>
<td>Govt takeover</td>
</tr>
<tr>
<td>Freddie Mac</td>
<td>R. Syron</td>
<td>50</td>
<td>213</td>
<td>$8M</td>
<td>Govt takeover</td>
</tr>
<tr>
<td>Bank America</td>
<td>K. Lewis</td>
<td>12</td>
<td>85</td>
<td>$7M</td>
<td>Govt bailout</td>
</tr>
</tbody>
</table>

Source: Data compiled from Forbes magazine

There is no obvious pattern in the CEO pay rates listed for corporations in Table 2.3. There were failed financial corporations with CEOs paid much more highly than the firm’s financial ranking would indicate (e.g. Countrywide, Lehman Brothers) and some with CEO’s with lower ranked pay (E.g. Citi Group, Bank America). Risk of corporate failure is not automatically associated with higher than average executive pay.

This is not a surprising result, given that US executive pay is related to corporation size more than performance as we have seen. If executive pay were related to corporate performance, we would have expected it to be inversely related to risk of corporate failure. This assumes that high-performing corporations are less likely to fail. If high performing

\textsuperscript{86} Scott DeCarlo and Brian Zajac “Special Report: CEO Compensation”, Forbes Magazine, 22 April 2009.

corporations were more likely to fail, then the performance would need to be factored down to reflect the increased risk of failure in assessing value to shareholders.

The second part of the analysis is to test whether very high CEO pay (irrespective of firm size ranking) is associated with increased risk of failure. The 10 highest paid US CEO’s for 2006, their corporation and its performance outcome for 2008 are shown in Table 2.4. Note that CEO pay listed is total remuneration including salary, bonuses and stock options.

### Table 2.4 Highest Paid US CEOs and Subsequent Results

<table>
<thead>
<tr>
<th>Rank</th>
<th>CEO</th>
<th>2006 Pay</th>
<th>Corporation</th>
<th>2008 Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>R Fairbank</td>
<td>$249M</td>
<td>Capital One</td>
<td>Govt bailout</td>
</tr>
<tr>
<td>2</td>
<td>T Semel</td>
<td>$230M</td>
<td>Yahoo</td>
<td>Profitable</td>
</tr>
<tr>
<td>3</td>
<td>H Silverman</td>
<td>$140M</td>
<td>Cendant</td>
<td>Broken up</td>
</tr>
<tr>
<td>4</td>
<td>B Karatz</td>
<td>$136M</td>
<td>KB Home</td>
<td>Profitable</td>
</tr>
<tr>
<td>5</td>
<td>R Fuld</td>
<td>$123M</td>
<td>Lehman Bro.</td>
<td>Bankrupt</td>
</tr>
<tr>
<td>6</td>
<td>R Irani</td>
<td>$81M</td>
<td>Occidental Oil</td>
<td>Profitable</td>
</tr>
<tr>
<td>7</td>
<td>L Ellison</td>
<td>$75M</td>
<td>Oracle</td>
<td>Profitable</td>
</tr>
<tr>
<td>8</td>
<td>J Thompson</td>
<td>$72M</td>
<td>Symantec</td>
<td>Profitable</td>
</tr>
<tr>
<td>9</td>
<td>E Crawford</td>
<td>$70M</td>
<td>Caremark Rx</td>
<td>Profitable</td>
</tr>
<tr>
<td>10</td>
<td>A Mozilo</td>
<td>$69M</td>
<td>Countrywide</td>
<td>Bankrupt</td>
</tr>
</tbody>
</table>

Source: Data from compiled Forbes magazine

Looking at CEO’s with higher than average pay, the risk of corporate failure does appear to be increased. From Table 2.4, of the top ten highest paid US CEOs in 2006, four of their ten corporations (40%) became insolvent or required government assistance in 2008. Of the corporations having the 100 highest paid CEOs in 2006, 11 (11%) became bankrupt or insolvent in 2008. Overall in 2008 a total of 13 corporations in the S&P 500 became bankrupt or insolvent, or 2.6%. Thus if the CEO of an S&P 500 corporation was in the top 20% of most highly paid CEOs, the risk of that corporation collapsing was quadrupled. It could be argued that this relationship is coincidental because most of the failed firms were finance corporations and these tend to have CEOs paid above the average and be more at risk from the financial crisis. Conversely, it was precisely the behaviour of finance corporations and their executives, motivated by attaining bonuses, which was one of the causes of the crisis.
Note that these relationships do not prove a causal link between executive salary and risk. Risks are by definition uncertain and executives making high-risk decisions do not necessarily cause insolvency, just as some companies may become insolvent despite low-risk strategies. Financial losses in 2007/08 were so large, particularly in United States markets, that they triggered a world-wide recession. As a result some corporations that had pursued low risk investments, such as savings banks, suffered large losses that in some cases led to their bankruptcy or need for government assistance. Hence not all failures were due to high-risk strategies on the part of the corporation that failed.

However some elements of the incentive-risk argument are clearly valid. There is a correlation between United States executives receiving very high rewards and the risk of corporate collapse. Causal mechanisms for this have been acknowledged already by those studying the causes of the crisis. Executive reward practices do not merit receiving all the blame for causing the 2008 financial crisis but clearly it is appropriate to apportion some. This will be discussed further in Chapter Five.

2.6 Executive Rewards and Wider Economic Performance

The correlation studies between executive rewards and corporate performance have dominated the business and accounting literature on executive rewards for the past three decades. However, as we have seen the results are inconclusive at best, and dependent on definitions of corporate performance. Moreover they do not answer the broader social question of whether or not a given level of executive rewards is rational for the society. To answer this, we need to investigate the economic question of whether there is any evidence that increased executive rewards are associated with benefits to the society.

That is, we seek to know if the evidence indicates that the level of executive salary influences the well being of the society. For high levels of reward to be justified, it would be desirable to demonstrate that countries with comparatively high levels of executive reward had superior welfare outcomes to comparable countries with lower levels of executive reward. This may be achieved by comparing levels of executive rewards with

social welfare between countries, to see whether there is any pattern between countries with comparatively higher or lower executive rewards.

Benefits to society will be proxied by statistics for economic growth available from the OECD\textsuperscript{89} and the World Bank\textsuperscript{90}. Arguably a more complete measure such as the UN human development index would be preferred as a comparator. However measures such as these incorporate many non-monetary variables that are not influenced by the actions of executives or the private sector generally and hence may give rise to spurious relationships. The claim of efficiency or incentive benefits from higher executive pay is narrowly economic and so it will be judged from the viewpoint of economic data.

At the national level it is possible to compare executive rewards as represented by CEO pay against economic growth statistics. This has been done for selected countries where data up to 2006/07\textsuperscript{91} is available for CEO pay, average income, GDP growth rate and share market index returns. The data for average CEO pay has also been divided by average income to obtain an index representing how high CEO pay is relative to average pay for each country. Similarly GDP Growth rates have been divided by population growth to obtain GDP growth rates per capita.

Note that a correlation between national income (per capita GDP) and executive income is not shown. It is not considered reliable proof of a causal relationship between executive reward and current economic performance. Each countries GDP and the wealth or capital that produces it has evolved over a substantial historical period. It is more related to past growth performance than current. If economic efficiency is related to executive reward, then it should be possible to demonstrate a link between current executive reward and current rates of economic growth.


\textsuperscript{90} World Bank Open Data Initiative, accessed from \url{http://econ.worldbank.org} on 4 July 2010.

\textsuperscript{91} Due to differences in definitions of financial years and delays in some countries reporting, 2006/07 is the latest year for which comparable statistics are available at the time of writing. This excludes the effects of the financial crisis of 2008-09.
2.6.1 CEO Pay and Average Incomes

CEO pay as reported by the Economic Policy Institute is shown against OECD data for average incomes for 2005 in Figure 2.7. CEO pay is related to, and usually much larger than, average income. For subsequent graphs CEO pay has been reported as a multiple of average income.

![CEO Pay vs Average Wage](image)

**Figure 2.7 – CEO Pay compared to Average Income**

Regression Slope 12.3

Correlation Coefficient 0.296

The pay rate for US CEOs in Figure 2.7 appears to be an outlier. Removing the US data from the analysis is undesirable because it represents a quarter of the world’s economic activity. Comparative data is only available for 13 countries, and it would be preferable to keep the sample size as large as possible. Further, executive pay theories are widely applied in the United States and it seems appropriate to test whether the US economy has benefitted from them.

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National GDP growth rate per capita (OECD data) is compared with the CEO pay multiple (of average incomes) in Figure 2.8. When CEO pay is adjusted to a multiple of average incomes there is a very slight trend of rising GDP with rising CEO income multiple, however the effect is not significant. The low correlation coefficient indicates there is no obvious relationship apparent in the data. Conversely the economy with the highest paid CEOs (USA) had comparatively low growth in the analysis period.

Figure 2.8 – GDP Growth Rate compared to CEO Pay Multiple
Regression Slope  -2.23
Correlation Coefficient  -0.118

National GDP growth rate per capita (OECD data) is compared with absolute CEO pay in Figure 2.9. From this data GDP growth appears to be inversely related to raw CEO pay. That is, for higher CEO pay, the economic growth rate is slightly lower. In this case the correlation coefficient indicates the relationship is relatively consistent (-0.57). Again the United States is a clear outlier, although the same relationship holds even if it is excluded.
Figure 2.9 – GDP Growth Rate Per Capita compared to CEO Pay.

Regression Coefficient  \(-0.72 \times 10^6\)
Correlation Coefficient  \(-0.048\)

Overall the graphs in Figures 2.7, 2.8 and 2.9 demonstrate that there is no evidence that higher CEO pay results in higher economic growth. There is some evidence of the opposite although the sample size is too small to be conclusive. CEO pay rates in the United States appear as an outlier in all graphs.

2.6.2 CEO Pay and Share Returns

Proponents of high CEO pay might argue that performance is better measured by corporate returns, as national GDP growth is affected by many factors beyond the CEO’s control. Average share market returns over ten years (1996-2006) for listed corporations (OECD data) is compared with the CEO pay multiple (derived as in Figures 2.8 and 2.9) in Figure 2.10. Again there is no obvious relationship apparent in the data to indicate higher CEO pay leads to higher share index returns. There is a very slight negative relationship evident. The best performed share markets (Sweden, Canada, Australia) appear to be those where the multiple of CEO pay to average pay is medium to low. Performance of the share market with the lowest CEO pay multiple (Japan) is also poor.
In the same manner average share market returns over ten years (1996-2006) for listed corporations (OECD data) is compared with absolute CEO pay in Figure 2.11. This time the relationship is still negative but even weaker. No conclusive relationship is considered to exist between shareholder returns and CEO pay in reported countries.
In summary the evidence from both economic growth data and share market returns does not show any significant relationship with average CEO pay. Any relationships evident were extremely slight. The strongest evidence was for a slight negative relationship between relative CEO pay and share returns – the higher the ratio of CEO pay to average pay multiple, the lower the share returns. Larger sample sizes than those available may have given more conclusive results. In all cases, the levels of executive rewards in the United States appear to be an outlier, that cannot be justified on macroeconomic grounds.

This conclusion means that there is no evidence of any apparent economic benefit to a society from higher CEO pay. This is true whether the analysis is of CEO pay in absolute or comparative (multiple of average wages) terms. Hence the requirement to justify higher executive rewards identified in Chapter One has not been found.

2.7 Corporate Governance and Executive Rewards

One question that the quantum of executive rewards in Australia and the United States today raises, is whether it represents a failure of corporate governance. The cost of executive rewards now represents a significant cost to shareholders, with no evidence that
corresponding increases in corporate performance are being gained and some evidence that risks are being increased. This makes them a poor investment of shareholder funds. Normally, corporate governance regimes would seek to maximise returns on corporate investment, including executive rewards. The question then remains whether there is any correlation between executive rewards and measures of strong or weak corporate governance regimes.

A previous OECD research paper by Maher and Andersson\(^\text{93}\) compared firm performance to corporate governance regimes within each OECD country, rather than firm performance being related to executive rewards. Firm performance was found to be positively related to ownership concentration (firms with more dispersed ownership performed worse), size of shareholding and the corporate governance regimes that affected practices leading to those occurrences, such as mergers and acquisitions. Countries with weak corporate governance tended to be permissive of such takeovers, that might dilute share ownership and be correlated with poor performance.

Marques and Ghose\(^\text{94}\) have examined the relationship between corporate governance and CEO pay level in OECD countries. In particular they studied variation in the ratio of average pay to CEO pay, which varied widely. They concluded that the following factors were the practical determinants of CEO pay across firms and markets:

- Scale effect (the larger the industry/firm, the higher CEO pay)
- Relative endowment effect (if capital - labour ratio of the country was higher, CEO pay was higher)
- Rent seeking effect (inversely related to corporate governance)
- Greater dispersion in firm ownership lowers relative CEO pay

Marques and Ghose’s model gives a clear explanation of why US CEO pay is so much higher: it has large markets with large firms and weak corporate governance regulations.

### 2.8 Norms for Leader Rewards

One final empirical question that has not previously been considered for executive rewards is how they compare to rewards for other leadership positions. Acknowledging David

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Miller’s finding that social attitudes to desert varied with circumstances, we can compare the ratio of the leader’s income to the average income within a range of different occupations. We can then compare this ratio of leaders income to average group members’ income between the occupations. This gives us an indication of whether there is a consensus for what reward premium is considered reasonable for leadership positions.

In most cases leaders of groups receive rewards greater than the average for members of their group, but not dramatically so. In some cases it is difficult to compare reward of leaders in groups because only the highest incomes are reported, which may or may not be for leaders. The ratios of average to leading incomes in occupations in Australia and the United States for which data is readily available are shown in Table 2.5.

**Table 2.5  Ratio of Average to Leader Income by Occupation**

<table>
<thead>
<tr>
<th>Group</th>
<th>Data Year</th>
<th>Average Income</th>
<th>Leader Income</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australian (Rules)</td>
<td>2004</td>
<td>$211,000</td>
<td>$800,000</td>
<td>3.8</td>
</tr>
<tr>
<td>Footballers</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>US (Gridiron) Footballers</td>
<td>2004</td>
<td>$3,200,000US</td>
<td>$13,000,000US</td>
<td>4.1</td>
</tr>
<tr>
<td>Australian State/Fed.</td>
<td>2007</td>
<td>$57,000</td>
<td>$309,000</td>
<td>5.4</td>
</tr>
<tr>
<td>Public Servants</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United States Fed. Public</td>
<td>2005</td>
<td>$59,000US</td>
<td>$400,000US</td>
<td>6.8</td>
</tr>
<tr>
<td>Servants</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Australian Defence Force</td>
<td>2008</td>
<td>$57,000</td>
<td>$233,000</td>
<td>4.1</td>
</tr>
<tr>
<td>United States Defence</td>
<td>2008</td>
<td>$54,000US</td>
<td>$206,000US</td>
<td>3.8</td>
</tr>
<tr>
<td>Force</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Australian Universities</td>
<td>2006</td>
<td>$79,000</td>
<td>$474,000</td>
<td>6.0</td>
</tr>
<tr>
<td>United States Universities</td>
<td>2006</td>
<td>$77,000US</td>
<td>$427,000US</td>
<td>5.5</td>
</tr>
<tr>
<td>Australian Corporations</td>
<td>2007</td>
<td>$59,000</td>
<td>$2,100,000</td>
<td>36</td>
</tr>
<tr>
<td>United States Corporations</td>
<td>2008</td>
<td>$41,000US</td>
<td>$10,500,000US</td>
<td>256</td>
</tr>
</tbody>
</table>

Data Sources: ABS, Australian Public Service, AFL, NFL, US Census Bureau, Times Higher Education Supplement, US Defence Force; all reported for 2006/07.
From Table 2.5 there is a remarkable similarity in the ratio between average rewards for individuals in a group and the maximum rewards for high performers or leaders of the group across most fields. Political, public service, academic, sporting and military groups all tend to have leaders or star performers receiving incomes of 4 to 7 times the average income for members of their group.

The striking exception to these trends in relative pay is in private corporations, where leaders’ rewards are dozens or even hundreds of times the average income for other employees within the same firm. This conflicts sharply with distributions of income for all other groups on which data is available. The trend is not explained by the relative size of the groups being led. The largest organisations considered are public sector departments (especially the US defence forces), which are larger than any corporation, yet do not follow the same pattern of income distribution.

We cannot say that there is a social norm operating for income distribution between leaders and other members of groups precisely because the case of corporate executives is so anomalous. However from this evidence we can say that current ratios of executive rewards to average rewards do not match normal community practice in income distribution. Further, the absence of a norm does not mean that the majority of citizens would not like such a norm to exist. If it were not for the case of corporate executives, a norm for income premiums for leaders would appear to already exist in Australia and the United States.

2.9 Summary

In looking at empirical evidence we must always be cautious and remember that correlation between data does not imply causation. Applying normal scientific methods for falsifiability, it would be more appropriate to test that a theory is not contradicted by the available data, rather than to seek evidence confirming it. Therefore while we will examine links between executive salary and corporate and societal economic outcomes, any relationships found do not guarantee that a relationship exists between executive salary and corporate or societal benefits. However the reverse does not apply: evidence of the absence of any relationship would disprove that such a relationship exists. Ideally, if reliable relationships between executive salary and business or societal welfare exist, it should be possible to predict one from the other with future data.
The empirical evidence that is available indicates that both Australian and United States executive labour costs have been growing in real terms for over three decades. This is contrary to normal economic theories of labour markets, unless correspondingly increased returns to shareholders can be demonstrated. The growth in executive labour costs was especially pronounced during the 1990s. The shift towards performance bonuses issued as share options resulted in windfall gains to executives as the share market grew in that period. The growth has been greater in the United States, where the relative size of share bonuses is far higher than in Australia. Growth in executive reward levels has stabilised since the 2008 financial crisis, but it is too early to say whether this change is temporary or indicates a change in trend.

A comparison of executive rewards with corporate performance suggests that higher executive salaries generate marginal returns to shareholders in Australia, and negative returns to shareholders in the United States. A comparison of executive rewards with national economic performance suggests that the executive labour market generates negative returns to United States society, while the evidence is inconclusive for Australia. The data does not support accounting or economic arguments for high levels of executive reward at either the micro (corporate) level or the macro (societal) level.

The absence of strong correlations between executive salary and corporate or economic performance does not mean the question is undecided. It indicates that no economic justification for high executive rewards exists. There is no evidence that high executive reward acts as an effective incentive to increase corporate or national economic performance. Without such evidence, the justification on social benefit grounds fails.

In the absence of such evidence empirically based theories, that higher executive salary results in better corporate or societal economic performance, cannot be supported. I consider that past claims that such evidence did exist were flawed, using statistical analysis that was methodologically inappropriate, and based on relationships that were too weak to represent a reliable standard of proof. Those relationships also failed the empirical tests of falsifiability and predictive accuracy.

United States evidence suggests that high executive rewards are a marker for risk of corporate collapse. Australian evidence is not conclusive, but also shows a correlation
between executives paid above the average for their size of corporation and risk of subsequent collapse.

Stronger evidence exists that maximising efficiency and firm performance is achieved more through strong corporate governance than high executive salary. Hence high levels of executive salary in the United States appear to be better explained at the corporate level by weak corporate governance, rather than strong corporate performance.

The ratio of executive salary levels to average corporate salaries is much higher than the ratio of leaders salary to average salary in other occupations. The reward premium given to executives for leading corporations is outside the range of practice for other leadership positions within Australia and the United States.

We can therefore reach some definite conclusions regarding empirical evidence on executive salary in Australia and the United States. They cannot be justified by corporate financial benefits, societal economic benefits, or norms for rewarding leadership positions. They may induce increased risk of corporate failures. This begs the question of why increasing executive salaries have been awarded in both countries. The strongest evidence points towards weak corporate governance as the cause. The executive labour markets in Australia, and especially the United States, appears to have been dysfunctional for more than three decades.

Having failed to find an empirical justification for executive salary levels in Australia and especially the United States using financial and economic data, I will next begin a theoretical examination of the problem. I will start by developing a philosophical framework under which to consider executive rewards and what their appropriate levels should be. In the following chapters I will use this framework to assess the validity of current executive reward practices, and then to evaluate the economic arguments commonly used to justify them.
3 Desert, Contribution and Social Welfare

3.1 Overview of Desert and Contribution Theories

We have seen that the empirical evidence for the United States suggests that current executive reward levels are not linked to improved financial outcomes at either the micro (corporation and shareholder) or macro (societal) level. US data also suggests a potential for moral hazard with high executive rewards being associated with increased risk of corporate collapse. Australian data is inconclusive at both micro and macro levels, but does not support any link between higher executive rewards and financial performance. Therefore current high levels of executive rewards are not rational in Australia or the United States in an accounting or an economic sense.

The inadequacy of current financial and economic explanations of executive rewards does not in itself make them wrong. Many activities may be uneconomic but still valued within a society. Just as financial or economic justifications would not have been sufficient to legitimise executive reward levels, their absence does not automatically invalidate them. We can say that the levels of executive rewards in Australia and the United States are irrational and inefficient, and perhaps even harmful in the case of the United States, but whether or not they are wrong remains a normative question we have yet to resolve.

To answer this question we must return to the normative criteria as defined by David Miller in Principles of Social Justice (1999) 95, namely equality, need and desert. Current executive reward levels cannot be justified under criteria of equality or need, and so the relevant question is whether or not they may be justified on the basis of being deserved. We must define what is a reasonable basis for measuring the desert of executives and, based on those criteria, whether current reward levels are deserved.

This question is within the field of distributive justice and of desert theories in particular. Distributive justice is the study of normative principles used to evaluate the distribution of material benefits within a society. Desert theories are the particular category of distributive justice principles that take the form that a person deserves some reward X, based on some desert base Y that the person possesses. This conception of distributive justice for

rewards is the one most comparable to community views on justice identified by David Miller. I will use it to define a theoretical basis with which we can examine the question of what is a reasonable level of reward for corporate executives.

Other types of distributive justice theories exist. These include strict egalitarianism, difference principles such as John Rawl’s min-max rule\textsuperscript{96}, resource-based principles, welfare-based principles, and libertarian principles such as those espoused by Robert Nozick. I do not intend to canvass the relative advantages and disadvantages of these other theories in this thesis, other than to point out that none match the commonly held views of distributive justice as identified in western societies by David Miller (1999) and referred to in Chapter One. Therefore, for answering questions about whether executive rewards are justified in the context of ideas of social justice as understood in Australia and the United States, they are not the most appropriate theories to use.

This leaves desert theories as the strand of distributive justice theory most applicable to this inquiry. Desert theories were first defined by Feinberg in the context of legal justice\textsuperscript{97}, but are now commonly applied in distributive justice. In this application, individual desert is based on the involvement of the person in some productive activity that is being rewarded. Common desert theories all share the objective of raising the standard of living of persons in the society\textsuperscript{98}. Collectively this standard of living may be referred to as the social product. Only activity that is intended to increase the value of the social product is valued under these desert theories. Thus destructive activity, regardless of whether legal or how well carried out, would not deserve reward under desert theory.

Within modern desert theory there are three commonly considered classes of personal attributes or \textit{desert bases} used to define the extent to which a person deserves some reward. These are not mutually exclusive, although they are generally considered separately.

The first type of desert based theory is *effort* based desert, as defined by Sadurski\textsuperscript{99} and Milne\textsuperscript{100}. These theories assume that reward for an individual should be based on their degree of effort made towards the activity under consideration for reward. This follows the arguments of John Locke, who felt that every person deserved the products of their labour as a reward for their effort. Effort theories are vulnerable to the criticism that by rewarding effort rather than outcomes, they will not necessarily encourage the achieving of better social outcomes by motivating beneficial activities. Hence they may not lead to as great an increase in social product as desert theories generally entail. Aside from this concern, it seems inconceivable that current levels of executive rewards could be justified by the relative efforts of executives compared to the effort of other workers. This type of desert theory will not be considered further.

The second common type of desert based theory is *compensation* based desert as defined by Dick\textsuperscript{101} and Lamont\textsuperscript{102}. These theories assert that the reward to a person should be that appropriate to compensate them for the conditions and difficulties of their work. This may include the complexity of the work, risk or danger, the physical unpleasantness of the tasks or the work environment, the qualifications required and other opportunities foregone. Although not considered by David Miller (1999), this theory is consistent with the sorts of community attitudes to justice he identified\textsuperscript{103}. This theory can be applied to any occupation including the case of leaders of groups.

It would be difficult on compensation grounds to justify current executive reward levels, since working conditions are not especially onerous. There is no cost of foregone opportunities since the reward level is the highest available. Also compensation theories are not directly comparable to the economic arguments raised for executive rewards. For these reasons compensation theories will not be considered further in this context, although I consider that they offer potential in future to assess an appropriate level of executive salary. I will return to them in a future chapter.

\textsuperscript{103} David Miller (1999), pages 61-92.
The third type of desert base theory is *contribution*-based desert as first defined by David Miller (1976)\(^\text{104}\) and Jonathon Riley\(^\text{105}\). In these individuals are rewarded in proportion to the relative contribution they made towards the activity being rewarded. This might also be referred to as productivity based desert. This closely parallels some of the common arguments used to justify executive rewards which I will discuss in chapters four and five.

Thinking similar to the contribution-based desert theory is frequently cited by corporate executives to justify their levels of reward. For example 1990s corporate executive “Chainsaw” Al Dunlap, when speaking of his $100 million equity pay, said “Did I earn that? Damn right I did.”\(^\text{106}\) Dunlap had overseen the restructuring of US corporation Scott Paper, during which the stock price appreciated by 225%. If current practice and levels of executive rewards can be philosophically justified, it should be possible to do so under contribution based desert theories. In this chapter I will examine contribution-based desert theories and how they may be applied to rewards for executives.

Having established that we will apply desert theory to the case of reward for executives, and use contribution as the desert base, we must still clarify how we will measure this desert base. There are conflicting views on this question. Shelly Kagan has developed a method for quantifying desert and argues that desert bases should be defined in absolute terms\(^\text{107}\). An individual will have merited a particular ideal level of desert in any distribution of rewards, and any departure from this level of reward for that individual will represent a situation less ideal than if that individual received exactly the absolute level of rewards they deserved.

Conversely David Miller argues that desert bases are comparative\(^\text{108}\), and the level of reward for an individual should be defined relative to levels of reward for other individuals being rewarded. The actual level of reward will be determined by combining the comparative level of desert and the possible frontier of benefit distribution to share the total benefits between those individuals deserving reward. Both methods lend themselves to


economic analysis of rewards and tying desert and rewards to economic productivity. Tuen Dekker has compared Kagan and Miller’s models of desert and shown that only comparative desert can achieve an efficient (Pareto optimal) distribution of resources\textsuperscript{109}. For this and other reasons I will show why I also prefer Miller’s comparative approach.

The next question is whether profits obtained from business executive’s activity (allocating resources more efficiently in a market economy) can be regarded as deserved and included in this desert base. Scott Arnold (1987)\textsuperscript{110} has argued that profits arise from re-allocating resources in a manner that creates outputs more valued by the society than those from their previous allocation. This increase in value represents a gain to the society. When a business entrepreneur identifies such opportunities for increased value (profit) from re-allocating resources, that action increases the social product, and identifying it deserves reward. This reward is also desirable for the society, as if the business entrepreneur did not gain reward for reallocating their resources, then they may not do so and the social product would not be increased.

It will be necessary to further clarify the type of contribution based desert theory to apply to the case of corporate executives, and of leaders of groups generally. Two versions of contribution based desert theory will be considered: the first I will define as marginal product theory, and the second is market rate theory as defined by David Miller (1989)\textsuperscript{111}. I will define marginal product theories first, as they most closely resemble economic theories currently used for deciding executive rewards. It will be shown that they have many philosophical problems in addition to their practical difficulties in measurement and defining comparison bases. I will then discuss Miller’s theory, which I regard as preferable for this purpose. This will be followed by a discussion of philosophical objections to the use of contribution theories for executives, and possible solutions to them.

Contribution based theory values the desert of each person (including members of groups engaged in group actions, such as corporations), by the increase they created in the social product of the society in which the group operates. Like all desert theories, it is a “backwards looking” theory, in that the desert base is derived from the value of the social

product of the actions being performed or just completed. In this respect desert theories are distinct from incentive payments which I will discuss in chapter five\textsuperscript{112}.

\subsection*{3.2 Marginal Product Desert Theory}

\subsubsection*{3.2.1 Marginal Product for Group Leaders}

By marginal product theory I mean to apply a modified form of the method used to calculate the marginal product of labour in economics, to the calculation of the value of desert for members of groups. Marginal product theory has existed in economics since the “marginal revolution” of the 19\textsuperscript{th} century, and became highly mathematical after the work of Arrow, Solow, Samuelson and others in the 1950s\textsuperscript{113}. It is used to calculate changes in the value of production from marginal (individual) changes to resources. As contribution based desert theory means defining desert based on the outputs produced, we can apply these economic marginal product theories to the calculation of desert bases for individuals. The purpose of this application is not to advocate these theories, but to demonstrate the difficulties that arise when they are applied to the case of individuals in groups, and leaders in particular.

The idea of valuing a person’s desert based on their outputs follows from the Lockean principle that each person deserves the fruits of their own labours\textsuperscript{114}. In desert theory it matches the contribution theory of Kagan\textsuperscript{115}, where the desert base of an individual is derived from the value of their production in increasing the social product. However these theories consider the value of production for individuals creating a good or service, and not the case of individuals contributing to some group enterprise, that results in some group output. I intend to develop a more refined version of this theory, which I will call marginal product theory, to explore the case of determining the desert base of individuals working within group activities, including the desert base for leaders of groups.

\textsuperscript{112} Julian Lamont (1997).
\textsuperscript{114} John Locke, “Two Treatises of Government”, edited Thomas P. Peardon (New York: Liberal Arts 1952) (original published 1689).
I will borrow and extend concepts from Frank Jackson’s approach to moral responsibility within groups for group actions to define desert within groups. Jackson defined a group action as any action jointly undertaken by the members of a group that could not be undertaken individually. For example, an orchestra playing a symphony is a group action. I will define a leadership action as any action of a group leader to direct or guide the group that has the effect of enhancing the outcome of the group action. Thus the orchestra’s conductor would undertake a leadership action in conducting.

The marginal product method for determining contribution-based desert for members of a group is to say that they deserve reward $X$, based on the value of the marginal social product $P$ of their contribution to the group action. The value of the marginal social product $P$ for a group member is the difference between the value of the group’s social product with ($P_1$) and without ($P_0$) their contribution.

Marginal product theory: $X$ (reward deserved) = $P_1 - P_0$

Then for groups with $N$ members (1, 2, 3 … to $N$) where there is some additional productive value $C$ accruing from the structure or capital of the group, the group social product ($P_N$) is as follows:

$$P_N = (X_1 + X_2 + X_3 + \ldots X_N) + C$$

We can extend this theory to define the marginal product of group leaders. For the group leader performing a leadership action, the value of their marginal product ($P_L$) is equal to the difference in marginal product before ($P_N$) and after ($P_{N+1}$) the leadership action:

$$P_L = (P_{N+1}) - (P_N)$$

This calculation of the value of the leader’s marginal product requires some clarification. The difference in the value of the marginal product from the leadership action ($P_L$) may not be entirely due to the leader’s action and therefore not exclusively allocatable to the desert base of the leader. We also need to distinguish it from the group’s capital and any additional efforts or resources applied within the group.

Arnold’s (1987) argument that profits are deserved was based on the profits of the business entrepreneur allocating their own resources. He also assumed that the entrepreneur would suffer the losses if the re-allocation of resources reduced the social product. The reward was deserved due to their bearing uncertainty in the investment decision, as well as for their entrepreneurial creativity. Arnold recognised that an employee might suggest such opportunities, and deserve some reward in return. However the executive employee will have a lesser desert base than the entrepreneur, as they do not bear the loss in the event that the re-allocation (leadership action) is unsuccessful. Thus for Arnold, to gain the full value of the marginal product from the leadership action \( P_L \) in a leader’s desert bases requires that the leader also be responsible for the results of the investment decision. This need not equate to ownership, but should represent a substantial stake in the outcome of the action.

If the change in group social product after the leadership action was achieved without the addition of any extra effort from the group or resources from the society, then most of the contribution desert base could be attributed to the leader. That is, the increase in social product from the leadership action, \( P_L \) would be due to an improvement in the efficiency of use of the groups existing resources.

For cases where additional resources have been added to the group in the leadership action, the calculation is more complex. For example, the leadership action may involve hiring new staff into the group, \( X_{N+1} \). These new group members will have made their own contribution and have a corresponding desert base, which is separate to the desert base of the leader. Assuming that the leader does not personally perform part of the group action (other than via direction of the actions of others), and thus has no contribution desert base directly, the leaders desert base will accrue from changes (increases) in the additional productive value \( C \) accruing from the structure or capital of the group.

\[
P_L = (P_{N+1}) - (P_N) - X_{N+1} \\
P_L = C_{N+1} - C_N - X_{N+1}
\]

118 N. Scott Arnold (1987), page 399.
Note that the leader’s desert base is not $C$, the group productive value, as this existed prior to the leadership action, and the leader may not have contributed to its formation. In a capitalist system the value of production from $C$ accrues to the suppliers of the group’s capital.

The contribution desert base of the leadership action should be net of the contribution of any additions to the group’s resources, $X_{N+1}$. From the societal viewpoint, if the group social product is increased solely by increasing the resources used by the group, then presumably the value of other social products previously created by those resources in other activities have been lost. There is only a benefit to the society from the leadership action if new resources are used more efficiently (create a greater social product) in the new activity than they were formerly.

A practical example of this resource consumption effect would be for executives who increase the output of corporations via a large merger or acquisition of another corporation. While this might increase the output of the acquiring corporation, the social output of the acquired corporation is lost or subsumed into it. Unless the net social product of the merged corporation is greater than the sum of the previous social products of the two unmerged corporations, there is no gain for the society. In practice, mergers are a common way by which performance targets for growth may be achieved by executives, when in reality the evidence for their success rate in efficiency terms is poor\textsuperscript{119}.

There is a further complication with the question of whether the leadership action involved any increase in contribution put into the group activity by each group member, $X_1 + X_2 + X_3 + \ldots X_N$. This might represent the ability of the leader to inspire greater effort from group members, or to work more effectively, perhaps via improved skills. The additional contribution is partly due to the group members, who must act on the leader action and its directions. In both cases there would be some proportion of this increase in contribution accruing to the desert base of each group member. Thus even in a straightforward case of an increase in group social product via an increase in contribution per group member, the change in social product cannot be claimed solely as the contribution desert base of the leader.

From a societal viewpoint, this increase in effort contributed by each group member will only be a social benefit, if it increases the overall social product and does not preclude any other contributions to social product the group members formerly made with the efforts or time formerly not contributed to the group. If additional contribution from group members was achieved by their working longer hours, so that they have less time to contribute to the society in other ways, whether through other work or other voluntary activities, then the loss in social product from the loss in other activity should be deducted. Disbenefits such as increased health costs for workers with less free time to exercise should also be deducted from the measure of \( P_L \).

It follows that executives who achieve increased contributions from each corporate employee via coercive means to increase work hours at the expense of other work, volunteer work or needed rest do not increase the social product. The real test of successful leadership actions then is whether social product per group member, per unit of time or resources spent on the group activity, is increased. This net improvement in productivity per resource is the true desert base of the leader.

There are also practical difficulties in measuring the value of the marginal product for group leaders including:

- Information requirements – in order to calculate the group leader’s marginal product \( P_L \) we need a large amount of data including the social product with the leader action \( P_{N+1} \), what the product of the group would have been without the leader action \( P_N \), and any change in contribution for every member of the group \( X_1 + X_2 + X_3 + \ldots X_N \).
- Identifying Capital productivity – there is no obvious way to distinguish the productive value of the group’s capital \( C \), from the value of worker's efforts \( X_1 + X_2 + X_3 + \ldots X_N \). Without knowing the difference in capital value we again cannot determine the leaders contribution base.
- Need for comparators – we could determine \( P_L \) if we have information on the group product of either an identical group without the leader’s action, or the same group prior to the leader’s action, assuming that no other attributes of the group changed. Otherwise we do not have a valid comparator for the group social product with the leader action. That is, in order to know \( P_L \) we need to know both \( P_{N+1} \), and what \( P_N \) would have been.
• Inability to distinguish individual contributions – the inability to distinguish contributions by individuals to a group action will make it extremely difficult to measure changes in effort or contribution for group members performing the same task due to changes in motivation. This may give rise to free-rider problems in groups that produce complex products with multiple contributors. This problem was first identified in economic analysis by Arrow\textsuperscript{120}.

In summary there is a legitimate desert base for leaders who improve the net productivity per resource in a group action. However the value of the leader’s contribution in a group action is indeterminate in practical terms under a marginal product analysis. This is due to the complexity of calculating contributions for other individuals within group actions, the reciprocal nature of some of the desert bases involved, and the question of to whom or what desert base the benefits of any economy of scale for the group should be allocated. This makes it impossible to calculate a contribution for the group leader other than in a comparative sense with other similar groups. Even then, the comparison will be of the relative merits of the two leader’s contributions, and will not be able to be distinguished from other group members’ contributions in an absolute sense. Hence the ability to calculate an absolute value for the group leader’s contribution remains.

3.2.2 Example of Marginal Product Theory Application

We can demonstrate this difficulty in allocating benefits within a group with a monetary example. Suppose two individuals A and B each have a productive capacity/income potential of $50,000 per annum for A and $70,000 per annum for B. If they form a partnership, they have a collective productivity/income potential of $200,000. Their collective marginal product has increase by $80,000 by working as a partnership. This raises the question of how this benefit should be distributed. The marginal product of A and B could be measured in a variety of ways, depending on how the group product is distributed\textsuperscript{121}. These are shown in Table 3.1.


\textsuperscript{121} David Miller (1976) had a similar example based on workers shifting sacks together, although this did not consider the question of splitting rewards with managers. See David Miller, “Social Justice”, (Oxford: Clarendon Press, 1976), pages 107-108.
Table 3.1  Possible Distributions of Benefits of Partnership

<table>
<thead>
<tr>
<th>Situation</th>
<th>Marginal Product of A</th>
<th>Marginal Product of B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Working separately</td>
<td>$50,000</td>
<td>$70,000</td>
</tr>
<tr>
<td>Partnership product</td>
<td></td>
<td>$200,000</td>
</tr>
<tr>
<td>Partnership input cost</td>
<td></td>
<td>$120,000</td>
</tr>
<tr>
<td>Partnership benefit</td>
<td></td>
<td>$80,000</td>
</tr>
<tr>
<td>Allocate partnership product equally</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Allocate product based on prior input value</td>
<td>$50,000 x 200/120 = $83,333</td>
<td>$70,000 x 200/120 = $116,667</td>
</tr>
<tr>
<td>Allocate partnership benefit equally</td>
<td>$50,000 + $80,000/2 = $90,000</td>
<td>$70,000 + $80,000/2 = $110,000</td>
</tr>
<tr>
<td>Allocate benefit to A</td>
<td>$130,000</td>
<td>$70,000</td>
</tr>
<tr>
<td>Allocate benefit to B</td>
<td>$50,000</td>
<td>$150,000</td>
</tr>
</tbody>
</table>

In terms of desert theory, the contribution attributable to the productive benefit of working as a group should be distributed to whoever was responsible for the two individuals forming the partnership. Assuming it was a shared decision, this would mean distributing the $80,000 increase in product value equally between the two, for a gain of $40,000 each. However the question remains of what to assume for the value of the contribution of A and B to the group product. B might argue that her contribution was in other circumstances more valuable, and she is entitled to her original productive value of $70,000 plus the $80,000 group benefit. A could respond that the partnership production was not the same situation, and that both had worked equal hours towards the shared product.

Given that the partnership results in a net increase in social product, it will be possible to distribute benefits so that both A and B are better off. However as Table 3.1 demonstrates, there appear to be several plausible alternative methods to do this, with no clear means of selecting between them.

We will now assume that, instead of a partnership, a company was formed for the same purpose by business entrepreneur C. C realises that the company can make an $80,000 profit with A and B working for them. If C offers A and B their same income as previously to work in the company, they will be indifferent to joining it. However there is sufficient productive advantage in the group action for C to offer A and B a premium over their
previous income to join the company while still leaving a margin for the company to make a profit. For example, C could offer A an income of $60,000 and B an income of $80,000 and still make a profit of $60,000 for the company. If C then appointed some manager D to lead the company, C would still expect their $60,000 profit as owner of the company, less some premium for the cost of D’s labour of management.

Following Scott Arnold\textsuperscript{122}, entrepreneur C would deserve the profit, say $60,000, if it was C’s idea and capital that was used to form the company and work as a group. The profit then represents a reward to C for both bearing the risk of allocating C’s own resources to the new project, and increasing the social welfare by $80,000. Note that the profit would not accrue to the manager, D, since D is not responsible for the idea that created the increase of social welfare by $80,000, and it is not D’s resources that are at risk in the company.

The situation becomes more complex if the company has worked in the industry for a long time and the original practices of individuals working at the same tasks separately have disappeared. Now there is no comparator to know what the individual value of the contributions of A and B would have been. The company will pay workers the market rate for labour, say $60,000 each, a fee for management and the shareholders who now own the company will expect to receive the balance as profit. The shareholders will seek to maximise their returns net of the cost of management, D. If management costs increase, then returns from the company will need to increase by a greater amount to justify the extra expenditure to shareholders.

\subsection*{3.2.3 Application of Marginal Product Theory to Executives}

The fundamental difficulty of applying marginal product theory to leaders identified earlier remains for executives. We do not know what proportion of the improvement in a corporation’s performance under the leadership of an executive is due to the efforts of that executive. The market that determines the value of the corporation’s output is external to it, and does not make judgements about individual contributions to that output from within the corporation.

\footnote{\textsuperscript{122}N. Scott Arnold (1987), pages 395-399.}
The larger and more complex the corporation becomes, the more difficult it will be to identify the contribution of an individual executive. In the example in Table One we saw that there were at least five different ways to apportion the benefits of group production in the simple case of two persons working in a partnership. Modern corporations employ thousands of individuals, working on many different tasks, and sometimes with work on the same group action spread over different countries.

Defining the leadership action itself will be difficult. Instead of a single executive there will be a large number of middle and senior managers, reporting to an executive group of at least five individuals. Even if the benefits of group leadership actions could be defined and measured, it would be difficult to allocate them between the various managers and executives who carried them out. To the executive who claims “you wouldn’t have made this profit without me”, the obvious reply is “how much profit would you have made without the corporation?”

This is not to say that leadership actions in groups create no benefits via increases to the social product. The difficulty is in measuring and allocating this desert base, not that it is spurious. Adam Smith\(^{123}\) cites the long term advantages to a society from increased economic efficiency through specialisation in group actions (the “division of labour”) as the primary benefit and reason for a market-based capitalist economic system. Group actions and consequent specialisation can lead to great efficiencies and increase in social product.

Smith cited the example of workers making pins, where a skilled blacksmith alone might make 1000 in a day, whereas less skilled workers in a factory, with each carrying out a specialist sub-task, could make the equivalent of 2300 each in a day\(^{124}\). Thus group actions are beneficial, and leadership actions that direct group actions are valuable.

The countries having systems that encouraged specialisation and economic efficiency were generally the richest at the time when Smith wrote. There is a long history of evidence to suggest that Smith was correct, with the gap between the richest and poorest countries nations having generally increased in the 230 years since he wrote. By the year


\(^{124}\) Adam Smith, (1776), page 113.
2000 all of the world’s richest nations\textsuperscript{125} had market-based capitalist economies and specialised production. These nations almost without exception enjoy the highest per capita incomes, longest life expectancy, and provide the greatest benefits to their citizens\textsuperscript{126}.

3.2.4 Objections to Marginal Product Theories

There are theoretical objections to applying marginal product theory to executive rewards. It cannot be proven that gains in economic efficiency for a group are the result of the actions or efforts of any one member of the group, including the executive. It may be possible to gain a comparative measure of an executive’s performance by comparing the corporation to other similar corporations. Mathematically, it is possible to estimate the effects of a single variable on some output by using multiple regression analysis, however this requires an exponentially larger number of sample points being available as the number of other variables is increased, in order to be statistically reliable. As was discussed in Chapter two, in practice there are usually too few corporations in a single industry for this form of comparative analysis to be reliable.

Implicit in the contribution desert-base concept for the executive is the assumption that their leadership is to a large extent responsible for the group surplus or economic of scale from the corporation’s activity. That is the executive’s desert base is assumed to be proportional to the economy of scale or capital value (C) of the corporation. Therefore the contribution based desert theory for executives is vulnerable to the claim that there are other primary causes of any efficiency generated by the corporation.

Most industrial economic studies have concluded that there are multiple causes of efficiency. Measured at the societal level, a range of political, social, and technological changes may cause economic and social advances, apart from the business efficiencies that may be generated by a single executive or corporation. For example, the general economic growth and prosperity enjoyed by most OECD nations in the 1990s might just as easily be traced to causes such as the “peace dividend” from the end of the cold war,

\textsuperscript{125} As of 2006 all 27 members of the OECD, comprising the world’s richest nations, had free-market capitalist economies. Outside of the OECD the fastest growing developing nations, such as Brazil and India, were also capitalist economies. Even “Communist” China had profit making corporations, stock markets, and private banks, having a capitalist system in all but name.

increased computerization, the population age profile ensuring record high workforce participation, and the increasing globalization of world trade. Some of these changes may have rested at least in part on management decisions to adopt them, and so could represent a desert base for executives. However it is impossible to know to what degree this was the case. The shift to rewarding executives proportional to increases in share values implicitly allocated a share of these benefits in this period to executives.

The most comprehensive studies to date of the causes of business efficiency and competitiveness were those carried out by Micheal Porter\(^\text{127}\) in the 1980s and 1990s. Porter developed a model of factors that consistently influenced the success of different businesses. These included firm strategy, demand conditions, related supporting industries, resource availability and government policy. Four of the five factors were external influences that firms had to respond to, rather than things they caused. Corporate leadership was undoubtedly important in the way the firms responded to the other causal factors. However only one factor was directly controlled by executives, corporate strategy. Overall it would seem that at best only a partial share of the productivity benefits from these factors could be allocated to the executive’s desert base.

In an Australian study Quiggin (1998)\(^\text{128}\) found that the apparent causes of improved efficiency include scale economies, technological innovations, X (factor)-efficiency gains and the removal of behavior aimed at merely satisficing performance targets rather than maximizing performance. Gains in factor efficiency may have been due to corporate leadership, such as through restructuring of corporations. This is plausible but difficult to prove. It cannot be isolated from other potential causes of factor efficiency gains, such as changes to regulation or government policy. For example, reforms to labor markets might improve factor efficiency in an industry regardless of the actions of an individual executive.

For these reasons most studies of executive performance rely on comparing corporate performance with that of other corporations in the same industry or market. They then make the assumption that any differences in comparative performance are due to executive leadership. Yet this is still only an assumption. It ignores the potential for exceptional contributions from other members of either corporation to influence their


performance. It is likely to overstate the value of executive contributions, by conflating it with the contribution of other individuals who may have caused the improved performance.

When assessing comparative performance for corporations that do not have better than average performance, which will be a large number of the cases, it will not be possible to identify any contribution by the executive. This may conversely understate the contribution of the executive. This will be particularly so when executives are hired to turn around struggling corporations, in which cases achieving average performance may be a significant improvement. For these reasons the comparative analysis should be carried out over time, with the change in relative performance over time used as a proxy of executive performance. This requires the length of tenure of individual executives to be substantial in order for performance trends to be measurable.

This leads us to a fundamental weakness of marginal product theories for determining reward levels for participants in any group action, including leaders. The results of any comparative analysis of performance might be able to justify differentials between the level of reward for an individual and their comparator group, but would not be able to justify any absolute level of reward.

For example, suppose it is possible to determine that one executive has a 20% better performance than that of her peers. When deciding her salary, it would seem reasonable, on a marginal product basis, to reward her with an income 20% higher than the income of her peers. But the question still remains: 20% of what? This analysis says nothing about whether the peer incomes are reasonable, or whether the reward is greater or lesser than her actual contribution to the group. Such an analysis assumes that the labor market that has set the peers’ incomes is efficient, but does not prove it to be so. This then becomes a circular argument.

A further difficulty is that, even if the contribution to a corporation of executive decisions could be isolated, it may not be possible to isolate the value of the marginal product of the CEO or any particular executive from the value of the marginal product of the rest of the executive group. One possible way to overcome this would be by identifying the period when a particular CEO was present and isolating the performance during their tenure from that before and after. The difficulty with this is that the impact of many decisions on corporate restructuring or strategy take time to become evident. The full benefits or dis-
benefits of their decisions will not emerge till some time later, perhaps after they have left the corporation.

3.2.5 Adverse Social Effects of Application to Executives

There are potential adverse social consequences from applying this theory to executives. There is a need for consistency of application of marginal product theory in all occupations across a society if social benefits are to be realised. A justification of marginal product theory for contribution based desert is it ought to encourage persons to make correct (socially beneficial) decisions on choosing occupations. Reward mechanisms are one means to influence that decision. This should benefit society, by producing the most efficient resource allocation of people into occupations. This benefit is only realised if all occupations being chosen between are given contribution-based rewards in the same manner. Then individuals making decisions on their employment can make a well informed judgement between career paths based on the comparative societal value of each.

However if contribution based rewards are not allocated to each alternative career path in a consistent manner, these choices will be biased in favour of the occupations where large contribution based- rewards are paid, even if they are not the most socially beneficial choices. This will result in a loss of overall social product, as persons better suited to other fields that are socially necessary opt not to choose them due to excessive financial rewards in corporate careers. Murphy et al (1991)¹²⁹ found a clear correlation between the economic growth rate of countries and the number of scientists and engineers they trained. A decline in these graduates, combined with a rise in graduates of law and finance, was linked to a slowdown in the US economy in the 1980s.

This miss-allocation is likely to be particularly problematic for social service fields whose nature is such that the value of their marginal product does not accrue to the organisation that produces it. A good example of this problem is the comparative difficulty of many western nations in attracting good quality students into the field of teaching as rewards for other business occupations greatly exceed them. Yet quality education systems have long been recognised as a prime determinant of national productivity and long term increases in

social product since the first research of Becker (1962) to Blundell (1999) more recently.

In this respect there is then only an efficiency case for allocating contribution-based rewards to corporate executives if all positions in the society with a significant impact on the social product are similarly rewarded. For example, if economic analysis demonstrated that the number and skill of scientific researchers, engineers and maths teachers are all closely correlated with advances in social product, then all would merit high reward on a contribution basis. Contribution based rewards need not be confined to economic benefits – professions affecting quality of life and social order such as health care professionals and police would also deserve reward on this basis.

Executive rewards would not be justified in being any larger than rewards to other occupations having a similar (positive) impact on social product. To be consistent, business economists who argue for occupational rewards based on evidence for contribution, should prefer that multiple other professions requiring higher skill and training than executives would receive similar rewards to them, based on clearer past evidence of their link to gains in social product.

From this viewpoint, we have no reason to believe that the very high reward levels for corporate executive positions in recent decades are deserved on the basis of contribution. They are not justified in themselves and may have an undesirable effect in distorting the allocation of human resources to other important tasks within the society. That is, excessively high rewards for executives may have induced a higher proportion of the societies best minds to chose careers in corporate management than would be warranted by their likely returns to society.

There is reason to believe that applying marginal contribution theories to executive salaries may also have some adverse consequences within the corporations. The inequalities it creates within the corporation, is likely to have a damaging effect on staff

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morale and productivity\textsuperscript{133}. Unjustified inequality of rewards within a group causes resentment among those with lesser rewards. The feeling that the benefits of the group activity are not fairly shared will undermine any sense of belonging to the group, and would presumably also increase staff turnover. Low staff morale lessens the work satisfaction of employees, and may be a cause of poor performance\textsuperscript{134}. Therefore if realized this consequence represents a potential loss to both.

It should be noted that the potential problem in this case is the difference in salaries within the corporation and not their level. An organization with uniformly high or uniformly low salaries is not likely to suffer from this problem. Conversely one organization paying its workers consistently less than rivals in the same industry would also potentially suffer from this effect even if rewards within it were relatively fair. With current executive salaries being tens or even hundreds of times the salary of average workers, there appears to be considerable potential for this effect to harm corporate productivity and social product.

3.3 Miller's Market Rate Contribution Theory

I have defined the conceptual difficulties in applying marginal-product type contribution theories to desert, and to executive rewards in particular. However this is not the end of our consideration of contribution theories. David Miller (1989)\textsuperscript{135} has defined an alternative market rate contribution theory that avoids some of the difficulties of the marginal-product theory for defining the desert base of leaders of groups. Miller’s theory still has difficulties, and critically requires that there are efficient markets for wages. I will now examine the pre-requisites for Miller’s theory in detail and consider arguments for and against their applicability to corporate executives. In closing, I will evaluate whether current practices in corporate executive labour markets would satisfy Miller’s conditions for efficiency and fairness.

David Miller’s market valuation theory uses a different measure of the contribution of an individual to marginal product theory. Miller acknowledges that measuring marginal contributions is difficult. He argues that the value of any person’s contribution (Pi) to the social product P is best represented by the market valuation of their salary, Y. That is, their salary Y is the best available proxy of their desert base. This assumes that the market for setting the salary is fair and efficient. We will return to consider the conditions that would be required to ensure such a market later.

Miller does not claim that market values of salary will always be a just reward. Instead, Miller considers that market rate valuations will be closer to a just reward for individuals than either attempts to value the marginal product (P_1 – P_0) from their actions, or the arbitrary imposition of a non-market valuation to their contributions. Thus for Miller:

\[ P_i = Y_i \]

Where

\( P_i \) = value of contribution of person i, and

\( Y_i \) = salary of person i.

David Miller defined his theory for application to individuals in different occupations. He did not specifically address the issues of application to members within group actions, or the added difficulties of desert for leaders of groups. I assume that he intended this to occur via an extension of his basic theory. Then for a group with N members:

\[ P_N = \text{the sum of all salaries } Y_i \text{ and capital productivity within the group} \]

\[ P_N = (Y_1 + Y_2 + Y_3 + \ldots Y_N) + C \]

Again, C is the return to capital (profit) from the benefits to group production of any capital equipment or plant. This would normally be paid to the owners of the group or its capital equipment. These would be the shareholders in the case of a corporation. Where a group is a partnership between equal members C is the added value to group production from any economy of scale from working together as a group. In the case of these and any self-owned groups the value of returns to C would then be divided between the group members.
3.3.1 Objections to Market Rate Theory

There is an immediate difficulty with Market Rate theory when applied to corporations in that it appears to involve a degree of circularity. The value of each group member’s contribution to the group is equal to their market salary. The value of returns to capital is equal to the difference between total market value of group production less total market value of salaries, presumably also less any other expenses for materials and consumables. We can assume that the cost of expenses and consumables is known and fixed and substitute Net production \( P_{N-E} \). Then:

\[
\text{Net production } P_{N-E} = \text{total wages } (Y_1 + Y_2 + Y_3 + \ldots Y_N) + \text{profits } C \\
C = P_{N-E} - (Y_1 + Y_2 + Y_3 + \ldots Y_N) \\
(Y_1 + Y_2 + Y_3 + \ldots Y_N) = P_{N-E} - C \\
\text{Individual } Yi = P_{N-E} - C - (Y_1 + Y_2 + Y_3 + \ldots Y_N)
\]

We cannot determine the fair value of any group member income using Miller’s theory, unless we know all the other incomes and outputs. Thus we cannot use it to determine fair levels of both wages and profits – we must assume that one or the other is fair, and use it to determine the other. Likewise we cannot determine the fair salary of any individual employee \( Y_N \), unless we also know the (fair) salary of all other employees. In this sense David Miller’s theory is a device for justifying a given level of salary as a market outcome, rather than calculating what it should be.

If the market is fair, it could be argued that the market value of each group members’ income and the group’s output is the sum of each individual valuation made by persons active in the market. Then the market valuation of both individual incomes and group output, and by difference, profits, is linked to their social utility, and is therefore also fair. We then return to Miller’s original conditions: if the market is fair then the salary of individuals and profit to shareholders are both fair. However we have not yet proven that either the market or the salary and profit is fair. This becomes a circular argument.

3.3.2 Conditions for Fair Markets in Market Rate Theory

This valuing role of market determinations of salary makes the conditions and performance of markets critical in David Miller’s theory to the inherent justice of market outcomes and
rewards. Miller recognised a number of objections to the justice of market valuations and responded to each in defence of his theory\textsuperscript{136}.

Miller does not claim that markets are perfectly just in their outcomes, merely that they are more likely to be just than the alternatives. Market allocations of desert are still preferable to the arbitrary allocation of desert by some third party. In his response to these objections Miller identifies the need for government intervention or a regulator to ensure that potentially unjust aspects of markets do not build up over time.

Miller goes on to define two conditions under which market transfers might be considered not only unfair but to represent exploitation that government regulators should act to prevent\textsuperscript{137}. The first is if a transfer is more advantageous to the exploiting party and less advantageous to the exploited party than some benchmark or equilibrium price due to the amount and kind of labour in it. The second is if the transfer must occur through some special advantage the exploiter has through asymmetry of information and/or asymmetry in bargaining power.

Both conditions assume the fact that the exploited party must make a transfer. They also assume there is a lack of ignorance or willingness to be exploited, either of which may lead to similar market outcomes without exploitation being involved. Miller does not consider it possible to identify simple rules to prevent these problems and further emphasises the need for government regulation.

Applying Miller’s theory to the determination of desert for individuals engaged in group actions raises the following additional concerns. Firstly, as groups become larger and more complex the potential for asymmetries of information and bargaining power will increase between individuals within the group. The existence of formalised power, reporting and command structures within groups will tend to concentrate these advantages in the hands of those in positions of power within the group. They will have a broader overall knowledge of the contribution of the group, its market position, and ability to provide rewards.

Second, positions of authority may also confer the ability to force or coerce individuals into acceptance of levels of reward they may not otherwise be satisfied with, unless there are also corresponding oversight and restraints on the use of such powers. In most group employment situations any exploitation is not between two individuals deciding on a voluntary transfer, but between one individual acting as a group member and another individual acting with the strength of the organisation behind them. These concerns apply to all groups with institutionalised structures, such as churches, schools, hospitals, government departments, universities and military and charitable organisations, as well as corporations.

Miller’s Market Rate theory gives some useful criteria by which to assess the fairness of the corporate executive labour market. Miller acknowledges market valuations may be dependent on luck and other factors. In the short term this is unavoidable to a degree, though in the long term a well-regulated market should not suffer unduly from such effects. Thus for Market Rate theory the long term efficiency and fairness of a labour market is more important than any perturbations towards higher or lower rewards in the short term. Taken in this light, any short-term correlation of the executive labour market between executive salary and corporate performance becomes less significant. The important question is whether long-term trends accord with expectations of a fair market.

The long-term trends in the Australian and United States executive labour market identified in Chapter Two suggest that this market is only marginally efficient in Australia and is not efficient in the United States. Changes in real rewards for executives have not corresponded to increased share returns or national incomes for almost three decades. The average level of rewards for corporate executives has been many times that in other occupation for at least two decades. Once this situation was reached in an efficient market there should have been sufficient incentive to encourage talented applicants to move into corporate executive careers. This increase in supply should then have stabilised the price of labour, yet the rising trend in rewards has continued. The trend data shows that the corporate executive labour market is not efficient but distorted, and therefore the reward outcomes are not deserved.
3.3.3 Causes of Exploitation in Executive Labour Markets

There are a number of structural aspects of the corporate executive labour market that appear to create opportunities for exploitative behaviour that are difficult to eliminate. These have been identified by Bebchuk and Fried (2004)\textsuperscript{138} for the United States executive labour market. Miller’s definition of exploitation give a useful framework against which to discuss these aspects.

The first category of causes of exploitation is asymmetry in information. There are many ways in which the access to information for negotiating of executive rewards is biased in favour of the executive.

Executive recruitment practice is unusual in that rather than advertising a position and reward package, corporate recruiters or “headhunters” are hired by the corporate board to select and approach candidate executives and make offers of employment\textsuperscript{139}. This immediately tells the candidate executive that they are in demand from the corporation, and that the corporation is willing to pay them at least the offered amount. In contrast they have revealed nothing of their own preferences, including the minimum reward they would be prepared to work for. There is no obvious reason why this practice should continue, as advertising vacancies is common in other occupations where skilled practitioners are in high demand, including executive positions in the public service. There is no apparent lack of applicants as a result.

The widespread use of “commercial in confidence” contracts by corporations for executives makes it difficult to obtain data on the total quantum of executive rewards and their performance targets, and compare them with actual performance. This can only be done after a time lag for reporting.

Commercial in confidence contracts also makes it difficult for executive recruiters to obtain details of the past performance of external candidates from previous employment in other corporations.

Once employed, the executive is in control of the performance reporting of the corporation. This allows them to potentially manipulate the reporting to disguise losses or inflate their success in order to qualify for greater rewards. This was the strategy adopted by Enron executives, aided by accountants Arthur Andersen, to obtain substantial bonuses for executives prior to Enron’s bankruptcy in 2002\textsuperscript{140}.

The second cause of exploitation is asymmetry in bargaining power, which is again evident in multiple aspects of negotiations for executive rewards. I will discuss each of these briefly in a corporate context.

Shareholders do not have control over the offer of executive pay. This task is carried out on shareholders behalf by corporate directors. In theory corporate directors are the employers of executives, but in practice the relationship is less clear. Bebchuk and Fried have highlighted numerous ways in which executives influence directors\textsuperscript{141}. CEOs and executive directors often recommend directors for election to boards, have power or influence over recommendations on their fees and rewards, and sometimes preside over their elections. This gives power over the director’s position and rewards to the executive.

Once in office executives have significant positional power to use as leverage in negotiating pay. Sudden departure of a CEO or senior executive from a corporation is often disruptive and seen as a negative to share prices. They may have valuable intelligence on the future market plans of the corporation that competitors would value. This makes the threat of unplanned departure a serious one, even when the executive is performing poorly, due to the further damage they may do in exiting the corporation.

The use of remuneration consultants to set executive rewards immediately removes power from the board of directors who are supposed to be the employers of the executive. In practice many such consultants are reliant on obtaining other consultancy work from corporations and so depend on the good will of the executives. This conflict of interest leads to higher reward recommendations than would otherwise be the case\textsuperscript{142}.

\textsuperscript{141} Lucien Bebchuk and Jesse Fried (2004) Pages 23-44.
\textsuperscript{142} US House of Representatives Committee on Oversight and Governance Reform, “Executive Pay: Conflicts of Interest Among Compensation Consultants”, December 2007. One of the two main proponents of performance bonuses for executives, Kevin J Murphy, while having a
Executives have influence over annual meetings of their corporation’s shareholders through their involvement in the mechanics of organising the meetings, and in some cases chairing them. In Australia shareholders vote on the size of executive rewards, however the vote is not binding on executives.

Finally, all of this assumes that the executive labour market is a typical two-agent market where corporate boards negotiate reward contracts with potential executive employees. In reality it may be closer to a multi-agent game between share fund directors, corporate directors and corporate executives. In this situation the rewards paid to executives may be a mutually convenient agreement between colluding allies rather than genuine bargaining. This problem will be explored further in Chapter 4.

3.3.4 Corporate Governance and the Executive Labor Market

The degree to which weak corporate governance may influence executive rewards can be illustrated empirically. Indexes have been compiled by the World Bank for the integrity of corporate governance regimes for each member nation\(^{143}\). The index component most relevant to ethical conduct of business is the “corporate legal corruption component” (CLCC). If we compare the CLCC index to average CEO pay for the national datasets in Chapter Two there is no clear relationship. However if we compare the CLCC index to the CEO Pay Multiple (of average income) there is a significant relationship. This is shown Figure 3.1.

Figure 3.1 – CLCC Index compared to CEO Pay Multiple

Regression Coefficient  -0.317
Correlation Coefficient  0.418

There is a negative correlation between the two, that is, the greater the integrity of governance systems to prevent legal corporate corruption in a country, the lower the multiple of CEO salary to average income. The correlation coefficient (0.418) is not strong and the sample size is too small for statistical reliability. However it is stronger than the correlations between economic performance and rewards identified in Chapter Two. In other words, weak corporate governance may be a better indicator of comparatively high executive pay, than strong corporate performance.

These results for international comparisons of the effect of corporate governance on the level of executive rewards are consistent with other micro-level studies that have been undertaken for the United States executive labour market. Core, Holthausen and Larcker (1999)\textsuperscript{144} found that rewards for United States executives were related to the board and ownership structure. Less effective governance structures were closely related with higher

CEO rewards. Similar results were found by Cyert Kang and Kumar (2002)\textsuperscript{145}. In the one study of Australian relationships between corporate governance and executive rewards, Lau, Sinnadurai and Wright (2009)\textsuperscript{146}, note that Australian corporate boards were smaller and had a much lower incidence of people in joint chairman/CEO roles. This may be one of the factors contributing to the generally lower level of executive rewards in Australian corporations.

The CLCC index includes aspects of political interference in measures of governance and corruption relating to corporations. The idea that corporations may attempt to influence governments for their own ends is well recognised in public choice theory, where politicians and government officials are seen as self-interested agents who may influence and be influenced by economic forces. One of the consequences of this is that economic forces may attempt to influence government to create regulations that allow them to undertake rent-seeking behaviour. This is a form of “government failure”. A logical consequence of this is that government failure might also cause market failure, such as through the preservation of economically inefficient monopolies by regulation. Thus it would be reasonable to expect that if high executive rewards are an instance of rent-seeking behaviour, they will be more prevalent in countries with a higher degree of corporate influence that effectively “corrupts” government.

In summary market rate theories of contribution as espoused by Miller appear to have several theoretical advantages over marginal product theories when applied to groups generally and corporate executives. They can also explain how inefficiencies and rent seeking behaviour may develop in executive labour markets. They do not indicate what the level of market rewards should be unless the market is assumed to be perfectly fair. However they provide an ethical justification for a market level of rewards provided conditions for fair (non-exploitive) markets are met. In Australia and the United States current practices in executive labour markets would appear to fail to meet these criteria. Thus current market outcomes for executive rewards are not ethically justified under a market rate theory of contribution in Australia and the United States.


3.4 Conclusions

We have now evaluated the two main contribution based desert theories and considered them in the context of the executive labour market. Of these marginal product theory, although easy to justify and attractive in principle, appears to be deeply flawed for application within groups. This includes consideration of rewards for group leaders such as corporate executives, which would require a very large amount of information to calculate. A more theoretically sound approach might be to leave the calculation of group contributions to group members, in a form of workplace democracy. This offers the potential to eliminate some conflicts in current approaches to determining executive reward.

The second, and far preferable approach to contribution in groups, is the market rate theory as defined by David Miller. This does not allow direct calculation of what rewards should be, however it does ethically justify market rates of reward provided conditions for competitive markets are met. In the case of current executive labour markets these conditions are not met and thus current reward levels are not justified under market rates theory. In fact, measures of corporate governance suggest that high executive salary is more associated with poor governance regimes, than high performance. Given the current reality of exploitation of executive labour markets, market rates theory cannot tell us what reward levels for executives should be.

The idea that any individual corporate executive is primarily responsible for the social product created by efficiencies of group action is not supported by either theory. Other economic factors appear to provide better explanations of the origins of group efficiencies.

With current practices in executive labour markets not defensible by contribution theory, we are still unable to define what executive salary levels should be. In the absence of such an explanation, current high salary levels for executives are unjustified. In the next chapter I will turn to agency theory and market power, the first of the economic theories used to explain executive rewards. These do not justify in a desert sense current executive salary levels. We will see whether they offer a better explanation of why current practices have occurred.
4 Agency Theory and Management Power

4.1 Context of Theories

In this and the following chapter I will examine economic theories that have been used historically to analyse levels of executive reward. These theories were first developed to explain the economic power relationships that resulted in the level of executive rewards then prevalent. More recently they have been used to explain the causes of the current level of executive rewards. They will also be compared to the philosophical understanding of justification for reward developed in Chapter Three.

We have already seen in Chapter One that empirical evidence of current practice in executive rewards shows that it does not match community expectations of reasonable income distribution. In Chapter Two, current executive rewards levels were shown to be not in shareholders interests at the micro level in the United States, and not economically efficient at the macro level in Australia and the United States. In Chapter Three we developed a philosophical understanding of desert for executives that shows the current executive labour market is exploitive (by executives) and therefore reward levels are not justified. This leaves the questions of what do relevant economic theories have to say about executive rewards, why current behaviour has occurred, and what level of rewards they would support.

The finding that current executive labour markets are exploitive does not necessarily invalidate economic theories that have been used to analyse executive rewards. As we shall see both supporters and critics of economic theories acknowledge that executive rewards practice has departed from their intended application in several respects. With the practice having departed from the theory, the practice does not invalidate the theory. The question still remains whether, in principle, economic theories might be able to offer a logical defence of executive reward practices.

I will commence by considering the agency theory and management power explanations of executive rewards in this chapter. Alignment or Incentive theories will then be considered in the following Chapter Five. Agency theory is the standard explanation of corporate management costs in economic literature. It identifies the causes of executive salary levels, but does not attempt to justify them. Agency Theory is presented to understand the
context of the explanatory theories and I do not intend to introduce any arguments against it.

Management power and Alignment theories are two competing explanations of current executive reward practice. Both theories are based upon Agency Theory. One of them (management power) argues that executive salary levels are not justified, while the other (alignment theory) is used to defend them.

Management power and alignment theories are posited as competing explanations of current practice by their protagonists, however they not mutually exclusive. Their principal advocates, Lucien Bebchuk and Jesse Fried for management power theories and Michael Jensen and Kevin Murphy for alignment (and incentive) theories, differ on the degree to which they apply. This distinction is not trivial, as depending on the degree to which the management power explanation holds, regulatory intervention in the executive labour market would be warranted or not.

Economic theories of executive reward have generally not been based on a philosophical conception of desert or any other conception of a fair distribution of benefits. They have focused on questions of economic efficiency and in particular on whether the executive labour market is economically efficient. As I outlined in Chapter One, this is not a sufficient defence of a practice. Community attitudes and philosophical theories of desert are relevant, and it is justifiable to intervene in markets to satisfy them. Nevertheless, economic efficiency is also important, as it affects societal welfare. An economic explanation of executive labour markets that was flawed and led to inefficient outcomes would not be satisfactory from the viewpoints of distributive justice or economics. Hence ensuring that we have a sound economic explanation of how executive labour markets work is a necessary, though insufficient, condition for their acceptance by the community. Therefore I will evaluate the economic theories in Chapters Four and Five against both the empirical evidence on efficiency from Chapter Two, and the desert theories from Chapter Three.

4.2 *Agency Theory*

Agency theory is an organisational theory that enables an understanding of the behaviour of complex organisations with multiple internal stakeholders. It is applied broadly in
business and political science to any situation where there is a principal who delegates some work to an agent to act on their behalf, but the agent may not have the same objectives as the principal. Therefore the agent may carry out the work in a way that suits the agent's objectives and not the principal's objectives. This creates the “principal-agent problem”, where the principal wishes to ensure that the agent acts upon their wishes. When applied to the behaviour of corporations, it is used to explain conflicts between shareholders acting as principals and executives acting as agents.\footnote{Kathleen Eisenhardt, “Agency theory: An assessment and review”, \textit{Academy of Management Review}, 14 (1) (1989): pages 57-74.}

Prior to the advent of agency theory, internal conflicts within corporations were recognised in economics but a theoretical means to analyse them had been lacking. Throughout the twentieth century corporations had increased in size, complexity, income and power. Correspondingly more elaborate theories of the firm were developed to understand their structure and behaviour.

Starting in the 1930s managerial and behavioural theories were developed which recognised conflicts between different stakeholders within firms. Berle and Means (1930)\footnote{Adolph A. Berle and Gardiner C. Means, “The Modern Corporation and Private Property”. (New York: Harcourt Brace and World 1932).} recognised that share ownership was now diffuse in large corporations. This meant it was more difficult for shareholders to communicate with each other and agree a preferred direction for the corporation, leaving executives with greater ability to direct them.

Ronald Coase (1936)\footnote{Ronald Coase, “The Nature of the Firm”, (November 1937) 4(16) \textit{Economica} 386-405.} added the important conception of transaction costs associated with the use of markets to understanding the forces motivating the formation of firms. There were transaction costs for a firm using markets to hire resources that made it more attractive to have the resources within the firm. Conversely there were also internal overhead costs of organisation and management within a firm. The optimisation of these two costs would determine the optimum size to which firms would grow. This was the first time that market costs and potential inefficiencies were recognised within theories of the firm.
Baumol (1962)\textsuperscript{150}, Marris and Williamson developed theories to explain how executives would pursue corporate strategies to further their own financial interests rather than shareholders. It was recognised that shareholders’ goals and managers’ goals might conflict. Strategies such as growth in sales or market share were pursued, which helped managers justify larger personal rewards. Managers still aimed to provide sufficient profit to shareholders to pacify them. However executives did not attempt to maximise shareholder profits.

The analytical formalisation of Agency theory in economics began with Arrow (1971)\textsuperscript{151} who recognised that there was a form of moral hazard inherent in risk sharing between individuals such as shareholders (principals) and managers (agents). Ross (1973)\textsuperscript{152} extended this to define the principal-agent problem in a quantifiable way based on costs for the principal and agent under assumptions of different objectives and informational uncertainty for each.

Jensen and Meckling (1976)\textsuperscript{153} in their seminal paper, “Theory of the Firm: Management Behavior, Agency Costs and Ownership Structure”, defined agency theory as contractual relationships within the firm. In this conception of the corporation the principal engages some agent and delegates decision making powers to them (over the corporation) in order to perform some service on their behalf (management of the corporation). The principal and agent may have conflicting goals. Jensen and Meckling go on to say:

“If both parties to the relationship are utility maximisers, there is good reason to believe that the agent will not always act in the best interests of the principal. The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent.”\textsuperscript{154}

Jensen and Meckling conceived of the relationships between principals and agents as types of contracts, with costs incurred by the principal. Divergences by the agent from utility maximising behaviour for the firm were also costs for the principal. This occurred in

\textsuperscript{151} Kenneth Arrow, “Essays in the theory of risk-bearing”, (Chicago: Markham 1971).
\textsuperscript{154} Michael C. Jensen, and William H. Meckling, (1976), page 5.
conditions of incomplete or asymmetric information, where the principal may not have information on each course open to the agent. Acquiring information (monitoring management) to ensure agent compliance was also possible at a cost to the principal. In this context information was seen as a commodity available to the principal at a cost. Finally the agent might also incur “bonding costs” to guarantee that their actions will not harm the principal. This assumes that it is not in the agents’ interest to harm the principal, otherwise the principal may dismiss the agents. Together these costs were defined as agency costs, which will always be present in such a relationship. In this formulation of agency theory the aim of the principal is to minimise the sum of agency costs.

Principals might minimise agency costs through a variety of strategies, such as offering incentives to the agent to act in their interests, and through effort expended in monitoring or “bonding” the agent. One of the questions Jensen and Meckling hoped to answer was what was the optimal form of contract between the principal and agent. Alternatives considered were a behavioural contract (specifying governance and compliance) or an outcomes-based contract (specifying incentives). In general they considered that incentive contracts were likely to be more efficient.

Jensen and Meckling conceived their theory in general terms that were broadly applicable. They applied it to several questions in corporate management and finance. These included the ratio of outside debt to equity, optimum size, when firms will find it efficient to have owner-operators, the issuing of different classes of stock, and accounting reports. They also considered relationships between executives as agents and shareholders as principals:

“issues associated with the “separation of ownership and control” in the modern diffuse ownership corporation are intimately associated with the general problem of agency.”

Fama (1980) highlighted the challenges for the principal to find the optimal trade-off between incentives, monitoring costs and divergence losses that minimises agency costs. He saw efficient capital and labour markets as information mechanisms for shareholders (principals for corporations). They could use this information to monitor the performance of the corporation and thus the performance of its executives (their agents). Critically, this

assumes that capital and labour markets are efficient, and are based on accurate information reporting from firms.

There are some critics of agency theories, and also some degree of argument as to how it should be applied in corporations. However I do not consider these significant for the case of executive rewards. Agency theory reflects the reality of the conflicts of interests between corporate shareholders and executives. Acceptance of agency theory does not commit one to accepting any particular level of executive rewards, or any particular means of resolving the conflict, such as the form of employment contract. Taken as a whole, we can see how the evolution of agency theory led naturally to the evolution of incentive and alignment theories, which we will discuss in Chapter Five. However before we do this, I shall define the theoretical explanation most commonly cited for current practice in executive rewards: management power.

4.3 Management Power Theory

4.3.1 Management Power Defined

In economic theory, management power is the term normally given to the organisational efficiencies of large corporations. Somewhat confusingly, in the executive rewards debate, management power is the label that has been applied by those who argue for primarily non-market causes of current executive reward levels. In this context, management power theory holds that the level of executive rewards is due to the abuse of positional power by executives, rather than being the outcome of a rational or efficient market. Proponents of the management power explanation of executive rewards accept that there are conflicting interests between shareholders and executives, but do not accept that contract incentives are sufficient to resolve those conflicts.

The “management power” theory in economics pre-dates agency theory, being first defined by Alfred Marshall (1890). It is not an alternative to agency theory. Management power theory was developed in the late nineteenth century to explain the economies of scale achieved by large corporations that were then expanding. Marshall used it to distinguish between the profits of capital and the profits of "management power" in such corporations. The “management power” represents the surpluses resulting from

157 Kathleen M. Eisenhardt (Jan 1989) pages 57-74.
modern systems of organization applied to the capital assets of the organization. They are the productive benefits of the business’s organizational structure compared to the production of the separate capital components. These included shareholders, boards of directors representing them, and complex corporate structures reporting to executives who ran the corporation on a day-to-day basis. The larger the organization and the more effective its structure, the larger is this "management power".

Marshall explained in economic terms why business executives’ income would be proportional to the revenue of the corporation in this situation. The management power was in the hands of, and in part due to, the efforts of the corporation’s managers. They could then use this position to obtain higher rewards from shareholders.

It is important to qualify this view. Marshall was developing an explanatory theory of what forces tended to cause incomes in business. He did not consider whether they represented a just distribution of rewards, or whether higher executive salaries were economically efficient. He did not comment on what would constitute an efficient executive labour market either, as one hardly existed at that time. Most corporations then were managed by the individuals who had founded them.

Marshall went on to make a normative claim about the income of managers (executives). In this he identified the value to the corporation of these additional organisational tasks they performed:

“The normal earnings of management are of course high in proportion to the capital, and therefore the rate of profits per annum on the capital is high, when the work of management is heavy in proportion to the capital. The work of management may be heavy because it involves great mental strain in organizing and devising new methods; or because it involves great anxiety and risk: and these two things frequently go together.”  

Marshall’s view that a manager’s labour of organisation should be paid in proportion to the capital needs to be understood in the context of the time (the era of the invention of large corporations in the late nineteenth century). The manager’s “labour of organisation” does not directly translate to the role of management today. Further to N. Scott Arnold’s(arguments discussed in Chapter Three, Marshall’s “labour of organisation” refers to the

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159 Alfred Marshall (1890), Book VI, part VIII, paragraph 9.
entrepreneurial organisation of firms, as well as the bearing of risk in investment outcomes. Thus Marshall’s rewards to management have conflated incentives for bearing risk, compensation for effort expended, and contribution desert for successful investment and organisational design decisions. Only the last two would apply to modern executives. Given this very broad definition of the labour of organisation, it is unsurprising that rewards should be expected to be high. This does not economically justify, paying managers of existing corporations of today in proportion to their capital.

From an economic incentives viewpoint, Marshall’s theory may create socially beneficial outcomes. If the same labour of management applied to a larger corporation resulted in a greater benefit than that labour applied to a smaller corporation, then it was economically more efficient to ensure management rewards encouraged the most skilled manager to work for the larger corporation. Paying managers in proportion to the capital was one means of achieving this outcome.

There are other difficulties with Marshall’s view. Even if the executive creates all this additional value, that does not mean that directors should pay them more in the same proportion. There is no reason to believe that economic efficiency is achieved by paying executives proportionally to capital. Rational directors of the larger corporation would only pay the minimum reward premium sufficient to make the more skilled managers transfer to the larger firm. Anything beyond this is an unnecessary cost and therefore not economically efficient.

Marshall’s view is sharply in contrast with the earlier writing of Adam Smith (1776).\textsuperscript{161} Smith held that the benefits of a company should be proportional to its capital, and should be returned to shareholders, who were the owners of that capital. Under Smith’s view it did not seem reasonable for the wages of any individual in the organization (including the managers) to be linked directly to the level of profits. He made this point explicitly in \textit{The Wealth of Nations}:

“The profits of stock, it may perhaps be thought, are only a different name for the wages of a particular sort of labor, the labor of inspection and direction [leadership]. They are however altogether different, are regulated by quite different principles, and bear no

proportion to the quantity, the hardship or the ingenuity of this supposed labor of inspection and direction.162

On balance, it seems difficult to justify the claim that manager’s rewards should be proportional to the firm’s capital for the reasons discussed in Chapter Three. Once the corporation’s organizational structure has been formed, these profits from “management power” seem to be indistinguishable from the profits of capital (C), since the structure is an intrinsic part of the organisation that results from the capital. The “management power” supervenes on the structure and cannot exist outside of the corporation in which it was created. Persons in positions with “management power” would not possess that power if they did not hold their position in the corporation.

Further Marshall’s “management power”, once defined as supervening on the corporation’s structure, which is owned by the shareholders, is itself then something that is the property of the shareholders. Thus as per Smith’s original view, the profits generated by “management power” should be returned to shareholders. Economically, Marshall’s view would not lead to an economically efficient setting of executive rewards, whenever rewards in proportion to the firm’s capital exceeded the reward level needed to attract and retain the executive. That is, the larger the corporation, the less likely this view would result in an economically efficient setting of executive reward levels.

While these are persuasive arguments against the claim that executive rewards should be proportional to corporate capital, they still do not support any particular level of reward. Directors will still rationally pay whatever level of rewards are needed to attract executives if they believe their efforts will benefit the firm by more than those rewards.

4.3.2 Management Power as Explanation of Reward Practices

In recent years Bebchuk and Fried (2004)163 used the term “management power” to describe their theory for the increase in executive rewards. This argument was developed starting in the 1990s and culminating early in the 21st century after reviews of long term trends in the level of executive reward by Bebchuk, Fried, Grinstein and others. By this stage the level of executive reward in the United States had risen six-fold in real terms

162 Adam Smith, (1776) page 151.
compared to the early 1980s and was also significantly higher than in Europe and other major capital markets. Unlike alternative theories they focused directly on the level of executive reward as being the product of the abuse of management power by the executives, and not the outcome of market forces in the executive labour market.

Market-based explanations of executive rewards assumed that there was a competitive market between corporations for the labour of executives. The directors of corporations bargained on behalf of shareholders to negotiate a pay contract with executives, based on what was in the best interest of shareholders. The level of executive reward was simply the market outcome from this situation.

Bebchuk and Fried defined this assumed practice as “arms-length negotiating”, between the board of directors and the executives. “Arms length” in this case meant that the board of directors acted independently of executives. Bebchuk and Fried concluded, based on their analysis of executive rewards practice over the preceding decades, that this assumption was false. The outcomes did not represent the workings of a competitive market. The theoretical model of corporate board behaviour in negotiations with executives over rewards was also false and in reality boards did not act in this manner. Boards did not act to protect shareholder interests on executive rewards.

Bebchuk and Fried identified eight practices that were found to prevent arms-length negotiations from occurring between directors and executives in United States corporations164. Firstly the executive rewards setting process is typically delegated to compensation committees. This tends to remove it from oversight by directors. Secondly Directors’ own rewards (fees) had risen substantially in parallel with executive rewards in the last three decades. Hence directors desire to be re-elected to boards. This gives directors an incentive to remain popular with the executive and other directors, in order to be re-elected. Thirdly, CEOs have many powers over corporate resources that they can use to provide benefits to directors. Fourthly, when directors work together with corporate executives closely for a long period, they typically get to know and often like each other, making it difficult for them to assess pay contracts impartially.

Fifth, CEOs have significant influence over the composition of boards, through their role in assisting with the conducting of the election of directors. Whilst directors are elected by

164 Lucien Bebchuk and Jesse Fried, (2004), pages 23-44.
shareholders, corporate executives may influence the timing and scope of the elections and sometimes the choice of potential candidates.

Sixth is what Bebchuk and Fried termed “Cognitive dissonance” but which I think is more accurately described as a form of cognitive bias. Corporate boards tend to be staffed with current and former executives, who will have previously been paid under similar performance bonus contracts and who will hold similar values to current executives. This makes it highly likely for them to believe those contracts and values are appropriate. This is likely to make them biased in favour of the executive in valuing the performance of an executive. This form of “group-think” also means it is unlikely that theories and processes resulting in higher executive rewards will be challenged.

Seventh, independent directors typically lack the time and information to challenge executive reward recommendations and decisions. Finally the use of compensation consultants has tended to bias analysis of executive rewards upwards as the consultants are also vying for other work from executives of the corporation. This means they have a conflict of interest when dealing with the executives.

Bebchuk and Fried concluded that the setting of executive rewards was an example of the use of “management power” rather than the operation of a market mechanism. That is, executives are in positions of power and influence, with control over both the information and resources of the corporation. They use this position to force or encourage higher levels of reward than are justified from shareholders\textsuperscript{165}. This is an example of rent-seeking behaviour by the executives.

Bebchuck and Fried argued that corporate executives are in almost complete control of the reward setting process. The only reason that prevents them from setting reward levels even higher is what Bebchuck and Fried refer to as an “outrage constraint”\textsuperscript{166}. That is, executives set their reward levels just below the level at which community resentment would force governments to make regulatory changes to the way in which executive rewards are set.

\textsuperscript{165} Lucien Bebchuk and Jesse Fried, (2004), pages 61-79.
\textsuperscript{166} Lucien Bebchuk and Jesse Fried, (2004), pages 64-65.
Another means by which executives maintain this system is “camouflage”. Executives are in control of corporate accounting and information flow. They have many opportunities to hide or confuse the perception of the true value of their level of reward. This is particularly the case with the value of future stock options, which can be easily manipulated by the executive as they control reporting of corporate performance to the stock exchange. Alternative explanations for trends in corporate rewards such as mistakes or misunderstandings by boards are rejected by Bebchuk and Fried as implausible, because the direction of the “mistakes” is not random. Board decisions have consistently been in the direction of higher rewards, which suggests an underlying force and motivation in the pattern of behaviour.

Bebchuk and Fried were not the only scholars to reach this conclusion on the reality of corporate executives’ power and the inability of boards of directors to control them. Lorsch and MacIver (1989) had reached a similar conclusion ten years earlier\(^\text{167}\).

One difficulty with Bebchuk and Fried’s management power explanation of executive rewards is that it is difficult to measure and prove that management power has increased. Murphy and Hall (2003)\(^\text{168}\) argued that the management power theory must be false because they considered management power fell during the 1990s. During this era focus on corporate governance increased and more independent directors were appointed to corporate boards. If the management power theory were the correct explanation for executive reward levels, then those rewards should have fallen during this period when in reality rewards kept on rising\(^\text{169}\).

However as Bebchuk and Fried (2004)\(^\text{170}\) pointed out in reply, Hall and Murphy assume that management power did actually fall due to the addition to boards of independent directors. They cited several reasons why independent directors did not greatly reduce management power. Other countervailing forces saw overall management power continue to rise, in parallel with executive rewards. One of the most obvious reasons was that


\(^{169}\) Kevin M. Murphy, “Explaining Executive Compensation: Managerial Power vs. the Peceived Cost of Stock Options.” University of Chicago Law Review (Summer 2002).

\(^{170}\) Lucien Bebchuk and Jesse Fried, (2004), pages 72-73.
independent directors were typically recommended for election by the incumbent executives.171

A similar counter-argument to management power theory as Hall and Murphy’s could be made regarding the increase in corporate regulation, corporate governance requirements and reporting following the dot-com collapses of 1999-2000. The passing of the Sarbanes Oxley Act (2002)172 in the United States, effectively prohibited some of the eight practices and required greater transparency in executive pay contracts. In Australia parallel reforms to corporate regulation and reporting of executive rewards was made with the CLERP9 reforms of 2004173. Critics might argue that this should have reduced management power and executive rewards if they were not market based.

Bebchuk and Fried concluded that the Sarbanes Oxley Act may improve the situation slightly. However they considered that the underlying cause of excessive CEO pay was managerial power, and that it was not due to a lack of transparency in the market. Lack of transparency is still an essentially market-based explanation of executive rewards. Managerial power was not greatly altered by the Sarbanes Oxley Act. Bebchuk and Fried felt that significant problems would remain, and average CEO pay would remain very high.

As we saw in Chapter Two, there was no change to the growth trend in executive rewards in Australia or the United States from subsequent to the Sarbanes – Oxley Act and CLERP9 up to the financial crisis of 2008-09. This suggests the likely growth of management power through this period, but neither proves nor disproves the management power theory in isolation. It does highlight one weakness of the management power theory. As management power is not a market-forces theory, some further explanation of the cause of increasing management power, beyond asymmetry of information, is required.

4.3.3 Structural Causes of increased management power

Proponents of management power explanations for the continued rising trend in executive rewards in the United States (and Australia) argue that management power has risen

173 Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 (also known as CLERP 9), Commonwealth of Australia, 1 July 2004.
Despite the changes in corporate regulation and governance that have occurred in the past three decades. This requires explanation of what else could have changed in this period to cause this rise in management power. Many theories could be advanced to explain this. I will now suggest an alternative hypothesis of what I consider to be the most likely cause of increasing management power: increasingly diffuse and indirect share ownership.

In the more than two centuries since Adam Smith first began modern economic theory, the nature of private firms has changed greatly. In particular, they have become much more structurally complex. In addition, the nature of share ownership arrangements outside the structure of the corporation has grown in parallel. More layers of ownership and control of shares have been added over time. This has made the link between ownership and control of corporations more remote.

In the 18th Century, when Adam Smith wrote, the first limited stock companies consisted of shareholders who passed their instructions to the company directly, or via the “principal clerks” Smith referred to, who fulfilled the role of managers or executives. This also created the first separation between ownership and control within the company. Smith warned in the Wealth of Nations, when ownership is separated from management (i.e. the actual production process required to obtain the capital), the former will inevitably begin to neglect the interests of the latter, creating dysfunction within the company.

In the 19th Century a revolution occurred in the organization of businesses, as many formed into the first modern corporations. Corporations were made possible by several critical legal “inventions”, notably the establishment of joint stock companies (the UK Joint Stock Companies Act, 1844) and the concept of limited liability for companies (the UK Limited Liability Act, 1855). These decisions defined companies as legal entities separate to their creators, and having liability for their actions limited to company assets. Subsequent court decisions saw some legal rights of citizens extended to corporations. This represented a significant government intervention in capital markets in favour of corporations, in assigning them new rights and powers. Large corporations were not a solely market-based outcome. They had not been possible before these legal interventions. Economically this resulted in significantly larger and more powerful corporations, however the social success of these changes could only be defined in terms of whether they made the society better off.

This concept of corporations as “corporate souls” was introduced in all western countries and enabled businesses to grow rapidly in size. Boards of directors represented the interests of shareholders to the executives, who then acted upon them within the corporation. In this way ownership became effectively two steps removed from the control of the company.

In the latter part of the 20th Century, two further changes in the nature of share ownership occurred which have tended to reduce the influence of dominant shareowners in corporations. Previously most share ownership was in the hands of a small number of wealthy individuals, who dominated the boards of the corporations. By the late 20th Century many individuals of average levels of wealth were purchasing shares in corporations, known in Australia as “mums and dads”. This did not add another layer of separation between ownership and control, but made share ownership more dispersed. This more dispersed nature of ownership, first recognised by Berle and Means (1933) increased the potential for executives to exercise management power.

In the past 30 years this trend has been taken a step further, with Australia and the United States compulsorily requiring workers to save for their retirement through investment of a fixed percentage of their income into superannuation funds and pension plans. These “institutional investors” are not companies and their managers cannot be voted out by investors. The holdings of institutional investors have become the dominant form of share ownership. In Australia institutions owned 78% of shares in public companies by 2004175, and in the United States over 60%. With institutional investors, share ownership is now three stages removed from control, with share fund directors, corporate directors and corporate executives all standing between the investor and the company. In recent years a further trend towards share ownership via unreported private equity funds has had a similar effect for private equity investors176.

Agency theories of corporations recognise that shareholders and corporate executives are different groups with different interests and that behaviour of executives may diverge from

that which best suits shareholders, resulting in an agency cost. Yet this is now not the only level of agency cost. Agency theory as applied by Jensen and Murphy treats shareholders and the directors representing them as one group, with no divergence or monitoring costs between shareholders and directors. This was acknowledged as a weakness in the original paper of Jensen and Mecklin.\textsuperscript{177}

Management power theory as defined by Bebchuck and Freid considers directors and shareholders as distinct, effectively resulting in two sets of agency costs, between shareholders and directors and between directors and executives. I would agree with Bebchuk and Fried on this point and consider their model as an advancement over Jensen and Murphy’s assumptions. However in my view it is still an insufficient explanation of all the agency costs now occurring in corporate ownership.

I propose a new, more complex theoretical model of corporate ownership and control to better explain management behaviour, control and agency costs. If management power theory also took into account the increasingly indirect nature of share ownership via institutional funds it would result in three sets of agency costs. Each layer of agency costs creates the potential to distort the market. Costs would be incurred in the interfaces between institutional (fund) investors and fund managers, fund managers and company directors, and company directors and executives. These three models are shown diagrammatically in Figure 4.1.

\textsuperscript{177} Michael C. Jensen and William H. Meckling, (1976), page 356.
Corporate Ownership and Control

Figure 4.1 Models of Corporate Ownership

The models in the figure may be taken as applying to Jensen and Meckling’s explanation of agency theory (18th century model), Bebchuk and Fried’s explanation of management power (19th century model) and current practice as I have defined it in this thesis (late 20th century model). The components of the late 20th century model are not controversial and are implicitly acknowledged in most modern business writings. The glaring inconsistency is that most theories used to analyse corporate executive rewards are based on the 18th century model (Jensen and Meckling) or the 19th century model (Bebchuk and Fried), even while acknowledging the reality of the late 20th century model.

In practice the effect of these changes is likely to be far more complex than simply increased agency costs. Each set of agency costs is the product of a game-theoretic set of decisions by the different agents. As the corporate management “game” becomes more complex, with more actors involved, the number of decision trees and possible outcomes increases greatly. It is not the intention of this thesis to analyse all of the possible interactions between the four sets of actors and identify the likely outcomes. However it would seem at least possible under the third model (allowing for institutional investors) for some or all of the agents (fund managers, directors and executives) to bargain with each other so that their own interests are achieved at the expense of shareholders.
Hartzell and Starks\textsuperscript{178} found in the 1990s that the presence of institutional investors led to lower executive rewards. Conversely David, Kochar and Levitas\textsuperscript{179} found that institutional share-owners with business relationships with the firm were associated with higher executive rewards.

This risk of collusion increases greatly when it is appreciated that in reality the power relationships between institutional managers, directors and executives are not necessarily one-way. As Bebchuk and Fried\textsuperscript{180} demonstrated, some of the agents may have power over the principals. Corporate executives can influence the selection of directors, supposedly their employers. Corporate directors and executives can also influence institutional investor managers, through their ability to offer them board directorships and other personally lucrative incentives to act as they wish.

At this point it would seem that the one group without any ability to influence outcomes are the institutional share investors, most of whom are compelled to invest by law. In this model, the reality of corporate power structures in the early 21\textsuperscript{st} century is better illustrated by the diagram shown in Figure 4.2.


\textsuperscript{180} Lucien Bebchuk, and Jesse Fried, (2004).
Power Relationships in Corporations

The possibility of multiple-level agency costs has been proposed previously by Spiller (1990) in the context of politicians, interest groups and regulators. Spiller showed that this quickly leads to outcomes different from the traditional self-interest hypothesis. The idea of multiple levels in organisational contexts was considered by Klein, Danseranu and Hall (1994) who advocated more research and more complex theoretical models. Since then the idea has been pursued in research on pure agency theory and its application within organisations and political science, but not on executive rewards.

In my view this gradual evolution of increasingly indirect corporate ownership is the primary reason for the rise in management power over the past three decades. Share funds including private equity, superannuation funds and pension plans are generally all outside the corporate governance regimes developed to control corporations. Investment in the latter is compulsory in Australia and the United States, without the ability of investors to control fund managers. Thus while corporate governance regimes for corporations

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have tightened, the overall degree of accountability of executives as agents towards their ultimate principals, now mostly share fund investors, has declined. The lack of comparable reporting rules for private equity funds makes this problem difficult to quantify. Further research into this aspect of investment and governance should be an urgent priority for corporate regulators.

4.3.4 Social Causes of Increased Management Power

There are further non-structural reasons why management power may be increasing. The increasing professionalisation and specialisation of business executives increases rather than decreases these risks. Previous economic theories of the firm assume that corporations are separate entities that compete with each other to minimise costs (including agency costs) and maximise profits. Share fund managers, directors and executives are (as previously) defined as different interest groups in trying to analyse these markets.

Yet in sociological terms, for the majority of corporations, this is clearly not the case. It would be more accurate to characterise share fund managers, corporate directors and corporate executives as members of a common occupational group – business executives. In Australia and the United States the majority of directors are current or former executives, while in the United States the majority of CEOs were also executive chairman\(^{183}\).

There has been a parallel move to develop more comprehensive corporate governance regimes to control such influences. The incidence of non-executive directors has become more common after Jensen and Fama’s influential 1983 paper, when the importance of “outside” or independent directors became recognised\(^{184}\). Prior to this the majority of board members were acting as both directors and executives of the same firm at the same time.

However corporate governance may still be greatly influenced by social links between the individuals charged with responsibility for the governance. Social or peer group networks will often connect between directors and executives that should in theory be policing one

another\textsuperscript{185}. In the case of directors, the widespread practice of individuals holding directorships on multiple corporate boards makes it likely that individuals will hold more than one of these roles at the same time. For example, Carroll, Fox and Orstein showed that the vast majority of Canada’s banks were controlled by a small group of individuals holding multiple directorships\textsuperscript{186}. Davis and Thompson have linked social groupings to corporate control mechanisms\textsuperscript{187}. Similarly Kramarz and Thesmar found that social networks strongly influenced the composition of French corporate boardrooms\textsuperscript{188}. That is, boards tended to choose new board members from individuals they already knew.

There are more concrete manifestations of such links. The Business Council of Australia (BCA) is composed of the CEOs of Australia’s 100 largest corporations. It purportedly represents the interests of Australian corporations (and presumably their shareholders). In 2010 its board was composed of a collection of CEOs, Directors, Managing Directors and Board Chairs and Presidents, including three individuals who were both managing director and CEO of their corporation\textsuperscript{189}.

The much larger United States Chamber of Commerce aims to represent all private business interests in the United States, and claims over 300,000 member businesses. Again, its board is a mixture of CEOs, other corporate executives, Directors, Managing Directors and Board Chairs and Presidents, with many individuals who were both Chairman of Directors and CEO of their corporation\textsuperscript{190}. In practice, it can be seen that corporate directors and executives do act and think of themselves as members of one group. This creates the obvious potential for conflicts of interests and increases the risk of collusion.

\textsuperscript{188} Francis Kramarz, and David Thesmar, “Social Networks in the Boardroom.” \textit{CEPR Discussion Paper No. 5496} (February 2006).
\textsuperscript{190} Retrieved online from United States Chamber of Commerce website at \url{http://library.uschamber.com/about/board/board-directors} on 14 July 2010.
Following the work of Fama and Jensen there have been many studies of the effectiveness of boards and their structural causes. Most of the evidence that is available suggests that board composition does affect performance. Daily and Dalton found that bankrupt firms were more likely to have had executive chairman\textsuperscript{191}. Carter, Simkins and Simpson found that where boards were more diverse, corporate (share) value was increased\textsuperscript{192}. Uzen, Szewczyk and Varma found a strong correlation between a lack of independent directors and the incidence of corporate fraud for United States corporations\textsuperscript{193}. As Fama, Jensen and Meckling hypothesised, the majority view is that boards with greater independence exercise greater oversight of the corporation, which leads to better performance.

There is a dissenting view that boards with close internal ties foster cooperation and may still perform well. Westphal found that boards with social ties between members tended to be more cooperative and effective\textsuperscript{194}. Ferris, Jagannathan and Pritchard\textsuperscript{195} found that there was no evidence that directors with multiple directorships were less effective at preventing fraud. This does not contradict Uzen Szewczyk and Varma’s findings, since directors with multiple directorships may still be a cause of increased independence.

Even if treated as members of competing organisations, there is no reason to believe that individuals with a shared interest will not cooperate in achieving that interest while competing in other respects. Members of other professional groups such as doctors, lawyers and engineers may belong to competing firms but still act jointly through professional associations when trying to achieve higher incomes for their members. This is simply the pursuit through group action of a rational self-interest shared at the individual level by all members of the group. Business executives have formed their own professional organisations such as the Company Directors Association (CDA) in Australia,


which lobbies government on their behalf on matters including legal liability and incomes of corporate directors and executives.

In this environment it is at least possible that share fund managers, corporate directors and corporate executives may act as members of competing groups when dealing with aspects of corporate strategy, but as members of a shared interest group when negotiating their personal incomes. Thus collusive games may emerge between them. For example, as Bebchuck and Fried pointed out, corporate directors may agree to executive remuneration committees that grant higher executive reward contracts, in implicit exchange for executives recommending higher fees or other benefits to directors\(^\text{196}\).

Proponents of incentive theories or other market based theories for setting executive rewards could argue that each agency cost within the more complex structure could be reduced to a secondary market. Assuming each market is efficient, owners/investors could choose to leave that market if dissatisfied with the performance of their agent. Thus the extraction of economic rents by various agents would soon cease.

In practice the ability of owners/investors to leave is questionable due to the compulsory nature of most retirement fund investments. Further, in Australia and the United States the rules on the management behaviour and reporting of institutional funds, notably private equity funds, are much weaker than comparable rules for public companies. Investors in such funds can choose to remove their capital from the investment fund, however they have little ability to influence the management of the fund. In such circumstances the likelihood of such a secondary market developing and operating efficiently would seem remote.

Theoretically, the assumption that a secondary market can be established to solve the multiple-agency cost problems faces other difficulties. It is not clear that the structure and behaviour of such funds constitutes a competitive market. In an environment where wage earners are legally obliged to invest in such institutions, there appears little incentive on the part of the funds to compete in a way that would eliminate economic rents being extracted from their investors. They might prefer to act as oligopolists to give one example of an alternative outcome structure. Institutional fund members in Australia and the United States cannot vote to sack their managers. In such an environment economic rents could

\(^{196}\) Lucien Bebchuck, and Jesse Fried, (2004), page 30.
be extracted by fund managers in a lasting manner, via collusive agreements between fund managers and executives.

4.4 Summary

In summary, we have reviewed two economic theories to explain corporate management costs (agency theory) and executive rewards (management power). Agency theory recognises that there will be conflicts between principals and agents, such as shareholders and executives. The theory fits with the structure of corporations and the evidence of trends in executive rewards.

Management power theory builds on agency theory to explain current corporate executive reward practices. Over time corporate power structures have grown more complex and share ownership has grown more indirect. The potential for increased management power to be acquired by agents has grown in an era of institutional share ownership and compulsory investment in share funds. The difficulty for management power theory is that once again, it cannot determine an appropriate level of executive rewards. It also requires some causal proof that management power has increased in an era of increasing regulation of corporate governance.

The cause of the increase is the change in share ownership that has occurred in recent decades, with the majority of share ownership now in institutional share funds. These generally operate outside the corporate regulations and governance practices developed for corporations. Thus while corporate governance for corporations has increased, control of corporations has largely moved outside this regime, and overall management power has increased.

The conventional understanding of agency theory in corporations needs to be replaced by one that includes institutional (share) fund investors and fund managers as well as directors and executives. This adds additional layers of agency cost. Collusion then becomes possible between any two of the agents, or all three agents in combination. If we assume that all agents do act in investors’ interests, the informational requirements for investors to make rational choices between agents would still be extremely complex, and may be beyond the ability of most individuals without specific training to comprehend. If in practice the individuals comprising fund managers, directors and executives are all known
to each other, they are more likely to cooperate to extract and share economic rents from investors.

In my view, this is precisely what has happened in the executive labour market over the past thirty years, and explains the rise in management power that Bebchuk and Fried identified as the cause of increased executive rewards. This is a more complex version of the management power thesis than Bebchuk and Fried’s. However it still relies on management power as the cause. It reinforces and extends, rather than contradicts, Bebchuk and Fried’s explanation. Increased management power remains the explanation of increased executive rewards. Changes in share ownership and corporate power structures are the cause of the increased management power.

Despite the strength of this explanation, the predominant view in business management remains that executive rewards are the market determination of the amount of reward executives need to be paid to work for their corporation. Next in Chapters Five and Six I will examine the alternative market based theories for rewards and their application to corporate executives. These are the alignment and incentive theories most commonly used as justifications of current practices by defenders of executive remuneration levels in Chapter Five, and remaining market based theories in Chapter Six. I will review arguments for and against each to see if either theory is more likely to result in an economically efficient executive labour market, or can justify current levels of executive reward. This will lead to a consideration of policy recommendations in Chapters Seven and Eight.
5 Alignment and Incentive Theory

5.1 Alignment Theories

In this chapter I will examine what I define as “alignment theory” for executive rewards. This has been the predominant model used for both explaining and justifying the level of executive rewards in the business and accounting fields over the past three decades. I will focus on alignment theories as defined by Jensen and Murphy, who gave the most commonly cited form of the theory used in executive compensation literature. Alignment theory is not a normative theory of rewards, though as we shall see, it has been used as such by its authors and others to defend the legitimacy of executive reward practices.

I will evaluate the validity of alignment theory against both the empirical and normative criteria we have previously discussed in Chapters Two and Three. I will demonstrate that alignment theory as applied in the case of executive rewards does not satisfy either of these sets of criteria. I will then discuss common criticisms of alignment theory, and whether or not it could be made more acceptable in a modified form.

Like management power theory, alignment theory recognises that there are agency costs in corporations, which prevent them from being optimally efficient in an economic sense. Unlike management power theory, alignment theory considers that it is possible to minimise agency costs through market-based contractual mechanisms between firms and their executives. The level of executive rewards that is the outcome of those mechanisms should then be efficient if executive labour markets are efficient.

The central assumption of alignment theory is that while an agent has different interests to the principal that hired them, the agent’s rewards may be structured so as to align the agent’s actions with the principal’s aims. That is, the structure of the reward gives the agent an incentive to act to achieve the objectives desired by the principal. Thus alignment theory is a sub-set of the broader category of incentive theories.
This solution to the “principal – agent problem” is not confined to executive rewards. Incentive theory has been recognised since the writing of Stiglitz\textsuperscript{197} and others and has been applied to fields such as agricultural production, and transport economics\textsuperscript{198} as well as pay-performance. I will briefly discuss the general context of incentive theories and how alignment theories are distinct from them. This distinction is important. There is evidence that incentive theories can be an efficient way to minimise agency costs in principal – agent problems if applied in an appropriate manner and circumstances\textsuperscript{199}. The concerns I will demonstrate are with the peculiarities of alignment theory, and its application in the case of executive rewards. I will argue that incentive theories such as alignment theory are not a solution to the principal – agent problem in the case of corporate executives.

5.1.1 Jensen and Murphy’s Alignment Theories

We saw in Chapter Two that current practice for executive pay in Australia and the United States relies on the use of performance-based bonuses to executives. This trend is often justified by reference to studies of the relationship between performance-based executive rewards and corporate performance. Two figures, Michael C. Jensen and Kevin J. Murphy, are most commonly associated with the evolution of these practices and research supporting them. Jensen and Murphy did not explicitly define a theory to explain this form of executive rewards, however their views became apparent over a series of papers. A brief history of Jensen and Murphy’s work gives a useful overview of current practice, which I will call alignment theory.

Following Jensen and Meckling’s\textsuperscript{200} 1976 paper, the possibility of using incentive payments to minimise agency costs had already been raised. It was claimed that contracts between principals (shareholders) and agents (executives) could be structured so that it was in the agent’s personal interest to act to maximise shareholder wealth. The question remaining was how to structure such contracts. Together first Jensen and then

Murphy pioneered forms of empirical analysis that they claimed to establish relationships between payments to executives and corporate performance. They then argued for executive rewards to be structured on a corresponding basis. It should be noted that the claims made in these early papers were based on economic analysis of what would be financially efficient for a business, and were not normative claims about the legitimacy of a reward practice.

Jensen (1985)\textsuperscript{201}, Murphy\textsuperscript{202} and others who were familiar with agency theory undertook quantitative research on executive salary and firm performance in the United States. There had already been previous investigations of the topic, but this was perhaps the first systematic program of research to understand executive reward practices from the viewpoint of agency costs. As stated previously in Chapter Two earlier studies had not indicated a relationship between executive rewards and corporate performance in the United States. By shifting the analysis from profits and pay to increases in executive and shareholder wealth (share price) significant relationships were found.

Jensen and Zimmerman (1985) claimed they had found evidence that the following executive pay practices were correlated with corporate performance:

1. Changes in executive remuneration were positively related to share price performance (Murphy 1985). The correlation was weak.
2. Managers with bonus plans choose accounting accruals that increase the value of their bonus awards (i.e. the share price).
3. The adoption of short and long term executive compensation plans and “golden parachutes” (contracts that gave executive large bonuses if their contracts were terminated early) were associated with positive share price reactions.
4. The stock price increases with the death of a firm’s founder.
5. Stock prices increase with the announcement of golden parachute clauses for executive contracts.


Jensen and Zimmerman hypothesised reasons for these relationships. They argued that most demonstrated that markets react positively to actions that tie the executive closely to the performance of the firm. The executive will presumably be rewarded when the corporation performs well in the share market. Reasons for the other relationships were less obvious but could be inferred. Golden parachute clauses in executive contracts were perceived to resolve a significant conflict of interest for the executive if a merger was involved. They would counteract the motivation of the executive to block a merger in order to preserve their own position and self-interest.

These findings led Jensen to the conclusion that “executive compensation plans [containing bonus plans for executives] help align managers’ and shareholders’ interests.” Shareholders benefited from the plans because the increase in share prices and consequent increase in shareholder wealth coincident with use of the plans exceeded the cost of the compensation plans to shareholders. Thus agency costs were minimised.

This was the foundation of alignment theory for executive pay, which was described as the “incentive hypothesis” by Jensen. Jensen and Murphy would continue to refine and defend the theory for the next twenty-five years. The core belief in it remained that the interests and actions of executives could be aligned to the “shareholders’ interests (presumed by Jensen and Murphy to be wealth maximisation via share prices and dividends) via contracts that closely linked executive reward to corporate performance. The link (alignment) would be achieved by paying executives performance bonuses of shares in the corporation, based on the achievement of performance targets such as improvements in the share price. It was intended to be as Jensen wrote in his 1985 conclusion:

“In summary the papers in this volume are consistent with the conclusion that executive compensation plans help align managers’ and shareholders’ interests.”

This conclusion was a subtle but significant shift from the conclusions on agency theory referred to in Jensen’s earlier 1976 paper, where managers’ and shareholders’ interests were taken to be different. Agency theory allows for the possibility that agent’s actions can be aligned with the principal’s interests through incentives structured into the agent’s

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rewards. It does not assume that the agent’s and principal’s interests are aligned. That their interests might conflict is one of the assumptions of agency theory.

Jensen viewed the alignment mechanism as purely a means to minimise agency costs rather than manage a fundamental conflict of interests. He did not consider that executives failed to act in shareholders interests in practice. He wrote in his 1985 paper: “For example an extreme view that has received considerable attention holds that executives do not act in their shareholders interests and that they control their boards of directors.”

There seems to be no theoretical basis for Jensen’s shift from alignment of actions as in his paper with Mecklin to alignment of interests as in the above quote from his paper with Zimmerman. This shift enables the elimination via alignment theory of a conflict of interests between principal and agent that is fundamental to agency theory. Contrary to Jensen’s view, I do not think we have any reason to believe that the conflict of interests can actually be eliminated, at least not solely by a contractual mechanism. I will return to this point later.

5.1.2 Assumptions Implicit in Alignment Theory

Jensen and Murphy’s conclusions are based on empirical research, but it is important to understand the theoretical and methodological assumptions that are inherent in them to determine whether they are valid. We will examine them to see whether they are valid in principle, and whether they are consistent with the empirical evidence discussed in Chapter Two. We will also note their implications for any normative conclusions that have been made using alignment theory.

The first and most obvious assumption in alignment theory is that it implicitly assumes that corporate performance, as measured by share price, is due to the executives’ efforts. Jensen and Murphy acknowledge other factors also influence corporate performance and do not suggest that executives are the sole or even primary cause of profits or share prices. Nevertheless, in using empirical relationships between corporate performance and executive rewards to justify their theory, they are assuming that the two are causally linked. This assumption of executives being the causal agents, without testing if other causes are more valid, as already discussed in Chapter Two, is methodologically unsound.

Other explanations can be posited for why corporate performance and executive rewards are related, that do not imply a causal link from the executive’s performance. For example, proponents of management power explanations could argue an alternative explanation. More efficient or profitable corporations will be more financially capable of giving larger rewards to executives. Astute executives will then seek out positions with corporations known to be efficient and/or profitable to obtain correspondingly larger rewards. However, subsequent large rewards being paid to those executives would not prove that they were responsible for the corporation’s performance, only that they had benefited from it. To be scientific in their approach, Jensen and Murphy should have discussed such alternative hypotheses and explained why they were less valid, rather than simply present their own hypothesis and fit it to the data.

The second major difficulty for this assumption is empirical. Putting aside questions of cause and effect, the relationships in Australian and United States data we saw in Chapter Two are extremely weak. They do not meet the normal standards of proof in social scientific research. Defenders of alignment theory might argue that this may be due to the incomplete implementation of the theory due to the many market distortions identified in chapter four, and in the absence of these distortions stronger relationships may become evident. Nevertheless after three decades of analysis and attempted implementation, the proof empirical proof for alignment theory remains weak. This is a fatal flaw in a theory that relies on empirical evidence, rather than any underpinning meta-theory of behaviour, for its legitimacy.

A second critical set of assumptions centres around the view that share prices are accurate predictors of the corporation’s performance. The first of these is that share markets are assumed to be efficient. This assumption is based on Fama’s “efficient markets hypothesis” (EMH), which holds that markets would rationally seek sufficient information to be efficient without external regulation. Jensen had earlier written with Fama on aspects of this theory. In alignment theory this is taken a step further, with the further assumption that share market prices assumed to accurately reflect all information known to the market.

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An important conclusion of EMH is that it is impossible to outperform the market in the long term except by luck. In recent times EMH has been criticised by behavioural economists\textsuperscript{208} who have found that markets are in practice not efficient. It has particularly fallen out of favour since the global financial crisis has exposed markets’ inability to price complex risks in asset markets\textsuperscript{209}.

Jensen and Murphy’s view on executive rewards is best understood in the context of prevailing trends in political and economic theory during the 1980s. There was a strong push towards decreasing market regulation of all sectors in most western countries, including Australia and the United States. This was the case during the period from their first writing in the late 1970s up to the global financial crisis that commenced in 2007/08. Free market ideologies such as those espoused by economist Milton Friedman\textsuperscript{210} became increasingly dominant in economic and political thought. Achieving social policy outcomes via market mechanisms such as bargaining for performance-based contracts came to be seen as inherently preferable to government regulation or “interference” in the market. Jensen and Meckling shared this view\textsuperscript{211}.

Assuming EMH theory holds, alignment theory has obvious benefits from an economic efficiency viewpoint. The share market is efficient in accurately reflecting the performance of a corporation in its share price. The share price is then also an accurate reflection of the executive’s performance, assuming that the share price is influenced by it. The executive labour market then is accurate in setting the level of executive rewards based on the executive’s performance, since the rewards are linked to the share price. In that case, an executive rewards package linked to the corporation’s share price will accurately reward the executive’s efforts, since their rewards will match the share price determined by

\textsuperscript{209} "We are all Keynesians now." *Boston Globe*, Editorial November 25, 2008. Retrieved on-line 2008-12-16. Chicago school economist Robert Lucas was quoted as saying “I guess everyone is a Keynesian in a foxhole”. Lucas had formerly won the Nobel Prize in Economics for theories critical of Keynesian economics.
\textsuperscript{210} Milton Friedman and Rose Friedman, “Free to Choose: A Personal Statement.” (San Diego: Harcourt 1980).
their efforts. Alignment theory then promises an economically efficient means of setting executive rewards, provided these assumptions are correct.

The difficulty with this approach is that it is a circular argument. If all three assumptions are true (efficient share market, efficient executive labour market, executives influential on corporate performance) then alignment theory may be valid. If any one of these assumptions is false, then alignment theory is not valid. For example the failure of EMH for share markets alone is sufficient to invalidate alignment theory, because if share market prices are not accurate reflections of corporate performance, then neither are the executive rewards linked to them. This means that Jensen and Murphy’s empirical analysis does not in itself prove alignment theory correct. It would only prove that the analysis has been undertaken consistently with the assumptions of alignment theory.

Against this criticism, a weaker form of alignment theory could be argued, that abandoned bonuses tied to share prices and still claimed the general principal of the theory: a contract that tied the rewards of the executive to the performance of the corporation might be sufficient to motivate the executive to act in the interests of shareholders. This would be an easier proposition to support, although it would negate virtually all of Jensen and Murphy’s supporting analysis. Alignment theory would then be theoretically possible, but unproven.

5.1.3 Level of Executive Rewards

Jensen and Murphy’s 1985 studies did not consider the level of executive reward. This was a major omission, since the overall level of executive rewards is, as we saw in Chapter One, the area of greatest community concern. Consideration of the level of executive rewards is relevant to evaluating alignment theory in several respects.

Firstly, arguments for alignment theory are based on empirical evidence that executive rewards can be linked to achieving greater economic efficiency. The level of executive rewards will itself be a factor in determining whether they are economically efficient. Secondly, alignment theory has been used in an explanatory or justificatory manner to rationalise executive rewards as an outcome of the executive labour market. Jensen and Murphy commented on the level of executive rewards in this manner in later papers, and
so it is appropriate to consider the broader question of whether executive reward levels can be explained by alignment theory.

Finally, and most significantly for this thesis, reward levels are relevant to making normative judgements about whether the rewards are justified. Jensen and Murphy’s analysis of differences in reward between executives is only relevant to the justice of reward levels *internally*, within the practice of corporate executives, but not *externally*, within the wider community. This is not sufficient for making a normative judgement on executive rewards. Principles of justice are not confined within a practice, but extend throughout the community in which it is based.

For example, when debating whether the pay rate of plumbers is fair, the debate does not focus on whether the difference in pay between the highest paid and lowest paid plumbers relates to their difference in skill. The question is whether the overall level of reward for plumbers, relative to the rest of the workforce, seems reasonable, given the skill and effort required in the occupation. The same principle applies to considering the justice of rewards for all occupations, including executives. Thus alignment theory is not an adequate basis for making normative judgements about the level of executive rewards though, as we shall see, it has at times been used in that manner.

I will consider economic efficiency first. Without consideration of the overall level of executive rewards, Jensen and Murphy’s analysis can only show whether the *dispersion* of executive rewards matched the *dispersion* of corporate performance. This is not sufficient to prove performance incentives are efficient. To be *economically* efficient, alignment theory must result in a level of executive rewards that is the *minimum* level sufficient to achieve optimum corporate performance. Otherwise agency costs are not minimised and so the result is not optimal for shareholders. Even if a distribution of executive rewards is perfectly consistent with the distribution of corporate performance, it would not be efficient if the same could be achieved with a lower level of rewards. Not considering the level of executive rewards is an extraordinary omission by Jensen and Murphy, since consideration of the level of rewards is a standard aspect of assessing the efficiency of labour markets for any occupation in economics$^{212,213}$.

For example, suppose that three corporations in an industry, A, B and C, have annual returns to shareholders of +10%, +20% and +30% of capital value. If their annual executive rewards were correspondingly $1 million, $2 million and $3 million, then under Jensen and Murphy’s analysis this would give a perfect correlation between reward and performance. Suppose the same performance were achieved and the level of rewards was divided by ten, so that executives received rewards of $100,000 for A, $200,000 for B, and $300,000 for C. Under Jensen and Murphy’s analysis the same perfect correlation result would be achieved, even though the shareholders would be better off by $0.9 million for A, $1.8 million for B and $2.7 million for C. Clearly, the second level and distribution of rewards is more efficient than the first.

This argument does not in itself prove that alignment theory results in economically inefficient levels of reward for executives. Conversely, it shows that alignment theory does not guarantee an economically efficient outcome either. Without that, one of the key justifications for accepting alignment theory is eliminated.

I will next turn to attempts to use alignment theory to explain levels of executive reward. The question of the level of executive rewards is not an arbitrary or subjective one. Jensen at the time of his first papers in 1985 did not view executive rewards as too high, contrary to public opinion. He stated that:

“the studies in this volume do not address the complex issues associated with the frequently made, but unsupported, assertion that executive pay is “too high”.”

Jensen claimed that it was equally plausible, though also unproven, that executive rewards might be “too low”. At this time executive rewards in the United States had been increasing, in comparison to 1970s levels. The 1970s were themselves the lowest point in executive reward in real terms since the 1930s. Executive pay in the United States in the 1980s was still higher than for any other occupation, and higher than for executives in any other country, and so Jensen’s claim that executive pay being too low was equally as plausible as it being too high seems highly improbable. Jensen did acknowledge that the question of the level of executive rewards needed further study and both he and Kevin Murphy considered it in subsequent work.

Alignment theory was developed further in a later paper by Jensen and Murphy (1990). At that time executive rewards had risen significantly in real terms in the United States throughout the 1980s and had begun to attract wider attention and criticism. Despite this, Jensen and Murphy considered the level of executive rewards as the outcome of a free labour market and did not regard them as problematic. They had researched data on executive rewards and corporate performance from the 1980s back to the 1930s, when corporations were less regulated. The higher executive reward levels (in real terms) in the 1930s, relative to the 1980s, were used to argue that rewards in the 1980s had not risen over historic levels.

“The current popular belief that CEO pay in the largest corporations has increased dramatically over the past several decades is therefore not supported by these sample averages.”

This view is even less defensible than the comments on reward levels in Jensen and Murphy’s 1985 papers, given the intervening rise in the level of executive rewards. Their view that the level of executive rewards in 1990 was acceptable because it had returned to unregulated 1930s levels is arbitrary. Adoption of a different earlier comparison point would have resulted in a different conclusion. Again, there was no attempt to link the level of executive rewards to any definition of economic efficiency.

The key empirical claims in Jensen and Murphy’s 1990 paper were:

1. Claims of excessive CEO pay growth were disputed because CEO pay in real terms had only returned back to the level of the 1930s.
2. Performance bonuses were now widely used but the performance measure (typically stock price) was usually based on absolute changes in the corporation’s share price and not relative to the rest of the market (relative performance evaluation or RPE).
3. There was little correlation between performance and CEO reward; the highest rewards were not going to the best performing CEOs.

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217 Michael C. Jensen and Kevin J. Murphy, (1990), page 38.

4. The lack of variability in CEO bonuses suggested they were almost always awarded, suggesting performance targets were set too low.
5. The share of stock held by the CEO was continuing to decline.

They acknowledged that the evidence did not support what they defined as agency theory (alignment theory):
“We believe our results are inconsistent with the implications of formal agency models of optimal contracting. The empirical relation between the pay of top-level executives and firm performance, while positive and statistically significant, is small for an occupation where incentive pay is expected to play an important role.”

At this point Jensen and Murphy should have been prepared to acknowledge that the executive labour market in the United States was not efficient. The explanatory strength of their (alignment) theory in regard to executive reward levels was shown to be weak. The empirical relationships identified in their earlier work and used to justify alignment theory in rewards for executives were declining in strength, despite the weaknesses described earlier in their original formulation. If EMH was correct for share markets and executive labour markets, this should not have been the case. If EMH was incorrect for those markets, alignment theory was invalid.

Jensen and Murphy considered opposing hypotheses to alignment theory but disagreed with them. Instead they suggested an alternative “implicit regulation hypothesis”, that acted in addition to alignment theory, to explain discrepancies between the data and the results expected from alignment theory. In this “political forces operating in both the public sector and inside organisations limited [minimised] large payoffs for executive performance”. This was then justified with comparisons to the 1930s data referred to previously. Again, there was no political or economic meta-theory introduced to support this. In my view this hypothesis is not sound. Applying Ockham’s razor, it is unsound to hypothesise additional elaborations of a theory, in order to justify its departure from available evidence, when it would be simpler to conclude that the theory was invalid. As an explanatory theory of executive reward levels, alignment theory had proven unsatisfactory by 1990.

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219 Michael C. Jensen, and Kevin J. Murphy, (1990), page 2.
220 Michael C. Jensen, and Kevin J. Murphy, (1990), page 34.
221 Michael C. Jensen, and Kevin J. Murphy, (1990), page 35.
Jensen and Murphy responded to critics of the level of executive rewards in other papers with proposals to better structure and target the payment of rewards\textsuperscript{222}. They still retained their view that incentive based pay was appropriate and the high levels of CEO pay were justified.

Murphy later stated that the campaign against CEO pay "is a disguised attack on wealth." By holding CEO pay up to public criticism, he said, "we run the danger of driving our best people out of the boardroom."\textsuperscript{223} These later views were Murphy’s opinion and he provided no evidence in support of them.

In continuing to hold their support for alignment theory in the face of contrary evidence, in my view Jensen and Murphy at this point ceased being impartial analysts and became advocates for particular (high) levels of executive rewards\textsuperscript{224}. As stated previously, that position cannot be justified on grounds of economic efficiency. They remained open and honest in describing their findings and requirements for further research. Yet explanations of the observed data that might contradict alignment theory, such as management power, were dismissed.

The trend towards rising levels of executive rewards accelerated through the 1990s, with CEO pay in US corporations reaching four times early 1980s levels in real terms by the late 1990s. Jensen and Murphy continued researching and writing on the topic. Murphy defending incentive type contracts with performance bonuses for executives in a 1999 paper\textsuperscript{225}. Murphy believed that market mechanisms, such as contracts with performance based bonuses, were the preferable form of managing agency conflicts. The managerial labour market was an ideal field to study them.

\textsuperscript{224} Subsequent to this in 1994-95 Kevin J. Murphy worked as a consultant for Towers Perrin, a prominent firm for advice on executive remuneration in the United States. Murphy acknowledged the potential conflicts of interest in compensation consultants in his 2009 paper: Kevin J. Murphy and Tatiana Sandino, “Executive Pay and Independent Compensation Consultants”, \textit{Marshall School of Business Working Paper No. FBE 10-09} (2009).
Murphy noted in his 1999 paper a number of empirical changes in US CEO reward practices since the previous 1990 paper with Jensen:

1. CEO reward had doubled in real terms in the 1990s compared to the 1980s. This had matched an increase in firm size.
2. US CEO pay was higher than other countries regardless of firm size, by a decreasing margin. This suggested a globalisation of the market for executive talent, as firms expanded internationally.
3. The link between CEO turnover and performance had declined;
4. Retiring CEOs were tending to do so younger, with shorter tenures;
5. Stock options tended to be exercised immediately, upon vesting;
6. The majority of CEO pay was now in the form of stock options and bonuses. The proportion of CEO share ownership had not risen.
7. Murphy identified further research needed especially on subsequent performance of corporations after bonuses. CEO pay was an ideal “laboratory” to investigate incentive-based rewards.
8. Murphy concluded that the targeting of bonuses had improved, with performance and reward more closely correlated. However he noted the use of relative performance evaluation (RPE) for awarding bonuses remained very rare, which seems contradictory.

Murphy (1999) acknowledged that several of these results were departures from the predictions of alignment theory. The evidence of declining pay-performance sensitivity, declining CEO turnover – performance sensitivity, shorter CEO tenure, and immediate exercising of stock options could not be explained by alignment theory, and were instead consistent with management power theory.

Murphy identified causes of these departures from alignment theory and the need for reform of executive reward practices. He concluded “Although there is ample evidence that CEOs (and other employees) respond predictably to dysfunctional compensation arrangements, it is more difficult to document that the increase in stock-based incentives has led CEOs to work harder, smarter and more in the interests of shareholders.”

Despite the honesty of these admissions, Murphy seemed unable to acknowledge that the excessive use of stock options suggested alignment theory was invalid. Stock options had

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226 Kevin J. Murphy, (1999), Page 54.
become the means of escalation in executive rewards, rather than a market solution to them. Jensen and Murphy cannot be blamed for this trend. Studies have also linked other trends to increases in real incomes for corporate executives. For example, as taxes on very high incomes were reduced, high incomes increased, including those of corporate executives. Yet equally, Jensen and Murphy were unable to accept that an alternative explanation of corporate rewards was required. Murphy’s preference remained for further research and refinements to alignment theory-based rewards.

After the corporate collapses of the “dot-com boom” in 2000 public attention on executive rewards increased again. Following this Murphy did express concern about the level of executive rewards in several papers. By 2003 average CEO pay for large corporations in the United States had increased six fold over the early 1980s. This resulted in a further paper by Murphy with Brian Hall in 2002 that investigated the cost to share holders of stock options issued to CEOs and executives. Hall and Murphy identified that corporate boards and executives discounted the value of future stock options due to their inherent risks. This discounting of the value of future bonuses made them a costly way of providing incentives to executives. Hall and Murphy saw this as a technical failure in implementing alignment theory that had prevented it from properly achieving its objectives. Murphy remained committed to his preference for market based alignment theories of executive rewards.

5.1.4 Response to Management Power Theory

By the time of Jensen and Murphy’s later papers in the 1990s other authors such as Bebchuk, Fried and Walker (2002), had begun to publish papers on executive rewards. They highlighted that the real cost of CEO share bonuses was becoming extremely high, and hypothesised that this was due to increasing management power rather than any market-based incentive theory in operation. Management power was a contradiction of

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alignment theory, as it represented a non-market based explanation of executive rewards. Murphy responded to these critiques.

Murphy had by then become concerned about the level of CEO rewards as well as the implementation of incentives in rewards. In a 2002 paper Murphy responded to Bebchuk, Fried and Walker (BFW), acknowledging their evidence that the level of CEO pay had become excessive and was not justified relative to performance.

“The BFW analysis is comprehensive and provocative, and their evidence that pay practices reflect more than optimal contracting concerns is compelling. Equally compelling is their evidence that most pay decisions are not made by truly independent boards in legitimate arm’s-length transactions.”

However, Murphy disagreed that this was evidence of management power and economic rents being extracted by executives and attacked Bebchuk, Fried and Walker’s arguments in three respects which I will describe in turn.

1. Murphy pointed out the evidence that he felt was not consistent with the management power theory. This included the rise in CEO pay in the 1990s coinciding with more independent members being on boards, the tendency for CEOs hired from outside corporations to be paid more, and the escalation in the use of performance bonus-based contracts.

2. Murphy argued that the “outrage costs” BFW defined to explain why executives prefer to be paid more in bonuses than base salary were so vague as to be irrefutable.

3. Murphy offered an alternative (market based) hypothesis to management power to explain the apparent data on executive rewards.

Regarding the composition of boards, Murphy is correct to point out that there were a larger number of independently chosen board members on average during the period of the fastest rise in executive rewards in the 1990s. This trend should have reduced management power of executives over boards. Yet the impact of more independent board members on reducing management power could still be counteracted by other trends that increased management power. These trends included the increasing institutional share ownership I identified in Chapter Four. The impact of other countervailing forces on management power was not considered by Murphy. Independent board members are

only one factor in assessing management power, and their increase does not prove that management power overall has decreased.

Murphy’s argument that externally paid CEOs were paid higher than internally paid CEOs does not appear to provide evidence either way on management power. For Bebchuck, Fried and Walker’s hypothesis of management power, the question is whether the pay-performance link has improved, not whether they are internal or external to the firm. If management power exists the executive, whether hired internally or externally, will exert influence on the board and increase their pay over time in real terms. As Murphy acknowledged, the pay – performance link did decline in this period, consistent with management power theory. Similarly the increasing use of stock options for executive rewards does not disprove management power. Again, the question is whether the pay received is increasing out of proportion to performance, not whether it is received as a salary or bonus.

In my view the only valid criticism of the management power hypothesis that Murphy made was that the explanation of “outrage costs” by Bebchuk, Fried and Walker was vague and could not be quantified or tested. Just as Jensen and Murphy’s “implicit regulation” hypothesis from their 1990 paper was not provable, neither was “outrage costs” as defined. This part of Bebchuk, Fried and Walker’s paper remains speculative. This still does not invalidate Bebchuk, Fried and Walker’s overall conclusion about management power.

Instead of management power, Murphy preferred a market explanation. He argued that executive rewards were still based on market negotiations between executives and corporate directors. The questionable outcomes (i.e. too high rewards paid) in executive contracts could be explained by what he hypothesised as the “perceived cost” problem. Under this view both boards and executives underpriced the cost of executive share options when negotiating executive reward contracts. Murphy recognised this underpricing was a “market failure of sorts”\textsuperscript{233}. Again, as with the “implicit regulation” hypothesis developed with Jensen in 1990\textsuperscript{234}, Murphy preferred to posit a new, unproven revision to alignment theory, rather than to acknowledge the contradictory evidence and discard it.

\textsuperscript{233} Kevin J. Murphy, (2002), page 14.
\textsuperscript{234} Michael C. Jensen, and Kevin J. Murphy, (1990), page 35.
Murphy felt that the solution to the “perceived cost” problem was greater education of executives and directors and altering accounting rules to eliminate the asymmetry of information. He rejected the implications of Bebchuk, Fried and Walker’s management power thesis, stating it was: “revising corporate governance to require truly independent boards, without any real evidence that such changes would lead to improved corporate performance or more rational compensation decisions”\textsuperscript{235}. Murphy remained convinced that a market-based solution to executive rewards was inherently preferable to regulation of market outcomes. Yet if the management power explanation of executive rewards is correct, as Murphy acknowledges the evidence suggests, education of directors is unlikely to be effective as a solution, since the directors do not control the outcome.

In summary I consider this to be an inadequate response by Murphy in defence of alignment theory. He did not dispute that management power may be causing rising trends in executive pay, and acknowledged a degree of market failure. Yet he still considered that a market solution (alignment theory) was a preferable explanation. Most of his counter-arguments amounted to assembling particular pieces of evidence that did not fit the management power theory, while ignoring the fact that the overall pattern of executive rewards was inconsistent with alignment theory. An overall conclusion should be based on the overall trend, and this clearly favours the management power explanation.

Further, whether or not management power was a primary or partial explanation of executive reward practices did not justify Murphy’s rejection of the need for regulation of executive labour markets that had been outlined by Bebchuk, Fried and Walker. Murphy described their recommendation to focus regulation on executive rent extraction as being “potentially misguided and diverts attention from more important issues regarding executive compensation”\textsuperscript{236}. In acknowledging that market failure was apparent, he should have acknowledged the parallel need for regulation. His own conclusion that education of director’s was the solution to rising executive rewards, will be ineffectual if management power is the cause of the rise.

\textsuperscript{235} Kevin J. Murphy, (2002), page 15.
\textsuperscript{236} Kevin J. Murphy, (2002), page 3.
5.1.5 Asymmetric Information and Executive Control

A final concern for alignment theory not considered by Jensen and Murphy is the difficulty of designing performance targets that cannot be “gamed” by highly intelligent and highly self-interested executives. To work as intended under alignment theory, executive contracts must select performance targets that maximise corporate performance, translate them into measurable and reportable parameters of the corporation, and identify appropriate rewards for executives that meet those targets. The contract must also ensure that executives do not “game the system” by maximising reportable targets rather than corporate performance itself. For this to occur it is critical that performance measures correctly reflect the structure of the corporation and that performance reporting is accurate.

Yet while the shareholders, via the directors, control the contract (in theory) the executives control both the corporate structure and the corporate reporting. This makes it possible for a self-interested executive to manipulate contractual outcomes in their favour by manipulating the information on which the outcomes are based. For example, deliberate misreporting of profit results by the Enron Corporation prior to its collapse was a classic example of this risk being realised. Setting executive contracts with performance targets for bonuses seems an almost impossible task to perfect, if the executives control both the reporting and the framework within which it is assembled.

Specialist auditors and advisors could be used to determine and monitor the targets. However if these are appointed by the corporation, this runs the risk of reinstating the agency problem one step removed, with corporate executives influencing the behaviour of the auditors. The behaviour of Andersens Consulting in auditing Enron demonstrated this risk. If they are appointed by the directors, this places a large management burden upon them, and negates some of the advantages of having separate executives to manage the corporation. The more complex the reporting mechanisms become, the more likely the directors will need some assistance from executives to manage them. This is a classic example of an agency cost that cannot easily be eliminated.

Murphy has argued that the main difficulty with the application of alignment theory has been the lack of adequate information on the part of both executives and directors in

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assessing the value of corporate bonuses\textsuperscript{238}. I do not agree with Murphy on this point – the evidence is not random, and only points to a lack of information on the part of directors. If the lack of information applied to both sides then it would not produce an upward pattern in executive rewards. The data suggests there is a consistent pattern of stock option bonuses being defined to the benefit of executives, hence the rising rewards in real terms. Theories of asymmetric information (one side in a bargaining session having an advantage of additional information over the other side), rather than insufficient information, explain how this may distort market outcomes. This may be reduced by tighter regulation of reporting.

The reality of this problem can be demonstrated by considering the incidence of payment of executive performance bonuses against the accuracy of share performance forecasting. As has already been indicated, performance bonuses were paid to executives in the large majority of cases throughout the 1980s and 1990s. This suggests that performance targets were set too conservatively, and targets were too easily met as a result. This is not in itself a fault of executive contracts based on alignment theory, if the nature of the error was random. However in can be shown that the “error” was not random.

Analysis of the accuracy of United States stock market forecasting by McKinsey Consulting for the period 1985-90 to 2004-09 (five year rolling averages were used), shows that overall, market forecasters were consistently non-conservative in their predictions of future share returns. The only exceptions were in the periods immediately after the US recession of 1999-2000. On average, market forecasters were 25% high in their forecasting. This is shown in Figure 5.1.

\textsuperscript{238} Kevin J. Murphy, (2002), page 8.
The question for alignment theorists is, if share market forecasts have been generally optimistic, why were executive reward targets usually conservative? Under a climate of optimistic share market forecasts, we would expect impartially negotiated performance targets to also be optimistic and thus not to be achieved by the majority of executives. The opposite has been the case, suggesting that the problem of overly-generous performance targets is not random, and is based on more than lack of information.

I contend that the power of executives over a corporation makes this problem much more than a question of asymmetrical information. Tightening of regulations on corporate reporting and the structure of financial products do not change the fact that the executive, if the incentives are strong enough, may still be in a position to restructure the corporation itself, or its products, as well as its reporting, so as to avoid such regulations. In this case

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the purely self interested executive will weigh up the personal gain from the manipulation against the risk of being caught and the personal cost of any penalty. They will not consider the cost to the corporation of the manipulation. The invention of sub-prime mortgage investment products by financial corporations that allowed executives to claim large performance bonuses, but carried high financial risks for the corporation, is an example of this risk occurring\(^\text{240}\).

Tightening of corporate reporting has been a consistent feature of the reforms that have occurred in Australia and the United States from the early 1990s onwards. Yet none of these reforms have halted the rising trend of executive rewards or the continued incidence of scandals arising from executive behaviour in pursuit of their bonuses. Akerlof and Shiller (2009) have shown how new forms of manipulation have arisen after each reform\(^\text{241}\).

In some respects the financial scandals of 2008-09 were worse than the Enron Scandal. Enron’s losses were the product of deliberate wrongdoing that is difficult to halt under any system. The sub-prime crisis was the result of the legal manipulation of an insufficiently regulated market. The causes of the 2008-09 financial crisis are complex and apportioning blame is still a sensitive question. However there is agreement from several analysts that achieving personal bonuses was a motivating factor for most of the participants\(^\text{242}\). Once it is recognised that there will always be a motivation for executives to manipulate reporting under incentive theories, then it can be seen that there will also be a motivation for executives to search for new manipulations of corporate activity and structure, and a continual need for counter reforms.

Resources such as tax accountants, corporate lawyers and remuneration consultants will continue to be used by self-interested executives to exploit any loophole in existing regulations for personal gain. Where none exist, corporations and their products may be restructured to create such opportunities. This was exemplified by the creation of the collateralised debt obligation (CDO) markets by trading bank executives in the post 2000


\(^{241}\) George A. Akerlof and Robert J. Shiller, ( 2009), Chapter 3.

decade. These products were designed to be outside existing reporting regulations. This enabled the banks to report huge profits, and realised large rewards for their executives, but also accrued even larger unreported financial risks that led to the global financial crisis of 2008-09. The crisis in turn greatly reduced share values, to the cost of shareholders, and was clearly not in their interest. Manipulation of corporate reporting, and corresponding changes to reporting standards, will remain an ongoing struggle between self-interested executives and regulators. There is no reason to believe in principle that this weakness of incentive theory will be eliminated by regulation of reporting. Reform of the control mechanisms in corporations is required.

The 2008 crisis also highlights a counter-argument to those who argue in favour of high executive rewards on grounds that it will improve corporate performance. If they argue that executives are responsible for the financial crisis then their performance bonuses are a motivating factor in creating the crisis. If they argue that executives are not primarily responsible for the financial crisis and the losses of their corporations during it, then they are also not primarily responsible for the performance of their corporation during growth conditions either. In that case, the executive reward – corporate performance correlations calculated by Jensen and Murphy cannot form a credible justification for performance bonuses, or current US executive reward practices.

In summary, alignment theory as defined by Jensen and Murphy represented an ambitious program to develop market-based executive rewards that would minimise agency costs and optimise shareholder returns. It became synonymous with incentive-based share bonuses in executive contracts. Its widespread adoption coincided with the dramatic and unjustified growth in executive rewards during the 1980s and 1990s. There were several historical trends that influenced that growth. It would be incorrect to say that the adoption of alignment theory (alone) caused higher executive rewards. Alignment theory contributed to the trend, and is related to an underlying shift in regulatory policy. It was also used as a justification for them, although the actual behaviour of executives and their reward levels has been an example of rent seeking.

Jensen and Murphy’s alignment theories were consistent with the prevailing economic views of their times, but are not theoretically sound. They are empirically based, yet rely on relationships that were statistically weak and declined in strength over time. They rely on a circular justification that assumes executives cause corporate performance and
cannot explain the level of executive rewards. They therefore do not provide an explanation of how they will achieve an economically efficient (minimal) level of agency costs. Despite this omission Murphy in particular continually sought to defend the level of executive rewards in the United States, at least until they reached their post 2000 levels. Paradoxically, his own thorough and prolonged reporting of executive reward trends provides the best evidence on which to judge alignment theory. Both economically and normatively, alignment theory alone cannot justify United States executive rewards practices. After thirty years of implementation, alignment theory cannot be shown to achieve an economically efficient level for executive rewards and should be discarded.

5.2 Alignment as an Incentive Theory

Philosophically one way in which Jensen and Murphy’s alignment theory might be made more defensible is to consider it as a form of incentive theory. I have shown that the application of alignment theory in the context of corporate executive rewards appears flawed in principle. The difficulty with the application of incentives under alignment theory is that they do not resolve the imbalances in management power identified in Chapter Four. However incentives more generally may still form a useful contractual form of reward structure.

In other situations, where such management power does not exist, incentive rewards can form a useful contractual tool to minimise agency costs. Further, if they are combined with some regulation to contain the impact of management power, there seems no reason why incentive rewards might not form a useful part of efficient executive reward contracts. I will now consider more generally incentive theories in this context and arguments for and against them. I will then examine whether a modified forms of alignment theory can be developed that might be more defensible for use in executive rewards.

5.2.1 Defining Incentives

Incentive theories were developed in behavioural science literature, notably by B. F. Skinner. The concept is that a reward, or incentive, will be given to a subject after performing a desired behaviour, to encourage them to repeat the behaviour. This may be

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done repeatedly, to encourage the behaviour to become habit. Incentives may be tangible or intangible, and internal or external, such as community recognition. In this context, I will define incentives as any reward given to a worker for completing a socially beneficial task, that is given in such a manner that it would encourage the worker to repeat the performance of the socially beneficial task.

Care needs to be taken in the design of incentives, to ensure that they do not result in unintended adverse behaviours. Kerr\textsuperscript{244} highlighted that poorly designed incentives may have the effect of rewarding harmful behaviour A, while trying to encourage beneficial behaviour B. Kerr cited examples of badly designed rewards in political, military, medical and academic reward systems. An example of badly designed rewards from executive reward practices would be the payment of “golden parachute” termination payouts to departing executives. These were introduced in the hope that they would align executive behaviour in mergers with shareholder interests. In practice they have encouraged excessive risk taking, contrary to share-holder interests. In behavioural research incentives are also distinguished from reinforcers, which are rewards designed to increase the rate of occurrence of an existing behaviour.

In the case of executives increasing returns to shareholders would equate to increasing the social product. Then performance based executive salaries may be justified if they act as incentives for executives to behave in a manner whereby shareholder returns are increased. Incentive theories are forms of entitlements, and are distinct from desert theories that are discussed in later chapters. To be entitled, the incentives must result in actions that increase shareholder returns in this case. That is, executive rewards are not necessarily deserved, but may still be entitled if share returns are correspondingly increased.

Incentives are distinct from economic rents, which represent higher than necessary rewards extracted by their recipient\textsuperscript{245}. Rents are by definition not economically efficient. Incentives intended to achieve a beneficial behaviour will be economically efficient if the value of the encouraged behaviour is greater than the value of the incentive, and if they are the most economical way to achieve the behaviour. Hence performance bonuses paid

\textsuperscript{244} Steven Kerr, “On the Folly of Rewarding A, while hoping for B.” \textit{Academy of Management Journal} Vol. 18, No.4 (Dec. 1975), pages 769-783.
to executives would only meet the definition of incentives if they motivated social benefits that would not have otherwise occurred, and would only avoid categorisation as rents if they were the lowest level of reward required to achieve the behaviour.

In principle incentive theories are forward looking not backward looking. They rely on causing future improvements in social product for rewards to be justified as entitlements, rather than being rewards for past contributions to social product. In this sense performance bonuses in executive pay might fit the concept of incentive theories, provided that bonuses are vested at some time in the future, when beneficial corporate performance can be demonstrated. For example, the previously cited behaviour of Wall Street investment banks achieving short term profits by creating massive long-term risks would not merit reward. The validity of this application of incentive theory to executives would then be an empirical question, dependant on social data after its application. On balance this is the most plausible argument for using an incentive theory in the case of executive rewards, provided the evidence holds.

Jonathon Riley has described this justification of incentive theories on grounds of economic efficiency as a “second best” theory, that is, it is only a partial justification, and IFF the empirical evidence actually supports the claim\textsuperscript{246}. There is no inherent benefit to the society in high rewards for leadership actions to executives in themselves, and arguably some dis-benefit from the effects this will have on equality in the society. Thus the high rewards are only justified for the society if the high rewards lead to additional benefits to the society. From Chapter Two we have seen that this is not the case for executive rewards in Australia and the United States (and most other nations examined). This disproves an incentive theory argument for executive rewards as currently practiced. Nevertheless it remains at least possible that an incentive based reward system for executives could be justified if distortions in executive labour markets and undesirable aspects of current practices could be eliminated, presumably via regulation.

5.2.2 Benefits of Incentives

Proponents of incentive theories could point to the socially beneficial outcomes that they are intended to achieve. These benefits are much broader than the reduction of agency costs discussed under alignment theory. Incentives might be applied to payment for any task, to motivate better performance by the person(s) performing it. Thus they may affect any productive activities to better utilise resources to meet a society’s needs. This in turn benefits all members of the society. This is a purely empirical argument and depends for its validity on whether or not the incentives do actually result in a social benefit.

The widespread use of performance pay and higher rewards to corporate executives was one example of policies of the period of the “neo-liberal revolution” of the 1980s and 90s247. This period of market deregulation had been in response to the failure of government regulation of markets in the previous decade of the 1970s, when western economies were largely stagnant. Other economic policy changes, such as tax cuts, were also described at the time as incentives to achieve greater social benefit, as defined by GDP growth. It was claimed that tax cuts would act as incentives to work more, and raise GDP, thereby also indirectly raising tax revenue248.

The effects of these changes were mixed, with equity declining in most western economies. Economic growth was higher in Australia, but lower in some other countries. In the United States equity also declined and economic growth rates were higher in the 1990s than in the 1970s, but also accompanied by severe losses from market failures249. The causes of economic growth in this period were multiple, and could not solely be linked to incentive policies. Nevertheless, in so far as any net improvement can be linked to the neo-liberal revolution, deregulated markets and greater incentives are among those policy shifts which might be allocated some of the credit.

The benefits of neo-liberalism have been greater in non-western countries. Market liberalisation in China and India has created large increases in economic growth in those countries and improvements in welfare for millions of their population. Critics of market liberalisation and neo-liberalism (including performance pay and high executive rewards) have sometimes criticised this on equity grounds, citing the widespread losses of low paid

jobs in western countries (transferred to countries such as India and China) that accompanied these policy shifts. From the viewpoint of equity within individual western countries this may be a valid concern, as high executive rewards have accompanied lower real wages for many sectors of the economy, including the lowest paid workers. However if we apply equity principles from a global perspective, the changes in the world economy have greatly benefited a far larger number of people in poorer countries such as India and China than those made worse off in richer countries. From a global viewpoint, equity has improved, although it has worsened within western countries.

A stark example of this benefit is the comparative economic progress of North and South Korea since their separation in the Korean War in the 1950s. Prior to separation both halves of the country were equally undeveloped and had a low standard of living after centuries of colonial rule by first China then Japan. Both had the same culture, and similar levels of education, resources and industry. In the decades since partition South Korea introduced a privately owned free market economy while North Korea adopted a state controlled Communist system. By the year 2008 South Korea had become a modern industrialised nation with per capita incomes of $17,724US per annum, ten times higher than the $1161 US per annum in North Korea. The advantages were not confined to economics. South Koreans enjoyed a better quality of life by every available measure, ranking 25th on the United Nations Human Development Index, compared with 75th for North Korea. This case shows that rewarding a more efficient system of resource allocation in a society does greatly benefit the society in the long term, and justifies incentive payments if they achieve greater efficiency.

Critics could argue that while some incentives may create social (GDP) benefits, this does not justify all cases of incentives and the inequality they may create. Lamont has pointed out that most studies show countries with lower levels of inequality have higher rates of economic growth, and vice versa. Krugman has shown that under increasing inequality,

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252 It could be argued that South Korea is considerably more democratic and respectful of individual rights than North Korea, and that this is also a contributing factor to development. Nevertheless it remains clear that economically South Korean has greatly outperformed North Korea.
where economic growth does occur, the benefits may be so concentrated that the majority do not benefit from it. This suggests that incentives that greatly increase inequality in a country do not result in social benefits.

5.2.3 Incentive Theory does not require high rewards

Jensen and Murphy both tended to defend the level of rewards paid to executives. They both at times acted as advisors to executive remuneration consulting firms. Over time both came to be seen as advocates for high executive rewards as well as performance based rewards, even though both began to criticise the level of executive rewards from 2002 onwards. This has had the unfortunate consequence of alignment theory and incentives generally being closely linked with high executive rewards in the public mind. This need not be the case – performance based rewards may be applied to any type of employment contract and are not restricted to any particular level of reward. Jensen and Murphy were explicit on this point – that they were not considering the level of rewards – from as early as Jensen and Zimmerman’s 1985 paper.

One of the reasons for the association of high rewards with performance based rewards was that when performance based rewards were introduced via bonus plans in the 1980s and 1990s, they were usually added in addition to the previous base salary for most executives. Thus when the bonuses were awarded there was an immediate inflationary effect on total executive rewards. However no aspect of Incentive theory requires this to be the case. The fault for this lies with the Boards of Directors that approved such bonus plans without adjusting base salary, and not with Jensen and Murphy’s alignment theory, or with Incentive theory.

Critics of Incentive theory might argue that it contained causal mechanisms that led inevitably to higher executive rewards, even if that was not the original intention. Defenders of Incentive theory could counter that this is not proven, and that the need for further research on the consequences of the theory was never disputed. Jensen and Murphy identified the need for further research in almost all of their papers. In their later

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256 Kevin J. Murphy, (2002), See Figure 1.
papers Jensen and Murphy both began to criticise the level of executive rewards, while still advocating incentive-based rewards\textsuperscript{257}.

Jensen and Murphy could also legitimately point out that their theory was never put into practice in its pure form. From their earliest papers on the topic, they identified changes to observed practices in setting executive rewards required to match their theory. Over the years these changed from being recommendations for improvement to criticisms of undesirable practice. An incentive theory reward for executives applied to an undistorted executive labour market, is still an untried concept.

Against this, as we have seen in Chapter Four, there is good reason to believe that there are structural forces in corporate organisation and ownership that act to prevent alignment theory being implemented as intended. Thus alignment theory remains unable to be implemented. However, if in future the imbalances that create management power could be reformed or regulated, incentive rewards of executives might then be able to be a feature of an undistorted executive labour market.

5.2.4 Other Criticisms of Incentive Theories

Agency theories were developed based on a meta-theory of the interests of corporations and executives, and empirical investigation of their performance. However there was no articulated meta-theory of alignment theories in themselves, and how they might rationally function. Nor was there any consideration of rational arguments against such a meta-theory. Redefining alignment theory as a form of incentive theory gives it a more sound theoretical basis, however there are still counter arguments against incentive-type theories, especially when used in the context of executive rewards. In completing this chapter I will briefly discuss these general counter arguments to incentive theories as they might apply to executives. These are not primary to this thesis, and I will not develop them beyond the discussion here.

5.2.4.1 Confusion of Interests with Actions

Jensen concluded that executive contracts and structured rewards could align executives’ interests with shareholder’s interests. This is a significant change and false from the

\textsuperscript{257} Brian Hall, and Kevin J. Murphy, (2002).
normal agency theory viewpoint. Agency theory (and virtually all economic theory) assumes individuals are rationally self-interested, in this case including both shareholders and executives. No contract can change the interests of the executive, but they may make it instrumentally useful for the executive to act in the shareholders’ interests under a given set of circumstances. If the circumstances change the relationship may break down.

This difficulty remains even if alignment theory is reformulated as a form of incentive theory. For purposes of analysing Jensen and Murphy’s argument further we will assume that incentive theory could have referred to a motivation for the alignment of executive actions and shareholders’ interests. Even so, this distinction is significant and will be returned to in a later Chapter.

The conception of shareholder interests as solely in profit maximisation is also philosophically problematic. It assumes shareholders have a shared interest. There may be a variety of reasons for individuals having a share of ownership of a firm. Many voluntary shareholders will seek profit maximization as an objective. However this does not make it their sole interest, or a common interest. Speculative investors will seek maximum share price growth in the short term. Long term investors will seek long term profit maximization and capital growth as their objective. Retirees will have minimal risk and income security as objectives. Shareholders may have other non-financial interests such as employment security, economic development and community stability.

Philosophically, the conception of shareholders as a group of separate individuals having a common interest is inconsistent with the normal understanding of interests. There will be a range of interests, some of which will be shared, most of which will include profit maximisation to a degree. This reality of diffuse shareholder interests increases the ability for the executive to insert their own interest into decision making.

5.2.4.2 Inconsistency with other Labour Market Theories

Some criticisms of the level of executive salaries have been characterised as “sour grapes” or jealousy\footnote{Ira Kay and Steven Van Patten, “Myths and Realities of Executive Pay.” (Cambridge: Cambridge University Press 2007).}. However it seems a valid criticism of incentive theory, and executive reward practices generally, that they are inconsistent with reward practices for
other occupations, even within the same corporation. It is then not surprising that bitterness and resentment are caused by this perceived inequity. Although equity issues are not the subject of this analysis, such resentment may have a negative effect on corporate performance and societal wellbeing.

The task of valuing the worth and appropriate salary ranges for occupations is a common aspect of human resource management. There are many examples of methodologies and guidelines for this evaluation. Typically, these involve evaluations of the role, knowledge and skill requirements, responsibilities and comparisons with other positions. Note that it is rare that the salary for an occupation would be left solely to a market mechanism, without some consideration of the relative worth of the role compared to other positions within the same organisation. The need to maintain some degree of internal pay equity within organisations is also recognised in business management.

The practice of allocating a very high proportion of potential executive rewards in the form of performance bonuses is inconsistent with practice in most occupations. Guidelines from a leading human resources consultancy suggested that while typical bonuses might range from 10% to 25% of base salary for middle managers, higher bonuses are recommended for executives of 50% to 60% of base salary, and for the CEO 100% of base salary. There seems no reason why the bonus should be so much higher a percentage of salary for executives than for other employees, if the principles of incentive theory apply to each.

5.2.4.3 Alternative theories of Motivations

Alignment or incentive theory effectively assumes that financial rewards are the sole motivator for executive actions, or at least can be designed so that they trump all other motivations for the executive. Jensen in later writing recognised that human motivation is far more complex than this. Yet the basis of alignment theory remained that reward

incentives could be sufficient to overcome other motivations of agents. There are various theories of motivation that would contradict this approach. I do not propose to consider all such theories, but will discuss some prominent examples to demonstrate that the motivational assumptions of Jensen and Murphy are too narrow to be reliably assumed.

The claim that higher rewards will act as an overriding incentive for executives may be considered from a psychological viewpoint. One of the seminal investigations into the motivations that influenced employee performance in businesses was by Maslow (1943). Maslow identified a hierarchy of psychological forces that motivated individuals. These were ranked from primary needs (for survival), followed by three other levels of “deficiency needs” to a higher level of growth needs. Maslow’s theory was that primary needs had to be satisfied first, and that individuals then sought the higher level growth needs.

Deficiency needs were defined by Maslow in ascending order as first physical needs (able to provide food, clothing, shelter etc), then security (certainty of position, values, belongings), belonging (to a group eg firm or category of executives), and finally esteem (respect for position). Growth needs were described as the need for self-actualisation (creativity through setting direction of firm).

For the executive, physical needs have probably already been satisfied in the preceding middle management career and are not relevant. Security is arguably reduced for the executive, due to higher risk of dismissal for poor performance. Satisfaction of the need for belonging is also questionable, as the holding of the power to discipline or dismiss other employees in a firm presumably reduces the ties of friendship to them. Conversely, the existence of an “old boys club” among executives suggests that being an executive represents belonging to a prestige group in itself. The desire for esteem would appear to be readily satisfied by executive employment for the same reason. The satisfaction of the desire for self-actualisation through executive employment is considerable, with frequent decision making, problem solving, and the opportunity to create a new direction for a large complex structure of people.

It could be argued that executive employment also contradicts Maslow’s theory in some respects. Many executive contracts represent individuals trading off deficiency needs (eg security of employment) for growth needs (e.g. self-actualisation/ability to direct the firm). The less popular aspects of executive employment (cutting cost through dismissal of staff, accepting salaries many times higher than fellow staff and citizens) might threaten the need for belonging and esteem.

Maslow’s theory has been criticized by subsequent behavioral researchers. For example, Wahba and Bridwell (1976)\(^{264}\) found that there was little empirical evidence for Maslow’s ranking of needs, or any apparent hierarchy. Max-Neef (1992)\(^{265}\) and others have argued that fundamental human needs as identified by Maslow are ontologically different and cannot be ranked or compared. On balance, it would be better to say that there are a range of different psychological needs and desires, which executive employment will satisfy to varying degrees. Whether taking Maslow’s view, Max-Neef’s, or others, it does not seem plausible to say that additional executive salary will in itself satisfy psychological motivations on the part of the executive.

Offering continually higher salary and incentives may simply preselect a category of persons to become executives, namely those who value material reward more highly than other motivations normally considered by persons. This carries the risk of narrowing the base of corporate leadership. It is likely to become associated with selfish and highly materialistic individuals, whose motivations are not representative of the norms of the community. These individuals are presumably more likely to do harm to the corporation, and this may actually increase the principal – agent problem.

I do not pretend that altruism is normal in executives or other individuals. However there is a spectrum of preferences for choosing material rewards over other life goals, just as there is a spectrum of willingness to consider the needs of others ahead of one’s own needs. Incentive theory (and alignment theory) may ultimately lead to an unhealthy concentration of individuals at the extreme end of both spectrums in corporate leadership positions. Although few empirical studies have been undertaken, the evidence that is available


suggests that sociopathic individuals may be over-represented at the highest levels of organisations\textsuperscript{266}. This creates the risk that such individuals will use their position to do harm to the organisation and other individuals in it\textsuperscript{267}. Narrowing the base of corporate leaders to a particular psychological type also risks “group think” between similar individuals, leading to poorer decisions.

It has been suggested that Australian executives seek higher salaries more in comparison to other executives, as a means of recognizing their comparative ability or performance\textsuperscript{268}. That is, high salary is a means of recognizing the status of the executive amongst their executive peers, not their performance. If this is the case regulations requiring the reporting of executive salaries as a means of restraining them would be self defeating. The information about salaries of executive peers would serve to motivate executives to seek parity with any more highly paid executive. If executives with superior to average performance then received a higher salary it would result in a cycle of continual increase of executive salary, precisely as has been happening in the past three decades.

This motivation explains the desire for continually increasing executive salaries, but does not justify them. Nor does it explain why the higher salaries are agreed to. Recognition of ability is an understandable desire in members of every profession, and higher salary is one of the means of providing it. Yet it is not the case that salaries in every other profession are continually rising quickly in real terms. Thus the desire for recognition might explain the motivation of executives seeking higher salaries, but does not explain why they are awarded. This motivation also has the undesirable feature that executives may seek higher salary as \textit{proof} of their ability irrespective of performance, rather than as a reward for performance.

In summary there is good reason to believe that the assumptions about motivations underpinning alignment and incentive theories are too simplistic and do not adequately explain human behaviour. Emotions and motivations have been a feature of research in

behavioural economics for several decades. Following the work of Akerlof and Shiller (2009), the role of emotions is beginning to be incorporated into macro-economic theories. There is a pressing need to incorporate a more complete understanding of human emotion and motivation into alignment and incentive theories as applied to executive reward, and into theories of corporate decision making more generally.

5.3 Summary
Alignment theory is the primary market-based explanation of executive rewards. Starting from the understanding of agency costs in common with management power theory, alignment theory as conceived by Jensen and Murphy holds that it is possible to align the interests of principals and agents by structuring the agent’s rewards to provide incentives to act to meet the principal’s objectives. In the case of corporate executives, this would be done via the awarding of performance-based share-options, whose value would rise with the performance, and thus the share price, of the corporation.

Alignment theory as proposed by Jensen and Murphy assumes that both share markets and executive labour markets are informationally efficient. The theoretical attraction of this is that, if this is the case, then alignment theories allow the achieving of an economically efficient minimisation of agency costs without external interference or regulation. This also requires the assumption that share prices are causally influenced by the executive’s performance. As we saw in Chapter Two, there was weak evidence of this in Australia, and evidence that this assumption was false in the United States.

Proponents of alignment theory have argued that executive rewards as implemented did not match alignment theory and so the outcomes do not disprove the theory. However after almost three decades of application of incentive-based rewards for executives, as a minimum it seems clear that the market will not adopt efficient levels of such rewards without external oversight. This is contrary to the predictions of alignment theory, and suggests that at least some degree of management power must be at work in the executive labour market.


In addition to the practical concerns, there remain serious theoretical concerns with alignment theory. The charge of circular reasoning remains, in that unless corporate performance is due to the efforts of the executive, and the share market and executive labour markets are both efficient, the theory is not sound. Even if these assumptions were all true, other problems would remain. Alignment theory can only determine the relative level of executive rewards appropriate through comparison to other corporations. It cannot determine what the average level of executive rewards should be, which is the primary issue of public concern. Moreover, since alignment theory seems to offer no way to minimise executive rewards, it cannot define an economically efficient solution, since executive rewards are also agency costs that must be minimised to achieve an efficient outcome.

Alignment theory may be improved by defining it more broadly in the context of incentive theories. There is no in-principle difficulty with the use of incentives in reward structures. Incentive rewards could be used in a reformed executive labour market. However these need to be developed in the context of a broader understanding of human motivation than exists in agency theory, which underpins alignment theory. Potential exists for this in the expanding field of behavioural economics, however this will require a substantial revision of both agency and alignment theories. In the absence of such a revised theory, there seems no prospect that the application of alignment theory in isolation will result in a level of executive rewards that is justified or economically efficient.

In the next chapter I will examine the remaining economic theories that are applied to executive rewards. These are not comprehensive theories of corporate decision-making and rewards comparable to agency theory, management power and alignment theories, however they are sometimes used to explain executive reward trends in the relevant literature. I will then proceed to consider the policy implications for these economic theories, in the light of the evidence of current trends discussed in Chapter Two, and the philosophical understanding of justifiable rewards discussed in Chapter Three.
6 Other Economic Theories

I have now discussed the main philosophical and economic theories used to analyse and justify the trends in executive rewards identified in Chapter Two. Before addressing the policy implications arising from these theories and possible solutions, I will complete the survey of relevant theories with a discussion of other economic theories that have sometimes been raised in the context of executive rewards. I do not regard these theories as comprehensive philosophical or economic explanations of current practice, as will be explained in this chapter. They are all "market-based" theories of executive reward practice, although they do not all lead to the conclusion that the executive rewards market is economically efficient. In reviewing them, my aim is to highlight a number of practical issues that will be relevant to any policy formulation for executive rewards.

6.1 Economics of Superstars Theory

6.1.1 Definition of Theory

The economic theory most commonly used to explain large differentials in the earnings of individuals is Sherwin Rosen’s “Economics of Superstars” theory. Like alignment theory and management power, this theory has been raised to explain the existence of high levels of executive reward, but it is not an ethical justification of them. If true, it offers an economic explanation of why it might be rational for shareholders to pay high rewards to executives given the returns on investment they might then achieve.

Rosen’s theory was based on analysis of fields, notably sporting, arts and entertainment, where “superstar” performers earn rewards far greater than the average reward for that field. The potential incomes in these fields have the character of prizes in a tournament, with a comparatively small number of prizes relative to a large number of competitors. The majority of competitors who don’t receive a prize then earn comparatively little. This theory is also referred to as “tournament theory” as further developed by economist Edward Lazear. The distribution of rewards is therefore not proportional to effort, with

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little or no reward going to most competitors, and the only significant rewards being gained by prize winners.

If a competitor has a difference in ability that makes them consistently more likely to win the prize, then they will gain a large share of rewards compared to other competitors, even if the difference in performance is small. In economic terms the rewards are likely to be distributed according to relative differences in ability between individuals competing in the field, and not according to their absolute level of ability or marginal productivity as I defined in Chapter Three.

It has been recognized in economic analysis by Rosen (1983) that in such highly competitive fields, a slight edge in performance may create a significant increase in the chance of competitive success. Where there is a market to employ such performers it is rational for a potential employer to recruit these “superstar” performers, even if paying them a reward premium. An employer of the superstar (or the superstar themselves if effectively self-employed) can charge users or spectators a premium fee for the performance. Thus high rewards for superstars might be in the rational self-interest of their employer. This allows superstar performers and their employers to gain a reward premium far greater than the actual difference in performance.

In philosophical analysis of distributive justice, the concept that a person or resource will consistently receive a reward greater than that needed to employ them is referred to as economic rent. “Rent” as defined in this fashion may be gained due to shortages, positional advantages or some other structural cause in the market. In each case though, economic rent represents a level of reward beyond that which would be deserved by the person or resource on grounds of desert alone. Thus the higher level of reward may be rational economically, but not justified philosophically.

Rosen and others demonstrated that this pattern of rewards applied to a number of fields, including sports, music, writing, acting, and media presentation. Any field where there is non-rival consumption, and a wide range of performers can be selected from by consumers who will only make a limited number of choices, will encourage the employment of “superstar” performers. For the same performance cost a superior performance will be consumed by a wider audience, generating a higher revenue. For
example, Krueger (2004)\textsuperscript{273} found that the top 5% of concert performers earned over 60% of concert revenue in the United States. The question remains as to whether the executive labor market shares these characteristics.

This theory could be applied to executive rewards in one of two ways, which I will consider separately:
1. that highly rewarded executives are superstar earners within their field and thus attract a reward premium over other executives; or
2. that corporate executives are superstars within the broader field of business management and attract a reward premium over lower level business managers who do not reach the level of executive.

\subsection*{6.1.2 Executives as Superstars within their Field}
For this version of Rosen’s theory to hold for corporate executives, there would need to be a large dispersion between the salaries of executives, with the highest performing “superstar” executives being paid considerably more than average executives. The difference in earnings could then be explained by the presumed difference in performance between the worst and best performing executives.

Empirically, there is evidence of a large dispersion in rewards in the executive pay market. The executive pay markets in Australia and the United States are not normally distributed, with the highest paid examples earning several times more than lowly ranked executives earn. This pattern in CEO and executive income for the 300 largest Australian corporations in 2008-09 is shown in Figure 6.1.

\footnote{\textsuperscript{273} Alan B. Krueger, “The Economics of Real Superstars: The Market for Rock Concerts in the Material World”, Princeton University and NBER April 12, 2004.}
The differences in earnings are significant both across and within levels. The highest paid CEOs are paid much more than the average CEOs. The highest paid other executives are paid much more than the average for other executives. There tended to be a smaller dispersion in rewards between CEOs and executives within a particular corporation.

The pattern for United States data appears to be similar to that shown in Figure 6.1. Gabaix and Landier (2008)\textsuperscript{275} argued that CEO pay is normally determined by the size of [their] firm and aggregate size of firms in the market. They found that the empirical data for the six fold growth in market capitalisation of (US) firms from 1980 to 2003 matched the six fold increase in CEO pay over the same time. Gabaix and Landier found that, in such a market, a small dispersion in CEO talent justified large pay differences. That is, if a better performing CEO increased a corporation’s performance, it was rational for a larger corporation to offer them a larger reward to attract them to the larger corporation, so that their performance benefit could be applied to the outputs of a larger corporation.

In reaching this conclusion Gabaix and Landier assumed that differences in executive and CEO performance were responsible for differences in corporate performance. Hence their research is vulnerable to all the criticisms identified previously for such circular assumptions in incentive theory research. In assuming that CEO pay is proportional to

\textsuperscript{274} Source: Productivity Commission Inquiry: Executive Remuneration in Australia, 2009, Chapter 3, Figure 3.3. Data Source: Financial Review. Companies are ranked in size from left (largest) to right (smallest).

firm size, Gabaix and Landier have also implicitly adopted Marshall’s management power hypothesis and the criticisms associated within it. That is, market rewards are not proof of “superstar” performance, but are proof of the exercising of management power.

The economics of superstars theory has been applied to CEOs more directly by Malmendier and Tate (2009)\textsuperscript{276}. They examined subsequent performance for CEOs identified as “superstars” by their earnings and other measures of status. Their finding was that “superstar” CEOs, although paid significantly more than others, did not show a performance differential in their corporation to account for this level of reward or status. Overall the financial consequences to shareholders of engaging superstar CEOs were found to be negative.

Similarly Main, O’Reilly and Wade (1993)\textsuperscript{277} surveyed over two hundred UK firms and found that the dispersion in executive rewards between firms was consistent with a tournament theory but the dispersion in executive rewards within a firm (top five executives) was not. The degree of dispersion or collectivism in executive rewards within a firm may partly be explained by the degree of collectivism or competitiveness in the business culture for that nation.

Considered at the level of comparing CEOs and executives between firms, if exceptional CEOs can generate exceptional performance for their firm, this theory would predict (but not justify) a large range in CEO salaries, ranging from very low for poor to average executives, to very high for exceptional executives. Bebchuck and Grinstein argue that the actual distribution of CEO salaries is not as would be predicted by this theory\textsuperscript{278}. While there are some CEOs paid more than others, none are paid poorly, and the average salary for CEOs is exceptional.

There are theoretical reasons why CEOs and corporate executives more generally do not seem an appropriate application of the theory of the economics of superstars. The nature of the CEO and corporate executive markets is far less transparent and not directly consumer led like the sorts of markets for which the theory was developed. Rosen


developed his superstar theory for markets such as entertainment and professional athletes. In these markets, consumers evaluate performances that are widely transmitted and reported and select their preference directly based on those performances. The markets are highly transparent and competitive. Failed entertainers and athletes are quickly discarded by music companies and sporting clubs. For entertainers in particular consumption is non-rivalrous in that purchase of a star’s music by one consumer does not prevent its purchase by another consumer. Their rewards reflect their market potential, which can be individually measured.

For executives the market and consumption effect is very different. “Consumption” by the corporation is exclusive, preventing an executive from working for another corporation. Shareholders do not check the performance of candidates before directors select them. The executive labour market itself is far less transparent than the entertainment and sports labour markets. Recruiting is rarely competitive between executives with “head-hunting” employment agencies seeking out candidates rather than all competing on an open market for advertised positions. Corporations are large group activities where it is difficult to measure the marginal product of any one executive. Entertainment and sports markets are either individual or small group actions where the performance of individuals can be easily assessed.

Overall then, differences in reward between CEOs and executives of different corporations does suggest that some form of tournament or prize system is operating, but does not support it as an example of Rosen’s superstar theory. First the differences in reward between the highest and lowest paid executives are far less than those cited by Rosen in music and sports, where the highest paid are millionaires and the lowest paid may struggle to earn the average wage. By comparison, all executives in an Australian and American context are paid many times the average wage. Second there is no indication that the highest paid executives are correlated with the best performing corporations. The strongest correlation is between size of corporation and size of executive rewards, suggesting management power rather than superstar economics is the causal factor.

6.1.3 Executives as Superstars within Management

A more plausible interpretation of Rosen’s economics of superstars theory as applied to the executive labour market would be to see all executives as superstars in the broader
field of business management. Executives would then be assumed to be the best performed managers, having worked their way through the ranks of management to obtain an executive position279. The small number of executive positions relative to the many thousands of management positions in most industries would then explain a large dispersion of rewards between the two.

This conception of the theory has the advantage that there clearly is a large difference in rewards between middle and lower level managers and executives. Management employment streams now comprise a significant percentage of all of the labour market participants in the economies of both Australia (over 7% of workers) and the United States (over 5% of workers). Manager incomes are much less than that of executives, though still higher on average than for any other group, including professionals, both in Australia280 and the United States281. In the 2008 United States occupational wage survey manager incomes were more than double the national average.

However we have no way to know whether the difference between executive and middle management wages is due to performance. In absolute terms the same problem identified in Chapter Three for executives remains for lower level managers – we cannot determine a marginal product for the leader of a group. The situation is worse in comparative terms than for executives. There is no available data to indicate whether differences in lower and middle level managerial rewards, as opposed to executives, are correlated with their performance relative to other lower and middle level managers.

In summary then, Rosen’s superstar theory cannot be credibly be used to explain executive rewards. There is a large dispersion of executive rewards as the theory would suggest. However this dispersion cannot be shown to be due to superior performance on the part of the highest rewarded executives, because the performance of executives and managers as a whole does not correlate with their incomes. Nor can the superstar theory explain why the rewards of all executives are much higher than average. Under the

superstar theory the poorest performers should receive below average rewards, which is not the case.

Comparing executive rewards with rewards of lower and middle level managers does not resolve either problem. There is no database with which to show that the rewards and performance of lower and middle level managers are correlated. It is not possible to identify what their marginal product is, or how it compares to the contribution of executives. Lower and middle level manager rewards are still above average for both Australia and the United States, which is contrary to the tournament prize theory.

6.1.4 Incentive Argument for Superstar Theory

A broader incentive theory interpretation of superstar theory could be considered for executives. In this large executive rewards would act as a tournament prize not only for incumbent executives, but for all those in management careers aspiring to executive positions. That is, the incentives have a motivating effect on the whole apparatus of business management.

From a philosophical viewpoint this theory, if proven for executives, would give a consequentialist justification for the quantum and structure of executive rewards. Unlike claims about the effect on corporate performance of individual executives, it does seem plausible that better motivating all business managers would improve overall corporate performance. This motivating effect would presumably include more junior managers as well as executives. Defining executives as superstars in the management career stream then has a much stronger justification than incentive theories for executives. This would benefit both shareholders and the community as a whole.

Considered at the level of comparative salary within firms, this theory might justify a wide variation of salaries between CEOs and other corporate executives, and between executives and other employees. In this case, the position and salary of the CEO could act as a prize that executives compete for, motivating higher performance from the executives, to the benefit of the corporation (Benjamin 2002). While this application of the theory would implicitly acknowledge that CEO salaries were not justified by the performance of the individual in the role of CEO, it would justify high executive reward if
the overall performance of corporate executives and managers as a group produced a corresponding benefit to the shareholder and/or community.

Against this, the incentive justification only holds if the positive benefits of such incentives are not outweighed by other negative consequences. These would include resentment created among lower paid colleagues, and the risk that internal competition for executive and CEO positions might cause some individuals to act in a destructive manner towards the corporation. Khurana (2002)\textsuperscript{282} cites examples where “superstar” CEOs were disastrous for the corporations that hired them. He suggests that the desire to have a “superstar” CEO is in itself a mistake, based on an overly emotional approach to leadership that does not rest on rational analysis.

The empirical evidence in Chapter Two suggests that on the whole the negatives do outweigh the positives. The countries with lower multiples of rewards between average wages and CEOs had better corporate performance (average returns to shareholders) than the countries with higher ratios of average to CEO wages. This does not prove that the disparity in rewards within corporations was the cause of the lower performance, but conversely, there is no evidence that the incentive version of the superstar theory is true.

### 6.1.5 Other Consequences of Tournament Prizes

This leads to consideration of further counter-arguments against superstar theories for executive rewards. Rosen’s theory suggests that rewards for executives would motivate high performing managers by their potential to become executives, and high performing executives by their potential to become CEO. Yet such promotions across management streams appear to be becoming rare.

Balogun and Johnson (2004)\textsuperscript{283} considered that management and executive management are both becoming increasingly specialised, with executives having studied for and embarked on that career path early in their working life. The number of manager positions in most organisations is now very large, and the likelihood of a manager being promoted to an executive is correspondingly small. As executives and managers become increasingly


separate career streams, the potential for advancement breaks down, undermining the rational for executive and CEO positions to be seen as prizes in a tournament game.

Baker, Jensen and Murphy (1988)\textsuperscript{284} spoke against the idea of promotion from middle management to executive level as a tournament prize. They warned that it “will result in type-B employees being promoted to top management, which is clearly inconsistent with optimal matching”. For Baker, Jensen and Murphy direct performance incentives being paid for each manager at every level were preferable to executive rewards being an incentive in a tournament type promotional contest.

This trend will also have a consequent demotivating effect on non-management career streams. As the ABS and Bureau of Labor Statistics data demonstrated\textsuperscript{285} management rewards are now already higher than for any other career stream, including professions such as medicine, law and engineering, which also require highly talented individuals to practice. If all persons are motivated by financial self-interest as the superstar justification for executive rewards assumes, this will have a negative effect on the quality of labour for other fields and hence the performance of non-executive employees in the corporation, who will feel correspondingly devalued.

Further, there will then be a corresponding cost to the wider society, from the lack of high quality applicants into complex fields that are necessary but outside private financial markets. This will particularly affect social services. In recent decades labour shortages have emerged in several such fields in Australia and the United States, notably in medicine, nursing, teaching, science and engineering. This will harm the quality of social services in the case of health care, and the long-term economic performance of the society in the case of teaching, science and engineering.

Overall the economics of superstars may offer a more defensible market justification of executive rewards than incentive theories, especially by defining executive positions as tournament prizes in the management career stream. However we have good reasons to


\textsuperscript{285} ABS 6306.0 (2009) and Bureau of Labor Statistics (2009).
question that the economics of superstars theory explains current executive labour market practice. Empirical evidence on individual performance is difficult to isolate in order to prove the case. Analysts who favour this explanation again make the circular assumption that differences in corporate performance are due to, and therefore indicators of executive performance. As with Jensen and Murphy’s incentive theories, this is at best unprovable and at worst false.

Even if the evidence suggests that the theory did apply, it might explain a high dispersion in executive earnings, but still would not explain the very high level of average CEO and executive rewards. Ultimately then, superstar theory may be the best market explanation of why executive rewards are at their current level but, without a better link between performance and pay, it does not justify them philosophically. In addition, there is nothing in the superstar theory to disprove the management power thesis.

6.2 Historical Argument

This argument has been proposed by Jensen & Murphy (1990), and Nichols and Subramanian (2001) based on empirical analysis of corporate performance and executive salaries over three decades. It recognizes the large rise in corporate executive salaries in the 1980s and 1990s. The argument is that corporate executives of today are not overpaid, but rather that their predecessors (presumably in the 1970s) were underpaid. Hence their salaries may still be economically efficient, and therefore justified.

This is a purely empirical and comparative argument, based on a type of contribution theory. As such, it is vulnerable to a number of criticisms of the empirical claims. Firstly, it is a circular argument that effectively assumes the conclusion. It only validates current executive rewards in comparison to the past by assuming that past reward practice was too low. The question arises by what criteria were the past rewards considered to be too low? As stated, it is in comparison to present rewards, which are therefore implicitly assumed to be reasonable. In itself this argument does not prove either that current rewards are reasonable, or that past rewards were too low.

Secondly, empirically this argument can only be true at a point in time, and does not justify
defence of any subsequent changes in rewards practice. In the time since it was originally
proposed in 1990 by Jensen and Murphy and again in 2001 by Nichols and Subramanian,
executive rewards increased in real terms afterwards in both cases. If the executive
rewards of 1990s levels were considered justified by Jensen and Murphy in comparison to
executive rewards of the 1970s, then executive rewards of the year 2000 should have
been regarded as too high in comparison to the 1990s. Likewise if Nichols and
Subramanian argue that executive reward levels of the year 2000 were justified compared
to the 1990s, subsequent rises to a higher level were therefore not justified in comparison
to 2000 levels.

Thirdly, it cannot take into account the many other performance factors that may have
changed which would invalidate comparisons across time. Nichols and Subramanian
(2001) have argued that it is not valid to compare CEO pay with other worker’s pay or
corporate performance. They offer no sound reason for this claim, but even if accepted it
still fails to answer the basic question: what is a satisfactory comparison base to assess
executive compensation against?

Long term evidence on US executive salaries by Frydman and Saks (2005)\(^{287}\) suggests
that the situation is far more complex than the historical arguments assumes. The
evidence shows that real rates of pay for executives were much lower in the 1970s than in
the 1980s and 1990s. However, this does not prove that executives were underpaid in the
1970s. Frydman and Saks argue that other changes, particularly to taxation policy, made
current practices of granting stock options to executives unattractive prior to the 1970s.
Differences in the regulatory, taxation and international trade environments made larger
profits, and larger executive rewards possible since then.

Further, while that might explain how such levels of reward became possible, it does not
morally justify them, or mean they are economically rational or efficient. Corporate
performance in terms of returns to shareholders was generally poorer in the 1970s than
the 1980s or 1990s. Earlier still in the 1950s though, returns to shareholders (capital
growth and dividends) were both higher, but executive salaries were not. If the 1950s

\(^{287}\) Carola Frydman, and Raven E Saks, “Historical Trends in Executive Compensation (1936-
were taken as the base for comparison, then executives from the 1980s to the present were all paid too highly.

In summary this empirical claim, whether proven or not, is not in itself a justification for any particular level of executive reward, past or present. To say that a particular level of executive reward is justified by comparison with some other level of executive reward is a circular argument. It assumes that one level of reward or the other is justified. Yet it is not justified in comparison to any external measure, such as the levels of reward in the rest of the society, or in comparison to the increase in shareholder or social value created by the executive. The historical argument is neither an economic nor a moral justification for any level of executive reward.

6.3 Supply and Demand

Another argument raised for high corporate rewards by economists such as Robert Frank\textsuperscript{288} and executives themselves\textsuperscript{289} is that it is a response to supply and demand pressures in the executive labour market. This is based on the normal theory of equilibrating markets and explains the continued trend of corporate executive rewards to rise. According to economic theory any field where resources are in demand, including labour markets, will see a rise in the price asked for the resource, so that those with the greatest demand for the resource will acquire the resources available. The market will then adjust so that more resources enter that field. In the long term the price will then adjust down again so that returns to those resources equate to normal levels of reward.

This explanation has been most recently examined by Gabaix and Landier (2008)\textsuperscript{290}. Parallel with the growth in executive rewards during the 1990s was a corresponding growth in the size of corporations. This increased the competition and demand for top executive talent, driving up the level of rewards in the executive labour market. The trend in United States executive rewards (blue and green lines) and share market value (red line) is shown in Figure 6.1. Reward growth matches company size.

\textsuperscript{290} Xavier Gabaix and Augustin Landier (2008), page 85.
Supply and demand is a market-based theory of executive rewards. It is an explanation for apparent data, though the data does not in itself represent proof of the theory. Assuming that data on rising executive rewards indicates rising demand does not prove that is the cause of the reward increase, unless it can be shown that the demand for executives is also rising, or the supply is falling. Where a market price increases without evidence of rising demand or falling supply it is generally seen as evidence of rent-seeking behaviour, and a market that is not perfectly competitive. Such markets will not deliver efficient outcomes that would be socially optimal.

The difficulty with fitting this theory to executive rewards is that there is not a reliable data source on the number of executives available in the labour market. Gabaix and Landier modelled executive rewards against the size of firms and the population of countries. In doing this they assumed, but did not prove, that demand for executives rises with the size and number of corporations, and that the supply of executives rises with population. None of these assumptions were proven. Moreover there are counterexamples in the data, such as countries that have large corporations but lower executive rewards (Japan) and

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291 Xavier Gabaix and Augustin Landier (2008), Figure 1, page 69.
countries with small executive labour markets but very high executive rewards (Switzerland).

There may be a valid case to say that the demand for corporate executives has grown in recent decades. The relative proportion of the world’s economic activity carried out by large corporations has been growing in the long term\textsuperscript{292}. This trend has accelerated since the end of the cold war. There has been the replacement of former Communist economies with market-based capitalist economies containing privately owned corporations. Within OECD countries, the trend has been to reduce the proportion of government spending (other than welfare) and privatize formerly government-owned services as profit making corporations.

The size of individual corporations has also grown in real terms, with 51 of the 100 largest economic entities in the world being corporations by the year 2000\textsuperscript{293}. Within each corporation, while other staff functions have typically been “downsized” or “outsourced” throughout the 1990s, there appears to be no trend to do this to executive positions. Thus overall there are more and larger corporations than before, and therefore a need for more executives.

However if the demand for corporate executives has risen, the apparent supply has risen even more dramatically. The number of persons being educated in the disciplines seen as entry level qualifications into business management careers – accountancy, business, economics and law – have greatly increased in all OECD countries in recent decades\textsuperscript{294}. If these are the skills required, then the supply of labour has increased to the point where some correction in the price of executive labour would be expected. If the supply of persons with the required skills to be an executive has not increased after two decades of constant increases in executive salary, this is contrary to normal labour market theory and raises the question of what blocks or prevents increases in the skill supply.

\textsuperscript{294} In Australia in 2004 there were 945,000 university students, of which 267,000 were studying management or commerce. This exceeded the combined total for all students in education, engineering and health disciplines (260,000). Source: Commonwealth Department of Education, Science and Training.
There is no obvious reason why increasing the supply of corporate executives should be unusually difficult. There is not the same long period of uncompensated and costly education other professions require, such as medicine, law or academic careers. Business degrees are typically shorter (3 years) than professional degrees (4 to 7 years). In many cases executives have not done any formal tertiary study. Business executives will typically have worked in paid positions in middle-management before becoming executives. Thus the “opportunity cost” of a business executive career would appear to be low, since it represents the culmination of a previous (well-paid) management career.

There do not appear to be any structural barriers to entry of the field. To date there are no formal qualifications required in any OECD country to act as the executive of a corporation. Possession of qualifications such as degrees in accountancy, law and MBAs is growing\(^{295}\), although by no means predominant, even among CEOs of the largest corporations. Academic entry requirements for business programs in Australia tend to be lower than for professional and scientific degrees in most universities. Studies of the effects of formal education in business leaders have shown little relationship between level of study (eg MBA programs) and level of business success or income\(^{296}\). This does not support the argument that the knowledge required to run a corporation is exceptionally complex or difficult to acquire.

Some might argue that the critical skills for success as an executive are not gained from formal education. If so this leaves two possibilities – either the required skills are inherent qualities that cannot be taught, or they can be learnt through experience in the business concerned. If the required skills are inherent, then the executive labour market is an example of a market where economic rents are being extracted by individuals possessing them.

If the skills are learnt from experience, it is in the rational self-interest of corporations to train individuals to become future executives. If there has not been a sufficient number of future replacements trained, so that there is a shortage of labour with executive skills, it would seem perverse to reward executives with higher rewards now because of their own

\(^{295}\) By 2002 there were over 140,000 MBA graduates each year in the United States.


or previous executives’ past failure to train sufficient replacements. The continuation of such a skill shortage would suggest the use of management power by executives to protect their own position at the expense of shareholders.

In fact there is evidence that salary expectations are a significant but by no means determining factor in the career choices of school leavers\(^{297}\). This is true even in places of comparative economic hardship\(^{298}\). Major factors influencing choice include educational performance and opportunities, family environment, advice of school counsellors and friends, location, gender, nationality and ethnicity\(^{299}\). A career being able to generate a sufficient salary to live on was a factor, but maximising salary was not usually the primary motivation in career choice. It would appear that the claim that the “best talent” can be attracted to a career simply by offering very high rewards is empirically false.

The comparative lack of influence of salary over career choice means that it is possible that the supply of persons capable of being executives into the executive labour market has not increased in the past three decades. In that case, if demand has risen, executive rewards would rise due to supply and demand. However the corollary of this is that if the supply is insensitive to price in the long term, contrary to economic theory, then there was no corporate or societal benefit to raising executive rewards. Thus at best, if supply and demand is the cause of increased executive rewards, it is also evidence of market failure.

Further, this is not to say that the case for supply and demand being the cause is proven. It still assumes that demand is insufficient, presumably because executives have rare and unique talents that cannot be developed by training. Reinhardt (2009) dismisses this claim:


“As a general proposition, of course, that argument may be no more valid than the idea that the supply of potential gold-medal winners at the Olympics is roughly equal to the number of athletes who actually won gold medals. But economists rest their case on it.”

Economists have also made other criticisms of this theory as an explanation for executive rewards. The supply and demand theory only explains the rewards for executives rising to such high levels if it is assumed that the executive is the primary determinant of corporate performance. Reinhardt refers to this as the “lone ranger theory of management”. I have already shown in Chapters Two and Three why this assumption is false.

In summary supply and demand is not an adequate explanation of reward practice. It cannot explain the differences in reward levels between the United States and other large corporate markets. Nor can it explain why the rising trend in rewards has continued for such a long period of time without a major market correction. If the skills required for executives are unique then it is at best an explanation of market failure. If those skills are trainable then it is proof of the abuse of management power. Supply and demand may be discarded as a plausible explanation of executive reward trends. In addition, it leads us to another recognised labour market phenomena that has implications for executive rewards, but has not been adequately considered to date.

6.4 Income and Substitution Effects

The incentive argument assumes that the predominant motivation influencing the behaviour of corporate executives is the desire for personal financial reward in the form of salary. A bonus (higher) reward is then assumed to increase the degree to which the executive works for the corporation’s interests. This ignores the fact that there are two recognized effects on the supply of any type of product (including labour) from an increase in the price of that product – an income effect and a substitution effect. These effects of price changes were defined in micro-economic theory by Hicks (1939).
For labour markets, the income effect means that an increase in labour income will make workers more willing to work in that field, increasing the supply of labour. Conversely the substitution effect means that the increased income per unit of work supplied will also allow at least some workers in that field to reduce their hours of work and receive the same income. They may prefer to substitute some of their work hours for leisure hours, thereby increasing their total utility. Thus it is not certain that increasing the price of labour in a field will increase the supply of labour. The net outcome will depend on the relative size of the income and substitution effects.

The income effect is at its greatest when incomes are low, so that an increase in labour price greatly increases the attractiveness of the work. Conversely when the income for a field is already very high, further increases are unlikely to greatly influence a person’s choice to work in it, and so the income effect is then low. For the substitution effect, the opposite is the case. We would expect that at very high incomes the income effect will eventually become marginal and will be exceeded by the substitution effect. Yet for the incentive argument to be true for executives, it must always be the case that the income effect is greater than the substitution effect in the executive labour market. Logically, this is likely to be false given the high level of executive rewards.

If the substitution effect outweighs the income effect this will adversely influence the overall corporate labour market. If incentive bonuses are made too high then the amount of labour willing to be supplied by each individual executive may begin to decrease. Executives may choose to work for a shorter tenure, increasing recruiting costs. Assuming a diminishing marginal utility of income, the higher the level of rewards for executives, the greater this impact will be.

There is evidence that the era of continuously rising executive rewards led to a reduction in the average amount of work contributed by executives. While there is no available evidence on reduction in the working hours of executives, the length of tenure of CEOs in the United States declined. CEO tenure reduced by 23% during the period 1995 to 2001.\(^3\) CEOs were retiring younger, and having shorter careers. Hasenhutl and

Harrison (2002)\textsuperscript{304} looked at firm specific data and found that higher CEO salary did not increase CEO retention, and the awarding of stock options appeared to increase CEO turnover. This represented a significant cost to corporations, as recruiting CEOs was costly, and high CEO turnover was usually associated with poor performance.

6.5 Summary

A review of these remaining economic theories commonly used to explain executive rewards shows a varying degree of validity. CEO rewards have been compared to economic theories for the rewards of superstars. CEO and executive rewards are widely distributed as the economics of superstars theory would suggest. However the high average reward for executives, and the inability to correlate rewards with performance, invalidates superstar theory as an explanation for executive rewards.

Historical data has been used to attempt to justify current executive rewards by comparing with executive rewards in past eras. Such historical arguments are circular, in that they assume the reward levels of previous eras were justifiable, and can be dismissed on logical grounds.

This leaves theories relating to supply and demand, and income and substitution. Supply and demand cannot be proven as an explanation of executive rewards, due to the lack of a reliable database on the available supply of executive labour. Empirically it seems implausible, given the enormous growth in business management education in recent decades. If such education is relevant then the supply should be ample to meet demand. If such education is not relevant then supply and demand becomes an explanation of market failure.

Finally, considering income and substitution effects (which are notable for their absence of consideration from the financial accounting literature) there is a strong theoretical reason why continual increases in executive rewards will not necessarily lead to increased executive performance and has already resulted in a reduction in supply.

\textsuperscript{304} Maria Hasenruhl and J. Richard Harrison, “Exit or Loyalty: The Effects of Compensation on CEO Turnover”, \textit{Working paper, University of Texas at Dallas School of Management} (2002).
Having now examined the evidence for executive reward trends and the economic theories used to explain them, and having defined a philosophical basis in distributive justice with which to assess them, we can form some judgements about whether executive rewards are justified. In the next chapter, I will state some of these initial conclusions, discuss their causes and consider policy implications for corporate regulation in Australia and the United States.
7 Policy Implications

7.1 An Explanation of Executive Reward Levels

The public demand for action over executive rewards, and the legitimacy of that demand, was shown in Chapter One. The fact that the executive labour market is not economically efficient in Australia and especially the United States was shown in Chapter Two. In the following chapters we considered first a philosophical framework for examining theories for executive rewards, and then we reviewed the predominant market-based and non-market based economic theories. We can now use this analysis to answer several critical questions.

The first question to answer is the core one for this thesis, whether current executive rewards levels can be justified in a normative sense. This will lead to the second question, whether to accept the market or the non-market explanation of the causes of current executive reward levels. In reality we have seen that there are elements of both market and non-market factors at work in the executive labour market. The question is to what degree one or the other set of factors appears to be the primary cause of reward levels. This is a question of interest to more than economic theorists. Depending on the answer, different forms of market intervention or regulation will be justified or not.

This will then lead us to conclusions on the final question – what is the appropriate degree of policy intervention? If executive rewards are the result of an efficient market, then they would be seen as just under David Miller’s market rate theory, and government intervention in the market would not be justified. If executive rewards are not the result of an efficient market, then they would not be seen as just and would be an example of market failure. Government intervention in the executive labour market would then be justified, either to reform the market, or to set reward levels by some other means.

7.2 The Justification of Executive Reward Levels

We return to the original question of Chapter One, to ask whether Carol Loomis was right, that executive reward levels are wrong. In a normative sense, there are very few ways in
which it is possible for them to be right. The disparity between executive rewards and rewards for other occupations in Australia and the United States is now very high. Current executive reward levels would not be justifiable under any other form of equity or rule-based distribution theory. Desert theories based on effort or compensation would also be unable to justify executive rewards. I therefore limited normative considerations of executive rewards in Chapter One to contribution-based desert.

Contribution theories allow the possibility of high reward levels to be ethically justified if it can be shown that they benefit the society as a whole. The evidence in Chapter Two indicated that this is not the case for corporate executives, with societies having higher executive rewards not showing any benefit, and in some cases some dis-benefit. While the evidence of dis-benefit is not conclusive, it is sufficient to dismiss any claims that there is a social benefit from high executive rewards. For an extra-ordinary level of reward to be justified, some evidence of a corresponding benefit should be required. We do not find conclusive evidence of such a benefit at either the corporate or societal level. Therefore from a contribution viewpoint, high executive rewards are not justified. The popular view in the community, that executive rewards are too high, is correct. It is not sour grapes, but based on legitimate concern.

From a philosophical viewpoint the application of contribution based desert theories to executives is complex. The contribution to social product of a corporation is the result of the actions of all of the individuals within the corporation, as well as the application of the capital resources owned by the corporation. Hence it is false for any executive to claim that the social product or profits of a corporation are due to their efforts alone. Executives may be able to claim a substantial proportion of any changes in social product (and profits) caused by their decisions as a personal desert base. However even then they will not be able to claim the whole amount. Further, if the effect of a decision on social product is negative there is a case to financially penalise the executive, rather than simply ceasing rewards, if this doctrine is to be consistently applied. Economic analyses that attempt to correlate corporate performance with executive rewards are therefore philosophically flawed.

David Miller’s market-rate theory gives a sounder basis for defining how executive rewards should be determined. This theory requires that a market should meet procedural conditions for its outcomes to be just. We saw that the current corporate executive labour
markets in Australia and the United States do not meet those conditions. They represent a form of exploitation as defined by David Miller. This does not mean that an executive labour market could not be made legitimate, though the current market would require substantial reform to achieve this. After three decades of rising executive rewards, there is no evidence of any internal motivation to reform the executive labor market.

7.3 The Causes of Executive Reward Levels

While it is straightforward to conclude that current executive reward practise and levels are not justified, explaining what has caused this situation is more contentious. Both market-based and non-market based explanations have been offered. From an economic viewpoint both the market and non-market based theories considered assume cost structures within corporations that approximate the assumptions of agency theory. This may be simplistic in comparison to modern motivational theories in behavioural economics, however it is sufficient to understand economic theories currently used to explain executive rewards.

None of the market-based economic theories of executive rewards we have reviewed (alignment theory, incentive theory, historical comparison, superstar theory and supply and demand theory) adequately explain or justify current levels of executive rewards in Australia and the United States. Alignment theory is theoretically attractive as it promises an internalised market solution to setting executive rewards that should minimise agency costs. The claim of alignment theory is that paying performance bonuses to executives as incentives will align their actions with shareholders interests. This is flawed in theory and empirically proven to have failed. It does not recognise the more complex motivational factors at work on executives, or their ability to manipulate the firm and its reporting to achieve bonuses. It also relies on the circular reasoning that share markets and executive labour markets are assumed efficient to justify the level of rewards set. Neither assumption is valid based on the findings in Chapter Two. Modifying alignment theory to a broadly based incentive theory might reduce these problems. This would require theoretical development that is beyond the scope of this thesis.

Historical comparisons can be disposed of quickly as a circular argument that neither proves efficient nor justifies any particular level of executive rewards. Superstar theory is
not relevant to the executive labour market because of the high average rewards and low opportunity cost of the career.

The only market-based economic theory that might explain current executive rewards, supply and demand, is effectively only true as an explanation if the supply of executive labour has been insufficient despite a massive increase in business education. I do not consider this plausible and, even if it were, would be an indication of another market failure that would itself warrant government intervention.

This leave the non-market based explanation of executive rewards – management power. As defined by Bebchuk and Freid, this appears to fit the observed trend in executive reward levels in Australia and the United States. Executives use their positional power over directors to achieve reward levels and contractual conditions that are not in the interests of shareholders. The difficulty with Bebchuk and Fried’s explanation is showing how management power has increased, when corporate regulations and reporting have tightened as executive rewards were increasing. Management power cannot easily be measured and correlated with executive rewards to prove the theory.

I have proposed an explanation for increasing management power via the increasing complexity of corporate structures and changes to share ownership. Modern corporate structures and share ownership patterns are such that the traditional two-agent explanation of bargaining for executive rewards (shareholders and executives) is obsolete. An explanation involving four different sets of agents (share investors, share fund managers, corporate directors and executives) is more representative of current corporate ownership structures. In this more complex model there is an obvious potential for collusive games to evolve between share fund managers, directors and executives, to the mutual benefit of those agents and to the disadvantage of investors. The result is likely to be a substantial loss to investors, via both an excessive share of corporate profits being paid to executives, and through capital loss from high-risk investment strategies being adopted by executives to meet bonus targets.

In conclusion the non-market explanation of high executive rewards – management power - is clearly to be preferred on both theoretical and empirical grounds. Market based-theories do not explain observed trends in rewards and have substantial theoretical weaknesses, especially in the circularity of their reasoning. As management power is an
explanation of market failure, this means that some form of regulatory intervention into the executive labour market is required. The next question is, what form of intervention would be preferable. However before discussing that I will examine the consequences of high executive rewards, to assess to what degree government intervention is justified.

7.4 Adverse Consequences of the Executive Labour Market

It is worth examining the practical consequences of the market failure in executive rewards. This is both to define the justification for regulation, and to identify some of the specific areas requiring intervention. Current executive reward practices based on alignment theory have given rise to several difficulties, which I will discuss individually.

Executives share bonuses may dilute shareholders ownership as they acquire an increasing proportion of the corporation’s ownership. Alignment theory assumes that shareholders will reward executives with some additional share ownership for each period covered by a performance bonus-type contract. Over time this may accumulate to represent a large proportion of the shareholding of the corporation. Even if these share bonuses may not be exercised until some time in the future, at that time there will be a significant loss in shareholder value. For example Disney Corporation CEO Michael Eisner accumulated millions of options for shares while CEO. When these were exercised as a block in 1997 it had a significant impact on the share price, with over $500 million in shares gained by Eisner.305

Executives may adopt strategies with perverse long term outcomes to meet performance targets that did not measure factors contributing to long term growth (e.g. corporate downsizing of 1990s).306

Modern recruiting practices for hiring executives have tended to eliminate several of the potential counter-forces to the temptation for the executive to “defect” from acting in the corporation’s interests. External recruiting of executives is now common. External candidates have no past history in which to have developed any personal ties or loyalty to

the corporation or fellow staff. This makes it less likely they will have any non-financial interest in them to counteract their own self-interest.

Corporate executive salaries have grown very large in comparison to all other forms of income. Current salary levels would appear to be self-defeating in terms of engendering loyalty. They allow the executive to quickly achieve their personal financial objectives within a short tenure in an executive role. They will thereafter be less concerned with further bonuses or the long term consequences for the corporation.

The use of “Golden parachute” clauses (employment contracts with large termination payout clauses) is now common. These were intended to minimise the risk to the executive from mergers but that is in itself an acknowledgement that executives do possess management power that they can exploit at the expense of shareholders. They also minimise risk both from the corporation becoming insolvent and from dismissal for poor performance.

The majority of corporate executive pay is now in the form of performance bonuses that, combined with the growth in absolute terms of executive salaries, makes the bonuses very large. Large performance bonuses do not necessarily motivate the executive to act optimally in the corporations interests. They may motivate executives to take undue risks with the corporation’s assets in order to achieve performance targets to receive their bonus.

As well as the direct objections to alignment theories and reward levels in implementing performance based contracts for executives, there is a further question to consider about them. That is, what other indirect consequences might widespread use of such contracts have on the behaviour of executives and corporate culture more widely? Alignment theory places financial incentives as the sole motivator of executive behaviour. The effect of these incentives on behaviour for executives and those under their direction should be considered more widely.
The first behavioural consequence of alignment theory to consider is incentives towards risk taking behaviour. The possibility that executive bonuses may become perverse incentives was warned about several years before the global financial crisis.\textsuperscript{307}

Performance bonuses appear to be problematic regardless of the level set for the performance targets. If the performance targets are set low then they will be achieved too easily and the executive is likely to be rewarded with a “bonus” for achieving average or below average performance. In such circumstances the bonuses become a means of disguising the level of base salary for the executive. If the performance targets are set high, and a large proportion of the executive’s rewards are dependant on their being met, then the executive will have a strong incentive to manipulate the corporation’s activities in whatever means is necessary to achieve the target.

There is no corresponding financial penalty to the executive if high risk investment decisions are unsuccessful (assuming they do not already hold shares), and thus the bonus scheme has the form of a “one way” gamble. If the risks are unsuccessful the only loss to the executive is of potential income (bonus) rather than an actual loss of personal possessed wealth. From a game theoretic viewpoint a self-interested agent (executive) is likely to maximise such risks if it maximises their own bonuses, discounting the potential for negative outcomes. The risk of loss is to the shareholders not the executive, and so the executive will not fairly weigh risks versus returns. Thus performance bonuses increase moral hazard in the corporation, as defined by Arrow.\textsuperscript{308} The returns to each party may be considered in the outcomes matrix in Table 7.1 below:

<table>
<thead>
<tr>
<th>Return to Corporation</th>
<th>Return to Executive</th>
</tr>
</thead>
<tbody>
<tr>
<td>High Risk Strategy</td>
<td>Low Risk Strategy</td>
</tr>
<tr>
<td>Success</td>
<td>Failure</td>
</tr>
<tr>
<td>High Profit</td>
<td>Large Loss</td>
</tr>
<tr>
<td>Bankruptcy?</td>
<td>Profit</td>
</tr>
<tr>
<td>High Bonus</td>
<td>Base Salary</td>
</tr>
<tr>
<td>Base Salary</td>
<td>Loss of Job</td>
</tr>
</tbody>
</table>


The only way to counteract this risk is to have the executive already holding a significant proportion of their wealth in the shares of the company. Unless the executive is forced to do this as a condition of employment, this is only possible if a large salary or bonus in the form of shares has already been paid out to the executive, diluting the degree of ownership of the original shareholders. The risk may be reduced if any bonuses are paid in shares that are vested in the executive some time later, to ensure the executive considers risks in the long term. However this practice appears to be rare.\textsuperscript{309} When done, executives will then tend to discount future earnings compared to current, and so it will still be less efficient for corporations to pay executives in this manner.

The second behavioural consequence of alignment theory to consider is the effect of “golden parachute” clauses. Executive bonuses, higher salary and “golden parachutes” were all separately identified as being associated with high corporate performance in the 1980s.\textsuperscript{310} The potential adverse consequences of these measures in combination were not considered. One consequence is that if the executive makes a failed investment decision and is dismissed, they will still receive the “golden parachute” payment. In this scenario the executive appears to be better off financially adopting a high-risk strategy whether the investment succeeds or fails. This combination of outcomes is shown in the revised outcomes matrix in Table 7.2 below:

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|}
\hline
 & High Risk Strategy & Low Risk Strategy \\
\hline
Return to Corporation & High Profit & High Losses Bankruptcy? & Profit & Loss \\
\hline
Return to Executive & High Bonus & Base Salary & Low Bonus & Base salary \\
 & Base Salary & Golden Parachute & Base Salary & \\
\hline
\end{tabular}
\end{table}

By further insulating executives from personal financial loss after failed investment decisions, golden parachutes would appear to skew even further the bias by executives

\textsuperscript{309} Lucian Bebchuk and Jesse Fried, 2004.
towards high risk investment decisions. Moral hazard is increased further. This is contrary to the long-term interest of shareholders.

A final problem with alignment theories based on bonus payments is that the focus on positive additional rewards for executives seems skewed towards the interests of executives. Executives can only gain additional rewards and do not face any corresponding additional penalties. Jensen and Murphy intended that bonus payments occurred in place of some salary but the emphasis was still on higher reward for good performance. There is no corresponding consideration of penalties against executives for poor performance. There is remarkably little discussion in the relevant literature about the use of any negative measures against executives, such as legal action to recover inappropriately awarded rewards, or seeking damages for instances of unethical conduct that may have damaged the firm.

Despite their enormous incomes and influence, corporate executives face little risk of punishment for poor performance. Some business theorists argue that such prosecutions should only be considered on a cost effectiveness basis and not on whether a person has acted in bad faith311. That is penalties should only be imposed when it is cost effective in that instance to do so, and not as a matter of principle when the action warrants a penalty. This view completely ignores the moral hazard again likely from the perception that misbehaviour will not be punished. That hazard is likely to create a high cost to shareholders.

This approach is inconsistent with the degree of liability most professions are held to for their actions. Penalties for poor performance are faced by all forms of professional employees, with doctors, engineers, and lawyers facing cost penalties and sanctions for causing damages to their clients due to poor performance, even when no wrong-doing or unethical conduct is suggested. The cost of prosecution is not a factor in the decision to prosecute. In most cases professionals found guilty of mal-practice (as opposed to simply poor or erroneous performance of their duties) may be criminally prosecuted and prohibited from further practising their profession, losing any opportunity for further income from it. Nor is professional liability a question of reward level alone, with modestly

rewarded professionals such as teachers and nurses also able to be held criminally accountable for the safety of persons in their care.

The evidence of market failure within the executive labour market, and the adverse consequences identified for executive rewards based on alignment –theory bonuses suggest that regulation is desirable. The two questions remaining before we consider regulating the market are:

(1) can executive actions or employee actions generally be aligned with shareholder interests?
(2) can some mechanism other than bonus schemes be designed to motivate executives to act more in accord with shareholder interests?

7.5 *Is a Market Solution Possible?*

We have already established that alignment of interests between agent and principal is not logically possible. This still leaves the question: is alignment of the agents’ actions and the principal's interests possible?

Proponents of alignment theory could argue that the fact that past contracts have not been appropriately structured or negotiated, does not make effective incentive contacts impossible. Egregious practices such as bonuses linked to absolute rather than relative performance, and bonuses granted immediately and not deferred to incorporate long term outcomes could all be eliminated from well structured executive contracts. The question then arises – supposing that executive bonuses can be structured to ideally match shareholder preferences in terms of long term rewards for improvements in corporate performance, do they then align the actions of the executive and the interests of corporate shareholders?

In philosophical terms, the interests described by Jensen and Murphy are motivations or mental states that would guide behaviour. Hence the intent to “align interests” represents an intent on the part of shareholders or their agents to alter the motivations of the executives towards the shareholders’ purpose, making them a common purpose. The question depends on whether it is possible to alter the motivational states of executives to match those of shareholders in the company.
From the prior discussion designing bonus mechanisms that accurately allow for what will be in the corporation’s best interest in the future is complex and may be impossible. Shareholders would have to offer an ever-increasing share of equity in the corporation (as bonuses) to the executive, to maintain the executive’s interest over time. Even then all the reasons previously identified (personal gain, own welfare needs satisfied) may tempt the executive to defect from shareholders’ interests.

If it were epistemologically possible to design such a bonus scheme to motivate the executive, it is still not the case that the executive’s interests have been aligned with those of the corporation. The interest of the executive so motivated remains in obtaining the performance bonus, which is a form of self-interest. Whether or not the executive’s underlying interests happened to align with those of the firm would be merely coincidental. Absent of the bonus the executive has no internal reason to act in the corporation’s interest.

Therefore a more plausible construction of Jensen and Murphy’s theory is to ask whether alignment of executive actions and corporate interests is possible. Whether this is possible will depend on the degree of market information known to those setting the executive pay package and targets. This in turn will also depend on the interests of those setting the executive pay contract and conditions. Directors are also individuals with differing and possibly conflicting interests. There is no guarantee that they will accurately reflect the shareholder’s interests in setting the executive pay contract.

In several respects the bonus mechanism may act to lessen the likelihood that the executive will act in the corporations interest. Making the primary focus in hiring, contracting and rewarding executives to be on performance bonuses will tend to pre-select executives primarily interested in obtaining performance bonuses for themselves. That is, it will attract primarily individuals who are primarily self-interested in the materialist sense. There will be a corresponding diminution of alternative motivations in executive candidates. The potential to attract executives who may be internally motivated to act in the shareholders’ interests because of other sympathetic, parallel or overlapping interests such as the desire to lead, loyalty to peers, personal professional pride (in the performance of “their” corporation) or belief in the corporation’s objectives may be reduced.
If such sympathetic parallel or overlapping motivations are absent from the executive when first appointed, the executive employment system focused on performance bonuses seems unlikely to encourage their development later. The system focuses the interests of the executive on performance targets and the obtaining of their performance bonus. Their performance is regularly reviewed and assessed on that basis. Their employment may be terminated if performance targets are not met. Such an environment seems unlikely to engender any underlying alignment or loyalty to the corporation itself and its objectives. The executive is never asked to become sympathetic to the corporation or its objectives – only to be focused on their performance targets and their bonuses.

This gives rise to a further question: is there any other mechanism by which the executive’s interests may be aligned with the corporation? Various motivational tools are used in current corporate management to motivate or encourage employees to think of the corporation’s interests and to ensure that there is “alignment” of values between individuals within a team. These include team-building workshops, corporate training, reward schemes, recognition schemes and mentoring. These are sometimes applied to executives. “Value alignment” is recognised as one of the explicit aims of such programs.

None of these methods could be described as an “alignment type” theory as proposed by Jensen and Murphy. They attempt to actively create alignment by means other than incentives. Hence none of these techniques, if effective, could be considered a validation of alignment theory and executive bonuses.

These techniques suffer from a number of potential negatives. Some may be perceived as coercive or condescending, and hence risk creating a negative outcome. If the schemes are solely intended to align the interests of the employee (including executives) toward the corporation then they will be seen as manipulative. Thus if they are aimed directly at the goal of alignment they are likely to fail, unless their intention is concealed. There is then the danger that the attempt at concealment itself will be recognised and create a more negative impression of the corporation. If the individuals being manipulated realise this it may have a negative effect on their alignment to the corporation. Conversely if they do not realise they are being manipulated it might be questioned whether they are sufficiently mature and independent in their thinking to make an effective decision maker in an executive role.
Dismissing mechanisms which are either manipulative, coercive or condescending, there are other mechanisms that may be effective. Management theorists consider the role of underlying values and objectives within organizations to influence performance. Students of organisational behaviour and culture identify the alignment of values within teams as a key feature in effective organizations\textsuperscript{312}. Generally these theories do not consider the role of performance bonuses in the gradual process by which genuine alignment of values may be achieved. Such alignment occurs over a period of time through osmosis, via immersion in the organisational culture, experiences of the individuals concerned, and their personal development. A healthy organization will foster such alignment, but cannot create or force it on any individual including an executive.

Working within an organization over a long period of time may give rise to an increased sense of identifying with it. Relationships will be built up with other employees. Personal time spent on corporate projects will create a sense of emotional investment that may at least partly align a person’s interests with the corporation. The loyalty of Japanese employees to their corporation, built up over a working lifetime, whether factory worker, salary man, or CEO, is a good example of this process. However these indirect mechanisms do not appear to be things that are capable of being built into the structure of an executive contract, or able to be accomplished within the timeframe of a tenure as an executive.

Finally, there would appear to be some non-financial interests that executives are likely to hold that no amount of incentive pay would induce them to bargain away in order to align their actions and the corporation’s interests. It seems unlikely that any performance based contract could be written in a way to induce persons to sacrifice personal values, relationships or projects that they valued more highly than their career. The image of a careerist executive who sacrifices everyone and everything else in their life to pursue their career might seem to suggest otherwise. Yet in practice it seems unlikely that close personal interests would be sacrificed. Even then, for incentive theories to be valid in all cases, the executive would need to be willing to sacrifice personal interest not for their own career, but for the corporation. For deeply held personal interests, this seems implausible.

Some recent examples of actual behaviour of executives facing such difficulties illustrate this point. In the Unites States, there were a long series of investigations and court cases involving State Health Departments and tobacco companies. At issue was the cost to health departments of treating persons who had contracted diseases from smoking. Some of the documents discovered demonstrated that tobacco corporations knew their products were a health risk, and that the corporations’ executives, had knowingly made false statements to inquiries in the past. Those individuals could have been subject to criminal prosecution for fraud or perjury.

The Tobacco Master Settlement Agreement was reached between the four largest US tobacco companies and the Attorneys General of 46 States in 1998. Under it the companies agreed to pay large damages (long term cost $365 billion US) to the States for as long as they continued to operate. One of the conditions of the settlement was that the companies, including executives, would not be liable to prosecution. While it could be argued that the agreement protected the corporations in the long term, it was not in the shareholders’ interests to negotiate to ensure that the executives were not prosecuted. It is possible that this risk to executives was removed in the settlement bargaining process, at the cost of a higher settlement value than would otherwise have been incurred by shareholders. There was potential for executives to do this, as some critics concluded that maximising the amount of the settlement was the principle objective of the State agencies.

In Australia, a similar situation involved the executives of the James Hardie Group, over the settlement of damages claims for disease caused by asbestos products made by the company. The James Hardie Group had established a trust fund to pay the damages, and in 2001 moved the corporation’s headquarters to the Netherlands to escape the possibility of any further liability to the fund. It subsequently became apparent that the fund was insufficient, and that James Hardie executives had mislead the government when it was established. An inquiry found that the company could not be legally obliged to refund the

pay the balance of funds required for damages. Whilst unethical, this outcome was in the financial interests of shareholders.

Despite this in February 2007 the company voluntarily agreed to return sufficient funds from the Netherlands to pay the damages. Criminal prosecutions of the executives were dropped in December 2008. Subsequent civil action launched by the Australian Securities Investment Commission found that the company board including executive directors had broken the law in their actions.

The cases are complex and it is not suggested that the prosecutions were dropped because of the voluntary decision of the company to return funds to pay damages. However there was obviously a strong potential conflict of interest for executives in considering shareholders’ interests (presumably to minimise payouts) and their personal interest to avoid prosecution. It seems unlikely that a financial bonus would be sufficient for executives to increase their risk of prosecution, regardless of the loss to shareholders.

7.6 Is Attempting to Align Interests Self Defeating?

The question of executive motivation may be considered philosophically in the context of work by Jon Elster on states that are essentially by-products, and by Derek Parfit on objectives that may be self-defeating.

Elster describes private mental states that may only be obtained as by-products or indirectly, and not through deliberate intent and action. For example, one cannot intentionally try to forget something, as the act of concentrating on what is to be forgotten, keeps it in the consciousness. Other examples of such private mental states cited by Elster include wisdom, hunger, humility, virtue, courage, love, sympathy, admiration, faith and understanding. In each case, deliberately attempting to obtain that mental state is unlikely to result in its being obtained.

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Elster acknowledges that the state may be obtained by luck (fluke) and may be foreseeable. However, they will generally not be obtained by any form of technology/technique or command (one cannot force someone to believe/feel something). They cannot usually be faked, unless in a self-defeating way. For example, qualities such as respect or love cannot be faked, since the act of faking them is contradictory to the relationship implied with the object of respect or love. Elster also considers that searches for meaning and some political theories may be self-defeating, such as that the purpose of the political system is to educate the participants. There appear to be several aspects of Elster’s theory applicable to the attempt to align the executive’s interests with the shareholders via executive bonuses.

Following Elster, genuine alignment of the objectives of the corporation and executive would seem to be in the category of objectives that cannot be achieved directly. For the reasons previously stated, if the corporation attempted it deliberately the attempt may be perceived by the subject and regarded as manipulative and cause a negative response, contrary to the intention of the action. If the attempt is not noticed the manipulated executive may have better aligned interests but a person so compliant that they can be manipulated in such a way may be unsuitable for an executive role making independent decisions.

It would seem to be inadequate for the executive to merely “fake” having interests aligned with those of the corporation. If the alignment is faked and not genuine, there are likely to be a myriad of circumstances where the executive will have the opportunity to either overtly depart from acting in the shareholders interests, or appear to act in their interests while not actually doing so.

Parfit in *Reasons and Persons* considers a further position, that some theories or objectives are indirectly self-defeating. The deliberate attempt to obtain such objectives will not only be unsuccessful, but will achieve an opposite or counter-productive outcome.

Application of Parfit’s concept leads to the conclusion that self-interested individuals will regard an attempt to manipulate their motivations and interests, whether overtly or

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covertly, as against their interests. Being self-interested, they will then be hostile to those making the attempt. Even if not self-interested in a materialist sense, they may still regard the attempt as condescending and disrespectful of their personal autonomy, and again evoke hostility instead of “alignment”.

In the case of corporate executives’ interests, aspects of Parfit’s theory appear to fit the situation of alignment of executives and corporations. Using bonuses and rewards to align executives may serve to attract executive candidates who are solely interested in the rewards and have no interest in aligning with the corporation or its objectives. Such persons will be almost certain to “defect” from the corporate investment strategy that is optimal for shareholders at any time their personal rewards are greater for some other set of actions.

Note that both Elster and Parfit cite examples of attempting to alter or influence the values or motivations of other individuals as being in the category of actions or objectives likely to only be obtained as a by-product, or to be self-defeating. While neither considered the example of aligning executive motivations specifically, aspects of it would appear to conform to their theories. This suggest that, regardless of the method used, alignment of corporate and executive interests may be an impossible task, at least by direct means. That is, regardless of the structure of executive contracts and bonuses, they cannot achieve genuine alignment. Consequently some form of external oversight or regulation of such agents will always be required.

7.7 The Case for Government Intervention

Government intervention in the executive labour market (or any market) is likely to have an associated cost, both to the market being regulated and to the government in providing the regulatory agency. If the government recoups the cost of the regulatory cost of the agency from the market the cost to the community is unchanged. Therefore in terms of economic outcomes, government intervention would only be desirable when market or other non-government mechanisms will not be sufficient to eliminate current undesirable practices.

This assumes that the regulation will require the imposition of some body or system for monitoring, investigation, prosecution and enforcement of the regulations where
necessary. Some of these tasks may be able to be performed by existing agencies, but this will require the allocation of additional resources, unless other regulatory functions are to be reduced in its place. For the executive labour market there are existing reporting requirements for executive salary and monitoring by market media organisations. Prosecution and enforcement of limits would require action by a government agency.

The case for government intervention is strong given the structural causes of the overpayment identified in earlier chapters. Once the cause of executive overpayment is recognised as management power rather than a market mechanism at work, there is no logical reason to believe that the market will eliminate the problem without the power of management somehow being limited. This limitation of management power would not be in the rational self interest of executives holding the power, and is therefore unlikely to be achieved voluntarily.

Neo-classical economists could argue that government intervention in executive labour markets is not required because markets should correct themselves over time. This claim seems implausible in the case of the executive labour market given the history of the problem. The rising trend for executive rewards first started in the late 1970s, and has been continuous for the thirty years from then till the time of writing. If the market were to be self correcting, this would have occurred by now.

A second potential argument against government intervention is that it is likely to be more expensive than the alternative of a free market operating. This counter-argument fails for two reasons. Firstly, it assumes that the corporate executive labour market acts as a free market, when we have already established that it has the characteristics of an exploitative market. Secondly, the case for government intervention on public interest grounds only fails if the cost of the regulation exceeds the costs of the current problem for the community as a whole, not only the corporation. If the cost of the regulation is less than the cost to the community of the current market failure, then it is justified.

It seems very unlikely that the cost of regulation could be more than the excess direct cost of current executive rewards. Bebchuck and Fried\textsuperscript{320} established that by the end of the 1990s executive rewards had exceeded an average of 10\% of gross profits for the largest 1200 US firms. At the start of the 1980s they had been less than 2\% of gross profits. By

\textsuperscript{320} Lucien Bebchuk and Jesse Fried, 2004.
contrast it was estimated that the total business regulation compliance cost for United States Corporations under the existing Sarbanes Oxley Act was 0.036% of revenue or much less than 1% of profits\textsuperscript{321}. Sarbanes Oxley has been widely criticised as cumbersome and unnecessarily costly to comply with. Thus the cost of regulation (<1% of profits) is currently very much less than the cost of the growth in executive salary that has already occurred (>8% of profits) in the United States.

Further, it may be argued that the indirect cost of executive reward practices to the wider community is very much greater than the direct cost to shareholders. Economics Nobel Laureate Joseph Stiglitz has cited executives achieving their bonuses as one of the motivating factors in Wall Street investment banks that led to the global financial crisis of 2008-09\textsuperscript{322}. This event cost shareholders in OECD nations over US$32 trillion dollars in equity losses and has caused unemployment for over 30 million persons. Governments have spent US$13 trillion dollars stabilising their markets and economies, creating debts that will have to be born by the citizens of each affected country for decades to come. Overall, the cost has been greater than the combined GDP of the G7 nations in 2008\textsuperscript{323}. A number of related developments in finance markets caused the crisis, yet executive rewards have been at least a motivating factor behind several of them. Almost any form of business regulation would have been cheaper than the costs incurred from that crisis.

Even if the cost of regulation were not lower than the cost of excessive payments to executives, that is not an absolute case for ignoring regulation. When a practice is clearly unethical and causing harm to a society, it is regulated against whether that regulation adds costs or not. The mere fact that there is a strong popular demand for action against current levels of executive salary is sufficient reason to consider imposing such regulation, as long as it can be done in an ethical fashion. Government regulation should not be solely a question of cost.

On balance then government intervention in the corporate executive labour market seems necessary, appropriate and likely to be far less costly than losses from current practices continuing.

7.8 **Summary**

We have now established that executive rewards cannot be justified in a normative sense. We have considered explanations for the causes of current executive reward levels, the type of reform needed in executive labour markets, the adverse consequences of the current situation continuing and a justification for government intervention in terms of likely costs versus benefits.

The executive labour markets in Australia and the United States are clearly dysfunctional, and do not result in efficient or defensible reward levels for executives. The primary cause for this market failure is evidently not market based, namely the management power held by executives. Market based theories such as alignment theory, supply and demand and the economics of superstars cannot account for current market outcomes. Given the non-market based causes identified for excessive executive rewards, market regulation and reform by government appears necessary. The costs of such regulation are likely to be very much lower than the costs of the current situation continuing.

In the next chapter I will consider some of the means by which governments may act to control executive rewards and whether they can be imposed in an ethical and effective manner.
8 Policy Solutions

8.1 The Objectives of Executive Reward Reform

We have now established an explanation for current executive reward levels, identified the need for reform of executive labour markets, the adverse consequences of the current situation continuing and a justification for government intervention in terms of likely costs versus benefits. I will next outline some of the types of reforms that I consider necessary to solve the problem. I do not propose to nominate specific legislative or regulatory reforms in Australia or the Unites States. The relevant legislation is voluminous, and the task would be far beyond the scope of this thesis. The intent of this chapter is to identify the areas of reform and types of measures required to achieve a more efficient executive labour market and justifiable executive salary levels.

Before discussing specific reforms, I will first identify what objectives should be set for such reforms. It is important to ensure that there are definable criteria against which reforms may be tested. This is to ensure that they are both sufficient to end the current problem, and not so excessive that they represent an undue burden to business and society.

The first objective should be to ensure that the executive labour market functions as a transparent, genuinely competitive market that is likely to achieve an economically efficient outcome. It is still desirable that an executive labour market exists, so that better performing executives are rewarded, poor performers removed, suitable quality applicants are attracted to the field, and resources allocated efficiently between corporations. However it needs to be structured and regulated so as to avoid exploitation in that market.

As a general principle, it would be desirable to ensure that reforms to the executive labour market make it more consistent with other existing labour markets and their regulations in Australia and the United States. It should only vary from these regulations where it is necessary to prevent exploitation by virtue of the nature of the executive market. I do not consider this requirement problematic. We have seen that many of the current problems in the executive labour market emerge from its unjustifiable departures from normal labour market practice.
The second objective should be to undertake more broad reforms of corporate governance arrangements to remove some of the structural causes of current market failures in the executive labour market. We saw in Chapter Four that the current combination of structures and ownership acts as a causal agent of executive labour market failure. This is likely to be a long term project but is no less necessary for that fact. Without removal of these causes, in the long term it is likely that the executive reward problem - exploitation of corporate power for executives' personal gain - will merely return in a different guise. This will require reforms to both the ownership and control mechanisms of corporations. I will next discuss some reforms that might reduce these structural causes of failure in the executive labour market.

8.2 Reforming Corporate Governance

Ultimately the excessive reward levels currently paid to corporate executives must be seen as a failure of corporate governance. Changes to share ownership and the structure of rewards may have caused the current problems with excessive executive rewards and perverse incentives, but corporate governance regimes still allowed them to happen, with considerable losses to shareholders. It is therefore appropriate to reform corporate governance as part of a solution to the problem.

Past changes to corporate governance, such as the Sarbanes Oxley Act in the United States and the Australian Clerp 9 amendments discussed in earlier Chapters, focused on evolutionary rather than revolutionary change, and were largely unsuccessful. In this thesis I am advocating fundamental structural reform of the corporate governance regimes for firms. Such reforms are likely to take a significant amount of time to define, legislate, implement and then take effect on salary levels. Therefore in the short term caps or limits on executive salary will also be necessary. Reforms to corporate governance should be seen as a long term and more permanent solution.

8.2.1 The Executive Labour Market

The executive labour market needs to be regulated to avoid what David Miller defined as exploitation. Miller did not define specific conditions to avoid exploitation. The aim of any such measures should be to prevent either of the following situations that Miller described:
1. A transfer should not be more advantageous to the exploiting party and less advantageous to the exploited party than some benchmark or equilibrium price.

2. A transfer should not occur through some special advantage the exploiter has through asymmetry of information and/or asymmetry in bargaining power.

To achieve this, regulation needs to ensure symmetry of information, and symmetry of bargaining positions. There are several means by which this may be achieved for executive labour markets. Most of these would be achieved by making practices in executive labour markets more consistent with practices in other labour markets.

Details of available executive positions, their duties, required skills and experience, and salary packages should be advertised for persons to apply, rather than using “head-hunter” firms. This would in itself reduce corporate costs. The past employment history and performance of applicants should be available for scrutiny. Employment decisions should be made by panels that are balanced in terms of gender, experience, and qualifications, and include internal and external (independent) board members. Clear rules should guide the declaration of any conflicts of interest by selection panel members, and where necessary disqualify conflicted individuals from decisions on that basis.

Note that Miller’s conditions are bi-directional. Although at present the concern is with executives exploiting their corporation, it should be ensured that the reverse is not possible in the future. Principles of justice should be universalisable following Kant’s dictum “Act only according to that maxim whereby you can, at the same time, will that it should become a universal law.”\(^\text{324}\). Thus conditions such as minimum hourly wages, maximum working hours and reasonable conditions should also be applied to executives as they are to other classes of employees.

The executive labour market needs to be regulated by an externally answerable body, as with other labour markets. This would mean bringing it within the province of existing wage arbitration and industrial relations processes in Australia and the United States. The aim would be to increase transparency and accountability in decision-making. Likewise legal accountability for executive reward decisions should rest with directors just as with any other corporate investment or hiring decision.

In the case of the United States, this would require a significantly stronger system of government control of working conditions. While this would be politically controversial, I see it as a necessary reform. Market advocates are fond of arguing for “unfettered” markets but it is clear that labour markets are subject to the abuse of unequal bargaining power by market participants. Low paid US workers suffer from exploitation by employers holding a stronger bargaining position. Likewise executives with compliant boards exploit corporations and shareholders due to their weaker bargaining position. In both cases the party with greatest bargaining power exploits it to their advantage. Neither situation is ethically defensible, or economically efficient\(^\text{325}\). The executive labour market illustrates the economic dangers of too weak market regulation.

Although some will argue this is an unwarranted interference in the market, government intervention has been shown to be necessary in this case. Moreover, government oversight of labour markets is normal for almost every occupation. There is no philosophical reason why the executive labour market should be exempt. Consistency with labour market laws would ensure that there would not be significant increased costs for government regulators in policing the executive labour market.

### 8.2.2 Structural reform of Corporate Governance

Current corporate governance mechanisms have proven so deficient in protecting share investors from excessive executive salary demands that there is good reason to believe that, over time, directors and executives working collusively will find new means to circumvent caps or limits and once again transfer excessive rewards to executives. The perverse incentives that performance bonuses for executives create have caused far greater losses to shareholders than the cost of the rewards. Therefore some reform to the structural mechanisms of corporate governance remains necessary.

Excessive levels of corporate executive salary may be seen as a symptom of a wider problem in corporate structures. That is, the corporate structures that have evolved over the past two centuries are weak mechanisms for translating the preferences of shareholders and investors into the actions of the corporation. The evidence of actual

corporate behaviour is that corporations are mechanisms that tend in practice to be guided by the preferences of executives, not shareholders or directors.

Corporate structures have been developed to increase productivity, but do not guarantee that the power resulting from that structure is used for its originally intended purpose, or to benefit those they were intended to benefit. In terms of political theory, they do not ensure decision-making by those in control of the corporation is in the interests of those with a legitimate stake in the corporation. Most corporate regulation focuses on regulation of reporting, rather than regulation of practices. Kym Sheehan reviewed Australian regulation relevant to executive remuneration and summarised as follows: “remuneration practice is largely regulated by statements of good practice, while legislative intervention is most prevalent for remuneration disclosure and voting on remuneration. Shareholder engagement is subject to the least amount of regulation, with most regulation being self-regulation by institutional investors.”

Previous discussion of corporate governance has focused on improving existing mechanisms for corporate reporting. These reforms implicitly assume that current corporate structures are appropriate. They also assume that corporations act towards their shareholders interests and require refinement to ensure that their powers are not misused in this process. The question of whether corporations do act in the interests of shareholders is seen as a separate question of the need to align shareholder and executive interests. In this regard the comments of Sheehan noted above were made on the Australian situation after the CLERP9 financial reforms of 2004.

Previous reforms have failed to include share investment funds which, as we have seen in Australia and the United States, are now the predominant category of share ownership. Any effective reform of corporate governance needs to extend a similar governance regime for the management of share investment funds as exists for corporations. In particular, this must include means by which share fund investors may have some say over the reward and appointment of managers of the fund they are investors in. Inclusion

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327 Paul Sheehan (2009) discusses the objectives of CLERP9 on pages 275-276, and goes on to explain why some are unlikely to be met.
of such institutions within the overall scope of corporate governance reform will be assumed in all following discussion of corporate governance reforms.

Given the conclusions already reached on the incoherence of the notions of corporate interests and alignment of interests, previous approaches to corporate reform are grossly inadequate. They have not addressed the fundamental questions of how the interests of different groups within the corporation are translated into corporate actions. This problem is widespread, and not confined to Australia and the United States. La Porta et al considered legal protection of shareholders in many OECD countries and concluded: “For most countries, the improvement of investor protection requires radical changes to the legal system. Securities, company and bankruptcy laws generally need to be amended”\textsuperscript{329}

Therefore it seems appropriate to look towards solutions from the viewpoint of political philosophy, to consider how corporations might be reformed to better represent multiple interests. Towards this end, two approaches to increasing the degree of democracy within corporations should be considered. The first approach is “bottom up” (democracy within the workplace) and the second is “top down” (democracy within the corporate ownership and control mechanisms).

\subsection*{8.2.3 Corporate Democracy in the Workplace}

The first “bottom up” approach is to replace “command and control” type mechanisms which proliferate in current corporate culture with more democratic operational mechanisms whereby employees have a defined role in corporate management. As we saw in Chapter Five, this could include employee involvement in the setting of salary and reward levels for both other employees and executives. I will define corporate management approaches where employees are involved in such decisions as workplace democracy.

At first glance workplace democracy might seem a radical change in corporate philosophy that rejects the current dominant form of business practice in Australia and the United States. Yet there is no intrinsic reason why the current allocation of powers within corporate structures must be a feature of corporations owned by shareholders. Other

models exist both in theory and practice. Shareholders should be supportive of changes in the balance of power between executives and other employees, if those changes improve returns to shareholders.

There are examples of employees successfully taking over the running of corporations. Semco (Brazil) and the John Lewis Partnership (UK) have already been cited. Among non-English speaking countries in the developed world alternative corporate models are more common. In Germany corporate boards in most cases are legally required to include delegates elected by workers.

Additional business models exist that have not yet been implemented. Weitzman in The Share Economy, proposed a model whereby employees would be paid an agreed share (proportion) of corporate profits rather than a nominal wage. This theory was aimed at avoiding stagflation and lowering unemployment rather than corporate governance reform. Although offering theoretical advantages, it was considered that this model would not be adopted because employees preferred to minimise risk rather than maximise outcomes. Nevertheless it highlighted that other income models than the traditional one may not only be viable but might have advantages.

It should be clarified that workplace democracy is not intended to supplant or overrule the rights or interests of corporate shareholders. Rather, it is an attempt to redistribute decision-making powers within the corporation in a more equitable way between employees and executives. This would make executives accountable to employees in a way that should act as a brake on executive salaries where they are greatly disparate from those of other workers.

Employee influence might also have other tangible benefits. It would act as a countervailing force to deter executives from taking unjustifiably risky corporate strategies to the detriment of shareholders (and employees). It would bring employee information on corporate operations directly to the board in a less filtered manner, enabling better informed decision-making. Evidence from Germany, where co-determination laws require

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employee representatives on boards of most large companies, suggests that this is to the
benefit of shareholders. Fauver and Fuerst (2004)\textsuperscript{332} found that firms with employee
representation under co-determination had increased efficiency and firm value was
increased.

Philosophically there are many other benefits to adopting structurally required employee
participation in corporate decision making. Such systems give greater recognition to the
knowledge and interest of workers in their corporation. They ensure employees have a
greater sense of autonomy over the work sphere of their lives, which for most will occupy
the majority of their adult lives. A role in decision making will create a greater degree of
engagement between employees and their corporations, increasing their own work
satisfaction, and possibly their performance.

This is not to suggest that employee involvement is a panacea for corporate governance
problems. Gorton and Schmidt\textsuperscript{333} found that of German corporations under
codetermination, those with one third employee representatives on the board performed
better than those with one half employee representatives on the board. There was
evidence that employee dominated corporate boards became too reluctant to reduce
payroll costs when economic conditions were difficult. This conclusion suggests that
employee representatives should provide an input, but not dominate corporate decision
making.

The trend in corporate governance in the United States in the past decade has been in the
opposite direction from structural reform – towards increased executive power. This may
seem an odd statement, given the increased corporate regulations introduced in Australia
and the United States in the wake of the collapse of dot-com firms in the late 1990s. Yet
since then the most dramatic change in corporate structure has been the rise of private
equity firms and hedge funds. Private equity firms and hedge funds were designed to
(successfully) circumvent normal corporate governance and reporting rules. In them the
power of executives is greatly increased compared to public corporations. By 2007 these
accounted for an unknown but large and growing share of US private assets\textsuperscript{334}. Thus

\textsuperscript{332} Larry Fauver and Michael E. Fuerst, (2004).
\textsuperscript{333} Gary Gorton and Frank A. Schmid, “Capital, Labor, and the Firm: a Study of German
University Press 2009).
while executive powers were being subjected to greater regulation in corporations, a larger share of business was moving outside the scope of these regulations entirely.

The growth of private equity and hedge funds further demonstrates the powerlessness of shareholders to control how their investments are used. The growth trend in this market was first claimed to be to the benefit of investors, thanks to the reduced costs from regulation and oversight. Precisely because of the weaker reporting rules it is difficult to obtain reliable data on private equity and hedge fund performance. Returns at first seemed better than average corporate returns, though not consistently.\(^{335}\)

However this advantage was spectacularly reversed during the global financial crisis of 2007-2009, with hedge funds recording average losses of 30% and many becoming insolvent.\(^{336}\) They had been amongst the largest investors in Collateralised Debt Obligations (CDOs), and could be regarded as one of the causes of the Global Financial Crisis.\(^ {337}\) Private equity firms have on the whole performed even worse, with consistently below market returns for investors, but above market returns for sponsors (executive managers).\(^ {338}\) In both cases, removing controls designed to protect shareholders’ interests has not proved to be in the shareholders’ interests for very long. This then leads to the second recommended area of reform: the relationship between shareholders and corporate organisation and boards.

### 8.2.4 Corporate Democracy in the Boardroom

Australia\(^ {339}\), the United States\(^ {340}\) and all other OECD countries have legislation governing the reporting, structure, principal office bearers, and requirements for directors’ elections within a corporation. Beyond that, few have any particular restrictions on how a


\(^{338}\) Ludovic Phalippou and Maurizio Zollo, “The Performance of Private Equity Funds”, University of Amsterdam Faculty of Economics, September 2005.


\(^{340}\) The United States has corporation laws in every State, with the Delaware General Corporation Law predominating. There are also some relevant Federal statutes, notably the Securities Act (1934) and the Securities Exchange Act (1934).
corporation may be organised, managed, or governed by directors. In theory corporations are democratic at the level of executive leadership, with shareholders voting to decide who will be directors, and directors voting on important issues of corporate direction (and the executives’ salary).

In practice I contend that corporations are ineffective as structures in ensuring democratic outcomes from these processes. This is because of the separation of ownership and control embedded in their structure. Historically this was first identified by Berle and Means in *The Modern Corporation and Private Property* \(^{341}\) (1932). Berle and Means clearly stated the mechanisms, typically proxy voting rules, by which executives dominated voting in corporations. They called for changes to increase shareholder ability to influence voting. Much of the subsequent literature on corporate governance was in response to the issues they identified. Yet it remains a sobering testament to the enduring power of corporations to resist legal reform that, almost eighty years later, most of the problems Berle and Means identified remain in both Australia and the United States corporations.

In this context I will define democratic as meaning that a decision is reflective of the preferences of a majority of the stakeholders in the group making it or affected by it. Shareholder democracy then, is defined as a corporation having governance rules, structures and methods of election for office holders, such that the decision making process (and body) of the corporation is fairly representative of the interests of shareholders. Fair in this context means that the influence is in proportion to the legitimate interest.

Based on this definition of corporate democracy, current methods to elect directors in Australia and the United States rate very poorly. Rules for directors elections are such that any individual who owns 51% of shares can control 100% of directorships and thus every vote. In practice share holdings of over 30% are generally considered to be controlling interests in corporations, as it is rare that all shareholders vote. In the absence of a dominant shareholder, executives are likely to have a higher degree of control using

the mechanisms Berle and Means identified\textsuperscript{342}. Some economists have argued that concentrated share ownership leads to benefits in efficient decision making\textsuperscript{343} whereas dispersed shareholding has benefits in share liquidity. I question this as, even if true, it does not ensure a fair distribution of the benefits of efficiency among shareholders.

Shareholders generally have no ability to influence the management of their corporation directly. Once directors are elected, there is little more shareholders can do to control the corporation other than sell their shares if they are dissatisfied. Most codes of corporate law require directors to inform shareholders of decisions after the fact. Only a small range of prescribed decisions, such as accepting hostile mergers, require a prior vote from shareholders.

Stakeholders other than shareholders and executives have no formal say in corporate decision making in Australia and the United States. This situation is typical of English-speaking countries, but contrasts sharply with Germany where we have seen employee representatives are required on boards, and Japan where banks or the government (Ministry of Trade and Industry, MITI) are often represented.

There is evidence that broader board membership has had the effect that abuses of corporate power for the benefit of executives have not occurred to the same extent. Executive salaries are lower in Germany compared to the United States and comparable to Australia despite being a much larger market. This is even more true of Japan where external parties including banks and government agencies are represented on corporate boards\textsuperscript{344}. Union or government directors have no personal incentive to conceal wrongdoing by executives that might harm their employees or community. Neither are banks with an equity stake in the corporation. This should reduce such abuses, or at least make them more difficult to perpetrate undetected.


Reforms that may increase the degree of shareholder democracy in corporations include changes to the decision making process, the process by which shareholders vote\textsuperscript{345}, and the process by which representatives (directors) are nominated and elected. Changes to the decision making process would primarily focus on ensuring that shareholder views are obliged to be acted upon by directors and executives. Making the results of shareholder votes on executive remuneration binding would be one example of this type of reform.

Changes to the selection process for shareholder representatives (i.e. directors) would be aimed at ensuring that the composition of corporate boards of directors was representative of shareholders, similar to concepts of proportional representation in political philosophy. The most obvious required reform to achieve this would be to enable shareholders to nominate for ballots for director positions, as argued by Bebchuk\textsuperscript{346}. At present ballot nominations are controlled by the corporation’s executives. A proposal to introduce this reform in the United States was rejected by the Securities and Exchange Commission in 2007\textsuperscript{347}. Philosophically, regardless of whether or not other changes to corporate decision making are made, restrictions to the nomination process for directors are indefensible, since they ensure that the existing status quo may be maintained indefinitely, even if it harms shareholders. That is, shareholders cannot attempt to gain control of their own asset.

Other reforms required to achieve a measure of shareholder democracy should include simultaneous election of directors with proportional voting methods. A majority shareholder would elect a majority of directors, but not all as at present. Directors terms should be fixed to legislated limits, with maximum term limits for the chairman. Board positions should be elected one half at a time, to ensure continuity. This would be similar to the half Senate elections held in the Australian and United States upper houses of federal government.

Opponents of corporate reforms to achieve increased shareholder democracy typically argue two key objections. Firstly corporate regulations and legislation are already numerous and cumbersome, and such reforms are unnecessary and will increase the

\textsuperscript{345} Kym Sheahan (2009), page 304.
compliance cost, harming profits and shareholders interests. Proponents of shareholder democracy cannot simply appeal to emotive arguments about rights, as we are not dealing with a fundamental question of individual liberty, only the management of (corporate) assets. They need to demonstrate that the benefits of such reforms will outweigh their costs. Karpoffa, Malatesta and Walkling have shown that, where measured, shareholder initiated proxy proposals have generally not improved the performance of corporations\textsuperscript{348} to date.

Reforms of the types proposed should not increase corporate costs. The intention is not for shareholders to interfere in day to day running of corporations. The intent is to prevent abuse of position by executives and directors, which should reduce overall costs.

A second objection is that any regulation that impacts on corporate decision making may reduce the responsiveness and flexibility of a corporation, harming its ability to create returns for shareholders. That is, there is no guarantee that corporate decision making under shareholder democracy would be any better than under current arrangements. Stout has argued that there is no evidence that reforms such as those proposed by Bebchuk will benefit shareholders\textsuperscript{349}. This is true, but is also a straw-man argument since, until the reforms are introduced there is no evidence either way. I do not consider this a valid criticism. It would preclude any organisational change to say that it could not proceed until proven effective, when it had not been tested.

On balance it would, as a minimum, be desirable to reform existing corporate director election processes and shareholder voting mechanisms to prevent abuses of power by executives. Both of these mechanisms already exist, and so this should not result in any additional costs to the corporate governance of the corporation. The resulting improvement in oversight should reduce agency costs in the long term.

The following reforms would seem essential, if the degree of shareholder democracy is to be increased from its present low level:


1. Election of corporate directors should be periodic, regular, and based on some form of proportional representation, with all directors subject to re-election at the same or alternating times.

2. Maximum term limits would be recommended for critical posts such as chairman of the board or CEO. (It should be a compulsory function of any good executive to identify and develop successors).

3. Processes for selection of corporate executives should mirror processes for other employees, including transparency of advertising, position descriptions and offered rewards.

4. Parallel reforms to governance of share investment funds are required to ensure that fund managers are answerable to investors.

The following would also be highly desirable, if costs are not increased:

1. Shareholder votes on topics such as executive compensation should be binding on corporate boards.

2. Employee and community representatives with observer status (at least) should be required on boards of publicly listed companies.

8.3 **Introducing New Motivational Incentives**

I identified in Chapter Five that the motivational assumptions in agency theory were simplistic and needed revision. Although a replacement theory is beyond the scope of this thesis, this highlights the potential to motivate executive behaviour by non-financial incentives. This merits further investigation as a possible means to reduce current executive reward costs. In (limited) defence of executives, it could be argued that at present in Australia and the United States financial reward is the only prize they have to strive for.

We can see the significance of non-financial motivations in executive behaviour when we consider the evidence on executive rewards from countries with different corporate cultures to Australia and the United States. In Japanese society membership of the workplace group as a community is very important. Esteem within the workplace is highly valued by individuals, leading them to display a much higher degree of loyalty to the
corporation than is normal in western countries. Japanese executive rewards are noticeably lower than in Australia and the United States (see graphs in Chapter Two). While I do not suggest that Japanese business culture is without its negatives, it shows that cultural practices can influence behaviour in the workplace independent of rewards.

If behavioural economic theories are correct, then there would appear to be potential to motivate executives through non-financial rewards. One method could be to establish formal external recognition for achievement by executives. This would take the form of independently awarded prizes or rewards for superior executive leadership as markers of status or recognition for high performance. These would aim to satisfy the desire for esteem and comparative recognition identified in executives by Haigh, without creating a cost burden for shareholders.

Ideally such an award would be nominated by a credible independent body. This could be done in a similar manner to the Nobel Prize for Economics created by the Bank of Sweden to raise the status of financial analysis, and the technology prize sponsored by Nokia. An incentive for executives to be praised for their contribution to society, rather than criticised for their greed in accepting current reward levels, could be highly beneficial for both.

As well as a carrot, use of a stick may be appropriate. I mentioned previously, there has been a notable focus on positive incentives for executives in finance literature on executive rewards and very little discussion of negative incentives. This raises the obvious question: why has there been so little discussion of the use of negative incentives (i.e. punishments for poor performance or misconduct) for executives? Proponents of alignment theories might argue that not receiving a bonus is already a negative incentive. However, when base salaries for executives are already multiples of the average wage, this defence rings hollow.

Given the prevalence of “golden parachute” clauses in executive contracts (and their endorsement by proponents of alignment theory), this assumption must be questioned. Many persons lose their jobs through no fault of their own when the demand for labour or a company’s profit falls. That risk is not described as a penalty for poor performance but as

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the labour market at work. The dismissal for poor performance approach inherent in alignment theory assumes that, given adequate performance, executive employment will continue at the same reward levels. It becomes an entitlement that cannot be removed except for wrongdoing, similar to the concept of tenure for some public servants and academics.

In an economic sense, if incentive payments are to be persisted with, then “clawback” provisions for bonuses from misreported profits must be added\(^\text{352}\). Financial penalty clauses should be considered for cases of grievous failures of corporate management. These should apply to directors as well as executives. There is now a movement towards greater accountability of directors for financial decisions over shareholder funds\(^\text{353}\). I have not found any discussion of such a possibility in alignment theory literature, where it is presumed that dismissal is sufficient penalty for an executive, and no penalty appropriate for a director. This has slanted the development of executive reward models sharply in executives’ favour. Roberts, McNulty and Stiles have shown that in respect of accountability, agency theory alone is inadequate to describe the full range of required functions of directors\(^\text{354}\).

For cases of unethical behaviour by executives, mechanisms for disbarment from future executive employment should exist. This is normal practice for other professions, where professional bodies assess complaints of unethical behaviour and deregister members for unethical conduct. There are no equivalent bodies for corporate executives, other than recourse to the courts. Codes of conduct have been introduced, but they are generally corporation specific and voluntary.

Regulators may prohibit persons acting as company directors in the event of convictions for breaches of corporate law\(^\text{355}\). Yet this is by an external body, and for criminal conduct, not merely unethical behaviour. There is no *internal* policing of ethical standards by


\(^{355}\) Kym Sheehan (2009).
executives or directors as groups in Australia or the United States. In this sense neither executives nor directors can be defined as professionals, since there is no internal attempt to hold individuals accountable to any particular standard of professional behaviour.

Given the lack of internal policing, an obvious means of adding negative incentives to reduce executive misbehaviour is to increase the degree of external surveillance and prosecution of unethical executive behaviour by government. This would require investigative and prosecuting resources as well as legal frameworks. Discussion of reform frequently focuses on change to corporate laws. While not disputing the importance of such regulation, without adequate surveillance of corporate activity by regulators and prosecution of misbehaviour, the deterrence effect of such regulation remains negligible.

The role of the financial press is valuable in regard to surveillance. In an Australian context the highest profile corporate prosecutions over the past two decades – Alan Bond356, Chris Skase, Ray Williams and the directors of James Hardie – all followed initial exposure of the alleged wrongdoing in the financial press. It is an open question how many would have been charged without this initial media investigation and exposure. Prosecution of executives other than following a corporate collapse remains very rare. It would be naive to pretend that breaches of corporate law only occur in the case of corporate collapses.

In Australia this was demonstrated in the inquiry into the collapse of HIH insurance, where the inability of the regulator, the Australian Prudential Regulatory Authority (APRA) to comprehend the industry, much less police it, was noted357. Thereafter Australian corporate regulator resources were strengthened. The subsequent strength of financial regulators in Australia has been identified as one of the prime reasons why the global financial crisis had less severe consequences there than in the rest of the OECD358. This stands in sharp contrast to the United States, where regulation was weakened in the decade prior to the financial crisis, with disastrous consequences.

8.4 Capping Executive Salary

In the aftermath of the major financial collapses in 2008 experienced first in the United States and then worldwide, caps on the quantum of executive salary have been proposed in many OECD countries, including Australia and the United States. In Australia in 2008 the Prime Minister proposed limits on executive salary to the G20 when it met to discuss the need for regulatory reform. At the time several countries actually imposed limits on executive salaries for companies in receipt of financial assistance, including France, Germany, Holland and Sweden\textsuperscript{359}. However by mid 2009 Australia had seemingly deferred this course of action, preferring to await the outcome of the Productivity Commission Inquiry\textsuperscript{360}.

In March 2009 the Australian Productivity Commission was charged with carrying out an inquiry into the regulatory framework around remuneration of directors and executives of companies regulated under the Corporations Act. The initial discussion paper of this focused on eliminating the most questionable executive pay practices, such as “golden parachute” clauses, and making shareholder vote on executive pay contracts binding\textsuperscript{361}. The question of executive pay caps was not pursued.

In the United States efforts to reduce or limit corporate executive rewards started with the attempted bailout of financial organisations under the Troubled Asset Relief Program (TARP) in 2008. It had been intended that (insolvent) financial institutions in receipt of direct government assistance would be conditional on paying executive salaries of no more than $1 million each per annum (23 times average salary) and not paying bonuses. Even these limits were not in practice enforced after both Republican and Democrat Party Senators opposed them\textsuperscript{362}.

In the first instance most of these proposals appear to have been driven by widespread anger at the greed displayed by individual executives in the most egregious cases. There is resentment at the social inequity caused by executives receiving rewards hundreds of

\textsuperscript{361} Australian Government Productivity Commission, April 2009, Ibid.
\textsuperscript{362} United States Senate Committee on Banking, Housing and Urban Affairs, “Summary of the Emergency Economic Stabilization Act of 2008.” (Retrieved October 2, 2008)
times those of other workers. A second rational is that very high executive salaries linked to performance bonuses had been a major incentive to adopt high risk investment strategies and thus acted as one of the motivational causes of the financial collapse. Therefore it would be in the public interest to limit executive rewards and end the perverse incentives to take excessive risks with corporate investment strategies.

8.4.1 The Ethics of Salary Caps

While market intervention in general is justified in cases of executive labour markets, we need to consider the ethics of salary caps. The first question that should be considered is whether it is ethical to intervene to limit the incomes of private individuals in general, or of specific occupational groups such as corporate executives. That is, is it reasonable for government to single out a particular occupational group and intervene to reduce or cap their income to a pre-determined level. This assumes that the current income they receive is from a distorted market where economic rents may be extracted.

In general terms governments already intervene to control market outcomes for incomes where the public interest is served. Restrictions are variously applied to the number of hours allowed to be worked, number of clients permitted, fee that may be charged per service and/or fees per hour. For example in Australia the fees that doctors charge are limited in ways that limit the maximum gross income able to be earned.363

Governments have also intervened to control or reduce incomes for workers more generally, and not only for particular occupations. In Australia in the 1980s the Hawke Labor government had a policy of wage restraint, whereby increases in wages were limited to those justified by increases in worker productivity. After allowing for the effects of inflation, real average incomes for most workers declined significantly during this period.

Historically maximum wages were set in the past in both England and the United States. In renaissance England the Statute of Artificers (1563) allowed magistrates to limit the wages of labourers, apprentices and tradesmen in a county. At the time certificates required to live and work in some counties had the effect of artificially creating shortages of labour and higher wages. Similar limits to wages for free tradesmen were imposed in 17th

century American colonies to prevent exploitation of labour shortages\textsuperscript{364}. Both of these cases were upper limits to wages for workers, not on the income of managers or the owners of capital. In the modern era several professional sports have salary caps on individuals or teams, such as in football and basketball in the United States and football in Australia. Many public service positions also have limits on the earning of income from outside (i.e. non-public service) sources.

Salary caps may also be implemented through indirect means, such as via progressive income tax scales. In western countries after World War Two progressive tax regimes incorporated very high marginal tax rates, up to 90\%, for very high incomes. These had the effect of setting de-facto maximum wages, with most income above the maximum rate threshold lost. There was a corresponding fall in maximum wages in real terms\textsuperscript{365}.

The fact that salary caps have been successfully implemented in the past, and in other fields, does not necessarily make them ethical. Salary caps may face economic counter arguments, as well as the criticism that they are an infringement of individual liberty. Monetarist economists such as Milton Friedman argued that high tax rates were a disincentive to creativity and innovation that would ultimately leave the society worse off\textsuperscript{366}. This criticism is purely empirical and depends on the net effect on society of the tax rate for its force. Friedman does not argue against high tax rates in principle.

Austrian school economists such as Friedrich von Hayek and libertarians such as Robert Nozick had more fundamental criticisms of interference in the market. They saw large governments and high taxation rates as underpinning the welfare state and an infringement on individual liberty. Hayek argued that they could ultimately lead to totalitarian states\textsuperscript{367}. He opposed the idea of “social justice” saying for markets “there is no point calling the outcome just or unjust”\textsuperscript{368}. It could be argued that this conflation of ideas is unfair – punitive taxation rates on very high incomes need not be associated with large government or a welfare state. However it does seem intuitively correct that punitive taxation rates are an infringement of a person’s liberty as conceived in the Lockean sense.


\textsuperscript{366} Milton Friedman and Rose Friedman, “Free to Choose.” (San Diego: Harcourt, 1980).


Locke argued that the fruits of a person’s labours belong to that person. From this it could be said that an earned income in a capitalist society belongs to the individual and should not be taxed more than is necessary to maintain the society. If this logic is extended to corporate executives, their salaries are earned from their own labours, and should no more be taxed than any other individual should be. The fact that their income might be larger than other workers’ incomes may reflect greater intellect, effort or good fortune, but is not in itself a reason to tax them more.

I consider that applying the Lockean argument to corporate executive incomes takes it much too far. Locke was referring to individuals’ incomes from things created by their own physical labours. It has already been shown in past chapters that corporate executives are not solely responsible for the production of their corporation. Hence the Lockean argument cannot be used as a justification for executive income by linking their labour to corporate outputs. It only justifies their income if it is the case that the effort or skill applied by the executive has resulted in the corporation’s social product. As we have seen the reality is far more complex for a large corporation, with the efforts of other workers and the capital of the corporation both contributing to the output.

The quantum of corporate executive rewards is now so great compared to other workers that it is implausible for it to be explained by differences in effort or skill. Executives are undoubtedly skilled, but there is no evidence that they are more skilled than other professions such as doctors, lawyers and engineers. Their requirements for formal training and education are generally less than these professions. Professional positions are typically paid more than average wages, but not greatly, with average incomes in the listed professions typically no more than twice or three times the workforce average, though higher for doctors in the United States. Differences in skill level are not sufficient to justify current executive rewards in comparison to other skilled occupations.

Differences in effort also do not explain executive rewards. Their working hours are long, but again not more so than many other occupations. Even if a person chose to do nothing but work and sleep in their life, compared to a “normal” forty hour week an individual working 100 hours per week, would justify a difference in income of up to 2.5 times on the basis of difference in labour exerted. Again, the difference in effort exerted is not sufficient to justify current executive rewards. Paying an executive dozens of times the average
wage (in Australia) or hundreds of times the average wage (in the United States) cannot be justified by differences in skill and effort. Hence the Lockean argument fails as a justification of current levels of executive rewards.

There is nothing about a transaction being a market transaction that makes it inherently just. Nor is there any moral principle that says the government may not intervene in markets to influence transactions or outcomes. Rather, the question is whether the public interest is served by restricting the market or not. If salary caps achieve the best overall social outcome, then they are ethically justified in the same way that the market is justified, by creating a social benefit.

There are particular reasons in the case of executive salary why caps on rewards may be more appropriate than usual. These are in addition to the weaknesses already identified in the executive labour market. In the case of public companies in Australia and the United States, government intervention has already affected the market for executive labour. Federal legislation requires all workers to have part of their pay invested into superannuation or retirement benefit funds. These in turn must invest some of the funds in private corporations through share markets. Thus government regulation intervenes in the share market in a manner that increases the flow of capital into it. This raises share prices and assists executives in achieving bonuses based on their company’s share price. If executive “performance” is defined by changes in share price, then a large proportion of the “performance” executives claim in their desert base over the past three decades has been due to government regulation rather than their own efforts.

A counter-argument to salary caps on particular occupational groups such as corporate executives is that they represent discrimination against those individuals. Such a salary cap, in the absence of caps on incomes of other groups, would represent an arbitrary judgement that their work was less valuable to society than occupations with uncapped incomes. This would be valid if the salary cap is targeted solely at corporate executives. However this objection can be circumvented in the design of the cap. A salary cap placed on all employees earning more than, say ten times the average income, including executives of any publicly listed corporation (presumably on other public institutions as well) would not be discriminatory but would still be highly effective. The quantum of

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corporate executive salaries is now so high that a targeted ban is not necessary. A salary cap could be set at a level so that it was highly effective on executives (eg. ten times average wages) without affecting the prospects of other occupational groups.

The acceptance of a range of different salary cap levels within the professional sports previously identified undermines any arguments about discrimination. Dietl et al have shown that professional sports demonstrate differential salary caps can benefit a practice and be acceptable to society given that there is a clear public benefit\(^{370}\). The principle to consider when applying salary caps is not whether they are discriminatory, but whether the discrimination is justified, in terms of the public interest. In this respect salary caps may have an advantage over punitive tax rates on all high income earners. They can discriminate between cases where very high incomes are justified, and those that are not. We have already seen that high levels of reward for executives do not appear to be justified. A salary cap on them would prevent this occurrence, while not affecting occupations where high rewards were individually earned, such as “superstars” in the fields of entertainment, sports, and enterpreneurs who owned their own business, and deserved to keep their income as the fruits of their own labour.

### 8.4.2 The Form of Executive Salary Caps

The first executive salary caps proposed have consisted typically of two components:

1. capping the total rewards (salary and bonuses) of executives to a multiple of average earnings either of all employees within the corporation or within the community as a whole; and

2. elimination of dubious payouts such as “golden parachute” termination payments received by executives upon dismissal.

Examples of such caps were proposed in Australia and the United States. In Australia the Australian Council of Trade Unions (ACTU) proposed limiting the total rewards to executives at an upper limit of ten times the average wage of workers in the enterprise concerned. Performance bonuses were to be strictly regulated and limited to cases where

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companies outperformed their industry peers over a five year period\textsuperscript{371}. These limits were intended both to reduce absolute reward levels and the discrepancy between executive rewards and other workers. The five year period would act as a device to limit perverse incentives towards taking excessive short term risks.

The ACTU proposal tried to link executive salary to the average wage in the firm rather than the community. This approach is questioned. It has the benefit to unions of providing an incentive to raise workers wages within the firm and should reduce inequity. However that does not make it inherently just. Evaluation of most occupational incomes is by comparison to overall average wages, not averages within an industry. If the task of executive leadership is essentially the same in different industries, there seems no reason why the leader of a corporation with highly paid workers should earn more than the leader of a corporation with lower paid workers. In industries where pay rates are unusually high throughout the industry, such as investment banking, such an approach would have acted as a significant brake on some of the most contentious executive salary cases in recent years. On balance a cap on executive salary linked to average worker rewards would be preferable to a cap linked to average wages within a firm or industry.

8.4.3 Criticisms of Executive Salary Caps

Opponents of executive salary caps argue that they are “creeping socialism” or an interference in the market that will lead to a “brain drain” of the best executive talent from the country\textsuperscript{372}. Others claim they are the “politics of envy”\textsuperscript{373} or will create unintended consequences. None of these counter claims are persuasive or proven, and some may be dis-proven. I will deal with each in turn.

References to socialism are ad-hominem type arguments (at least in the minds of libertarian critics) without philosophical force. Whether a policy represents “socialism” or not is a political question but is not an ethical criticism. As for the claim itself, socialism is normally taken to refer to systems where the means of production, such as corporations, are owned by the State, not simply regulated. We have already identified many forms of government intervention and regulation, including limits on income for private agents that

\textsuperscript{371} Australian Council of Trade Unions, Resolution on Executive Salaries, ACTU Congress June 2009. Also submission to Australian Productivity Commission, April 2009.
\textsuperscript{372} Dino Cesta, “A cap on CEO salaries – Creeping Socialism?” On-Line Opinion, 16 March 2009.
are present in market economies. Regardless of the intervention, the market agents still remain private, not State owned, entities. Thus an executive salary cap does not represent socialism by definition. The criticism is false and, even if it were true, not persuasive. Complaints of interference in markets are not a counter-argument either; there is nothing sacred about a market that prohibits such interference.

Claims of a “brain drain” are at best unproven and at worst false. There is little known evidence that the skills and knowledge that creates a successful executive in one market is transferable internationally, or that such brain drains ever occur. Nor is there evidence that the level of executive pay will cause executives to leave a given corporation, much less a nation. Hasenhuttl and Harrison found no relationship between relative CEO pay and the likelihood of leaving a corporation. OECD studies have shown that it is predominantly scientists, engineers and technicians that move internationally for higher pay. Business executives move mostly due to mergers and acquisitions by their corporation. There is no evidence that a “brain drain” for executives exists, or would be created by differences in levels of reward or any other reason.

A refined version of the brain drain argument by Kaplan is that restrictions on executive salary will lead to a brain drain of executives from corporations to hedge funds and private equity groups, that already pay much higher rewards to executives than publicly listed corporations. Kaplan is correct that private equity groups and hedge funds do pay executives more than public corporations. The highest paid US hedge fund managers in 2007 are listed in Table 8.1 below:

<table>
<thead>
<tr>
<th>Rank</th>
<th>CEO/Manager</th>
<th>2007 Salary</th>
<th>Hedge Fund</th>
<th>Fund Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>John Paulson</td>
<td>$3.7B US</td>
<td>John Paulson &amp; Co</td>
<td>$35B US</td>
</tr>
<tr>
<td>2</td>
<td>George Soros</td>
<td>$2.9B US</td>
<td>Quantum Fund</td>
<td>$17B US</td>
</tr>
</tbody>
</table>

However Kaplan’s argument raises other problems. Firstly it is only relevant to the executives of finance corporations since they are the persons likely to transfer to management of private equity and hedge funds. Secondly private equity groups and hedge funds are not models of good practice. Private equity groups and hedge funds formed a growing sector of the US economy in the decade up to 2007. At their peak in 2007 hedge funds contained 2.5 trillion US$ in assets, although this fell after the sub-prime market bubble burst, and during the global financial crisis of 2007-09. Many of the practices associated with the causes of the global financial crisis were intimately related to the investment behaviour of hedge funds. Many funds became insolvent, or suffered massive losses during this period.

Hedge funds are not (at the time of writing) subject to the same reporting rules and regulations as publicly listed corporations. Many were deliberately structured to avoid such rules. Hence it is difficult to establish their true level of performance or the justification for executive rewards. Rewards for the highest paid and most successful managers are known, but industry averages are not. Hedge funds typically charge clients management fees of 2% of funds invested and an additional performance fee of 20% of the profits made. In many respects hedge funds are pure speculators rather than productive entities. The number of staff employed is usually small. Managing one is an analytical task of investment judgement, rather than a leadership task of a large organisation. Their enormous rewards is as an indication of weak regulation rather than proof of superior management.

On balance I consider that comparison of corporate executive pay with private equity and hedge fund managers’ incomes is a straw man argument that does not justify either. If there is a risk of a brain drain from corporations to hedge funds, it only occurs in the finance industry. In that case, the solution is to regulate hedge funds and their executives’ incomes, not raise corporate executive incomes to the same level. A salary cap that

<table>
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<tr>
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<th>Name</th>
<th>Value (US$)</th>
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<tbody>
<tr>
<td>3</td>
<td>James Simons</td>
<td>$2.8B</td>
<td>Renaissance Tech.</td>
<td>$29B</td>
</tr>
<tr>
<td>4</td>
<td>Phil Falcone</td>
<td>$1.7B</td>
<td>Harbinger Capital</td>
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<td>5</td>
<td>Ken Griffin</td>
<td>$1.5B</td>
<td>Citadel Investment</td>
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included hedge fund managers as well as corporate executives would eliminate the possibility of Kaplan’s brain drain.

The politics of envy argument is that the demands for caps are based on jealousy and do not fairly assess the value of the executive. Describing objections to high executive rewards as jealousy misrepresents the criticisms most often made of executive rewards. It implies that the critics wish to do the same as the executives and would do so if they had the opportunity. It also implies that the criticism is based on emotion and not rational argument. While the motivation for popular commentators is unknown, amongst professional and academic critics this is clearly false.

Academic critics of high salary objecting on principle, such as J.K. Galbraith, Jared Harris, and Paul Wilhelm\textsuperscript{379} argue that nobody should earn rewards either so high or so much higher than fellow workers. Academic critics objecting on economic grounds, such as Lucien Bebchuck, Paul Krugman, Rakesh Kurana, Nell Minnow and John Shields argue that the rewards are not in the public interest and by implication would regard it as wrong for them to take such rewards themselves. Neither group work as executives and have never expressed any desire to become executives and earn an executive salary. Professional business critics such as Warren Buffett and William Gates have had the means and opportunity to pay themselves such rewards as executives and declined to do so.

The emotional aspect of the response to excessive executive rewards would be more accurately described as resentment rather than jealousy. The level of executive pay has been proven to fail all relevant tests of fairness in earlier chapters. Resentment that is present as a result would seem justified. All of the listed critics have cited rational reasons for their criticism. Hence the implication of an emotional nature to the criticism of executive rewards is false both in terms of the emotions claimed to be at play, and false more generally.

Another argument against executive salary caps is that they will be very difficult to define and enforce. This may be true, as all previous attempts to force full disclosure of actual executive salary have proven at best partly successful. Complex bonus options that may

be vested in future years make it difficult to determine what part of an executives’ reward was earned in the current year. As long as the executives in question remain in control of the reporting mechanisms of their corporations, forcing disclosure will remain difficult. This may in turn require tighter regulation, which will in turn add a compliance cost to the corporation, which is also a cost to shareholders.

The argument about difficulty in enforcement of salary caps is a perverse argument in another sense. Much of the complexity that does exist arises from the efforts of executives themselves to conceal the level of their rewards and bonus targets from scrutiny. This is done through the continual invention of new jargon to describe rewards and through complicated reporting structures. It would not encourage ethical behaviour in reward practices to abandon attempts at regulation due to the efforts of the rewarded parties to evade them. Intelligently designed, new regulations may become a disincentive against opaque reporting structures. This raises another argument that may affect the ability to impose salary caps – that there is a right to privacy of information regarding income for executives.

A counter argument to the cost of implementation criticism is that it is not necessarily the case that regulations such as salary caps need be costly and inefficient. It is possible to intelligently design such restrictions to minimise implementation cost. It is often the case in practice that the more simply defined such restrictions are, the more difficult they are to evade and the less complex is their implementation.\(^{380}\)

None of these counter-argument justify the non-implementation of executive salary caps. The question should not be whether a reward cap is difficult, but whether a cap is needed. That need has already been established, as has the likelihood that the compliance cost of the regulation is less than the economic losses now arising from reward practices. The argument about difficulty of regulation is therefore not sufficient to discount implementing such measures.

\(^{380}\) For example, in Australia in 1986 the introduction of the Fringe Benefits Tax (FBT), incorporated a simple definition of income as all forms of financial or material benefit. Whilst unpopular with business interests, this definition was highly effective in capturing such income.
8.4.4 The Right to Privacy over Income

This argument assumes that there is a right to privacy over personal information such as income. Philosophically, Aristotle first distinguished between the public or political, and the private or domestic spheres of interests in *The Politics*. Legal rights to privacy exist over various aspects of life, such as voting intention and medical records. These were implied in the Fourth amendment of the United States Constitution (1791), became a specific constitutional right to privacy after a US Supreme Court case (1965), and now exists in most western countries. However while these instances may be seen as instrumentally necessary to particular practices, there is still no general philosophically agreed definition of privacy, or agreement on a right to it.

Warren and Brandeis raised the concept of “informational privacy” in the 1890s, but did so in the context of persons’ thoughts, sentiments and emotions, not finances. William Prosser gave a more specific definition of four different interests in privacy. These included intrusion into private affairs, public disclosure of embarrassing private facts, damaging publicity, and appropriation of a person’s likeness (appearance). It was not clear if these interests would apply to matters on the public record, and presumably could still be trumped by a public interest. Prosser’s work was based on a review of legal cases and still did not amount to a general theory of privacy. None of the interests he cited would justify non-disclosure of income for a corporate executive or anyone else.

For there to be a “right” to privacy over information on personal income, such a right must be universalisable to all employed persons. At present this is impossible in most western countries. The incomes of employees in public service and on other fixed pay scale positions are able to be known accurately for anyone whose individual pay level is known. Hence a right to privacy over personal income is not universalisable and cannot be regarded as existing as a right at present. Claims by business groups that disclosure of aspects of executive income are a breach of such a right to privacy are false.

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381 The Fourth Amendment to the United States Constitution (part of the Bill of Rights) related to personal security from unreasonable seizure and searches. The 1965 case *Griswald v Connecticut* (381 US 479) established a specific right to privacy.


384 For example, see Business Council of Australia, “Submission to the Productivity Commission Discussion Draft on Executive remuneration in Australia.” Comments on Draft Recommendations 8 and 12, November 2009.
Supporters of a privacy right over personal income would also have to show how it would be in the public interest for such a right to exist for it to be adopted in future. This is difficult to show for economic information such as personal income in a free-market economy because it will reduce the amount of information available to the market and hence reduce the efficiency of market outcomes. Posner cited this reason in arguing that the kinds of interests protected by privacy are not distinctive\textsuperscript{385}. That is, they are for private economic gain, not public gain, and not justified.

There seems no possibility to argue for a right to privacy of information on corporate executive income in opposing salary caps. If the corporate executive labour market works competitively then the information on income is required for efficient working of that market. If the corporate executive labour market does not work competitively then interventions in the market such as salary caps are warranted.

There is no evidence that the opaqueness of current reporting structures is in the interests of shareholders, as the notorious Enron case demonstrated. In the post 2007-08 financial collapses era, disclosure and independent auditing of executive rewards would appear to be desirable and in the shareholders’ interest. Given the public cost of bailing out failed firms in this period, the same argument would apply to the public interest.

Another solution to this problem is that governments could use the income taxation mechanism to both define executive income (taxable income) and check that the income did not exceed the relevant limit. Public access to taxable incomes is a feature in several nations, including Japan for corporations, and Norway, Sweden and Finland for all individuals.

### 8.4.5 Other Payment Restrictions

Other proposed restrictions on executive rewards, such as bans on golden parachutes and other types of unearned bonus payments, do not face the same counter-arguments as salary caps. The original justifications for these payments were purely empirical and failed to consider their negative consequences. There seems no ethical difficulty in imposing a

ban on a particular form of payment such as these. Such a ban does not limit an executive’s potential income, and protects the community from possible harm. Given that these bonus payments are by definition unearned the executive does not have a moral claim to them via a Lockean argument. Ethically, banning these forms of payments is not only justified, but desirable to protect the public interest.

The comparative acceptance of regulations banning or limiting such payments also undermines in-principle arguments against salary caps generally. If defenders of high executive pay believed that salary caps were in-principle wrong then they would presumably oppose caps on termination payments and golden parachutes as well, since these are a component of executive pay packages. The lack of objections to such restrictions illustrates that opponents of salary caps do not have a principled argument against caps, and only seek to defend the status quo.

Australia and the United States may soon find themselves overtaken in this area of regulation by international developments. In several European countries shareholders of corporations have had the right to vote to reject executive pay agreements for some years. That is, unlike Australian legislation, the votes are binding on the boards. In Germany in 2009 the Bundestag (Lower House) passed a law limiting executive salary in several ways:

- share options may only be cashed out after four years
- executives may be liable for damages up to 1.5 times their salary

This trend does not in itself justify executive salary caps. Nevertheless, it demonstrates that such limits are part of a movement for change. In this context, similar restrictions being emplaced in Australia and the United States would seem reasonable.

8.4.6 Appropriate Levels for Executive Salary Caps

The level of salary caps requires careful consideration. The cap limits actually proposed to date have all been very high – ten times average earnings in the firm in Australia (ACTU), $500,000 per annum in the United States (TARP limit on executives; 13 times average US earnings), and 500,000 Euro in Germany for finance executives (14 times average

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earnings). These caps all represent multiples of average incomes (10 to 14 times) that are higher than those established in Chapter One for any other field. From that analysis, a salary limit of four to six times average incomes would be more consistent with community norms, and should be sufficient to accommodate appropriate levels of average executive reward, assuming acceptable performance.

Any executive reward limits should allow for reasonable bonuses for executives performing exceptionally well and thus have some margin for above average rewards. The potential for excessive bonuses to cause moral hazard must be curbed. The difficulty with bonuses has been their excessive size and receipt even when performance was poor, not the concept of incentive payments itself. If an allowance of up to an additional 20% were made for rewards to executives performing above average, then a maximum executive salary cap of six to eight times average incomes should be sufficient. This is based on an average executive reward of four to six times average incomes, with performance bonuses of up to an additional 20% of the base salary. This should be sufficient to allow for reasonable incentives. This would correspond to executive salary caps of up to $480,000 AUS in Australia in 2009, and up to $320,000 US in the United States in 2009. The US figure is based on a different definition of wages (including part time workers). In reality the United States cap figures would be similar to the Australian cap figure. There is no evidence that capping salary to a higher level than this is justified.

There is preliminary evidence that salary caps of a similar level may be effective. Following the United States Troubled Assetts Relief Program (TARP) “bailout” of financial and automotive corporations in 2008, those firms’ executive salaries required administrator approval. Most salary packages were limited to under $500,000 US in cash with higher amounts in stock to be held for three years or more. For some executives this represented a reduction in income of over 60%. Despite claims that executives would leave if caps were imposed, in these firms 88 out of 104 executives (85%) still remained in their positions two years later. It remains to be seen whether this will remain the case as the United States economy improves.

In more normal circumstances such caps may be difficult to implement. In labour market economics wages are notorious for being difficult to adjust downwards, even when there is a compelling case to do so. The fact that many executives have base salaries in excess of these levels means that they would require large downward adjustments in existing contracts to comply. This would make such salary caps politically difficult to implement due to the management power able to be exerted by incumbents over government. For example when the Swiss government proposed executive salary caps in the wake of expensive bailouts of Swiss banks in 2009, Peter Brabeck the chairman of Nestle threatened to relocate the corporation’s headquarters away from Switzerland. There was no suggestion in the threat that this would be in the interests of Nestle shareholders.

This does not mean that the proposed salary limits are not required or are too low. It illustrates the magnitude of the problem due to management power and excessive executive salary. However a weaker salary limit is not a desirable compromise. If the salary limits were set at a level that required no downward adjustment of current executive rewards they would simply be an acknowledgement of the current status quo and would not represent any honest assessment of what level executive salaries should be. Given that current salary levels are excessive by all means of analysis considered in this thesis, caps set to accommodate those salaries might have the undesirable effect of legitimising and thus perpetuating them. Salary limits should be based on what level would encompass a fair reward for executives performing as expected, not on political expediency.

8.5 Political Difficulties in Limiting Management Power

At this point we have established that the current corporate executive labour market is exploitative, that executive rewards are excessive and that as a result the public interest is harmed, while existing regulation of executive labour markets is ineffectual. High executive salaries are also highly unpopular in societies where they are observed, and benefit only a tiny number of individuals. Politically it should be a simple and popular task

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for governments to regulate to reform executive labour markets and reduce executive salary.

Yet effective reforms have not occurred after three decades in Australia or the United States. This raises the question of why politicians would not act on an issue that is both necessary and likely to be politically popular. One obvious reason for not introducing limits to executive salary is a lack of political will (from politicians) to act to implement them. I will now sketch a theory as to why this occurs.

From economics, public choice theory\textsuperscript{394} explains how corporations use their financial power to lobby politicians to distort business regulations in favour of corporate (shareholder) interests at the expense of the public interest. This enables market failures to remain in the long term\textsuperscript{395}. From Agency theory we know that corporate executives use management power to further their private interests rather than shareholder interests.

We have established in Chapter Four that corporate interests as such do not exist. Therefore not only should we expect that corporations will use their influence with government to distort regulations to benefit shareholders, but that they will do it to benefit executives’ private interests as well. I will define this concept of corporate executives using the lobbying power of the corporation to induce governments to legislate for their private interests as “executive influence theory”. This may be summarised as follows:

\begin{align*}
\text{Public Choice:} & \quad \text{Corporations lobby governments for corporate ends} \\
\text{+ Agency Theory:} & \quad \text{Executives use corporate powers for private ends} \\
\hline \\
\text{= Executive Influence: Executives lobby governments for private ends} \\
\end{align*}

Seen in the light of executive influence theory, the ongoing failure of Australian and United States governments to effectively regulate corporate executive salaries is easy to explain, though still difficult to defend. This trend has worsened in recent decades, with the increasing tendency of executives to donate corporate (i.e. shareholder) funds towards political campaigns. Corporate donations are now the dominant source of political funding


This represents a serious political problem that will be difficult to repair. The importance of corporate funding to politician’s prospects of election continues to grow as electronic media become more influential in society. The proportion of western economies made up by large corporations also continues to grow over time. It would seem that the ability of executives to use shareholder funds to buy influence from legislators, to ensure that legislation allows them to continue to extract an excessive amount of shareholder funds in their rewards, will only increase over time.

One area where governments may have leverage to move towards reform is in the regulation of how retirement savings are invested. Prudent risk management alone would recommend that these savings not be invested in companies that paid executives excessively or using risk encouraging bonus plans. In Australia, governments could require that “approved” superannuation funds (eligible to receive tax deductible contributions) could only invest in private companies that followed a code of practice including salary caps, bonus caps and no “golden parachute” payments. In the United States similar restrictions could be placed on any corporation receiving funds (shares or equity) from pension plans and retirement savings plans. This would not impose such changes on all corporations, but would add a strong market incentive for them to reform. If not they would be cut off from a large pool of investment capital.

As a minimum in both jurisdictions, governments should include all private equity, pension, and superannuation and funds in similar corporate governance regimes to public corporations. This is to ensure that share investors may have some say on the rewards of fund managers and the use of invested funds. Without such controls, it cannot be guaranteed that fund managers will exercise their position as institutional shareholders to benefit fund investors and not themselves. At present the same agency problems exist in these institutions as between shareholders and corporate executives, but with even less transparency, and no ability to control the outcome. This is not economically efficient, in addition to the impact on executive rewards.
In the long term, this issue highlights a threat to the integrity of political systems in capitalist democracies. Capitalist democracies based on representative governments enshrine the concept of equal rights between citizens. Considerable power and a unique combination of legal rights, without some legal obligations that fall to citizens, have been accrued by corporations. These entities are controlled by an individual CEO or a small number of executives who can use corporate powers to pursue their private interests. The existence of large corporations controlled by a few executives undermines the concept of political equality between individuals. The individuals who control corporations wield considerably greater power and influence over government than other individuals in the society.

There are numerous examples of this use of corporate power to pursue private agendas already occurring. In Australia the politically active and often partisan behaviour of media barons Rupert Murdoch and formerly Kerry Packer has been notorious for its interference in government and the political process. In the United States the historical actions of individuals such as Randolph Hearst, Henry Ford and John Rockefeller, and more recently Rupert Murdoch (now a US citizen) show the same pattern of behaviour. Perhaps the most famous instance is the career of Italian Prime Minister Silvio Berlusconi, who has on many occasions used his media company RAI, not only to pursue political agendas, but to promote his own political career.

The most prominent examples of the political use of corporations are by individuals who were CEOs or executives of media companies, but they are by no means the only individuals who are politically active through their corporate powers. Many corporations lobby government to pass laws that suit their business activities. The actions in office of former US Vice President and Halliburton CEO Richard Cheney illustrate a further related problem: conflicts of interest for politicians awarding government contracts to firms of which they were formerly executives.

This issue of corporate influence over political as well as economic policy is not new. It was raised by J.K. Galbraith over forty years ago in, for example, identifying the role of US

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oil corporations in US foreign policy to the Middle East\textsuperscript{399}. At the time such examples were tolerated by Galbraith as examples of corporations acting for their shareholders’ best interest through indirect means. However some corporations now support political causes in a manner that does not generate any obvious benefit to the corporation or shareholder, and more likely reflects the preferences of the individual executive.

\textbf{8.6 Conclusions}

There is a compelling case for governments to regulate corporations in a manner that effectively reduces corporate executive salaries over time. Such action is necessary, morally justified and in the public interest. There is nothing in the current trend of corporate governance to indicate that the problem will solve itself without external regulation.

In the short term there should be a direct cap on the level of total executive rewards, linked to average incomes. There should be prohibitions on perverse and unearned rewards such as golden parachutes and performance bonuses not tied to defined comparative performance measures. The proportion of salary that may be paid as a bonus should also be limited, to reduce the risk of perverse incentives. Despite the claims of critics, it is difficult to see disadvantages for the society or shareholders in implementing executive salary caps in the short term. The current level of executive salary is so much higher than that of other occupations that it could undergo massive reduction (by a factor of ten in Australia or fifty in the United States) and still represent a substantially above average income that would prove attractive to new business career aspirants.

These measures are not described as “short term” because they are only assumed to be necessary in the short term. Rather it is because in the long term executive salary caps are likely to be necessary but insufficient. In the long term additional measures are likely to be needed, as it is assumed that incumbent executives will use their positional power and political influence to circumvent such restrictions as public memory of past abuses fades.

In the long term reform of the nature of corporate governance is required. Such reforms need to be revolutionary not evolutionary. Current systems consider market efficiency and

fair competition but not the public interest or in some cases shareholder interests. Corporate structures were never developed to achieve compliance with any overarching political or ethical theory but were developed to further commercial interests at the time. Corporate structures were developed by corporate executives for the efficient control of the corporation by the executives. In that sense they remain highly efficient mechanisms, but this power is being used to benefit the interests of individual executives sometimes at the expense of shareholders.

Now that corporations have grown to be the dominant economic force in most western democracies there is an urgent need to revisit their powers and the degree of accountability for decision makers within them. In this light, excessive executive rewards may be seen as a symptom of a broad and growing problem. This creates an imbalance of power and influence in the hands of corporate executives compared to other citizens. Unchecked, this threatens to harm democracy itself.

The solution is to reform the processes by which corporate decisions are made, and to reform the process by which corporate decision makers (directors and executives) are selected. The objectives are to make the selection processes: more representative, so that all shareholders interests are proportionally considered; more inclusive, so that groups such as employees and the community are represented (especially in publicly listed companies); and more transparent, so that executive positions are filled in the same manner as other employee positions, and with similar conditions.

A large number of legal changes will be required to achieve these objectives. Critical areas for regulatory reform include the nomination, election and terms of corporate directors, rules for handling of proxy votes of shareholders, and legally binding codes of ethical conduct for both directors and executives. Parallel changes to bring the regulation of retirement and investment share funds into the same governance regime as corporations are equally important.

These changes may be politically difficult to implement, but are essential if the causes of excessive executive rewards are to be eliminated. As a starting point, it is recommended that governments introduce such rules on investment funds wishing to be eligible to receive government mandated retirement savings. This will create an incentive for the market to move towards reform.
In the next and final chapter I will briefly summarise the findings of the thesis for executive rewards. I will also develop some conclusions on the implications of the executive rewards problem for relevant branches of philosophy and economics. In my view, this problem highlights the need for greater collaboration and change in the far too separate disciplines of philosophy, economics and finance.
9 Conclusions

I will now summarise my findings, starting first with the most basic question of whether the current levels of executive salaries are justifiable. I will then proceed on to conclusions firstly about the philosophical theories of distributive justice that might be used to examine executive rewards, and secondly about the economic theories used to justify them. This leads to conclusions about the causes of current trends, and policy recommendations for changes in the structure of the executive labour market and its regulation. These policy recommendations are based on the Australian and United States executive labour markets, however they would also be applicable to other democracies with large private corporations operating in similarly regulated markets.

Beyond the findings relating to the executive labour market, this thesis also suggests broader conclusions about the macro-economic theories that have dominated the political-economy discourse over the past thirty years. The trends of the executive labour market over this time have implications for both the practice of corporate governance, and indirectly to political governance structures.

Conclusions about what the nature of corporate and political governance structures should be depend on many factors, of which executive reward is only one. Nevertheless I will show that the conclusion of this thesis is that in so far as executive rewards are problematic, they are already having an adverse effect on both the economic performance and political institutions of capitalist countries. There is a need to rethink aspects of both corporate governance structures and political governance. Finally, I will explain the need for greater integration of the relevant disciplines.

9.1 Executive Salary Levels

The public reaction against the current level of corporate executive salaries described in chapter one is understandable. However it does not in itself mean that those reward levels are unreasonable. The real question should be, whether the current salary levels can be justified, and what would constitute reasonable criteria for deciding levels of executive reward, and what those levels should be.
As we have seen in the subsequent chapter examining empirical evidence, the public criticism of reward levels is in fact correct. There does not appear to be any justification for the current levels of executive rewards in Australia and particularly in the United States. They cannot be defended on the basis of equity or economic efficiency, either from the point of view of the individual corporation or for the nation as a whole. There is a slight correlation between executive rewards and corporate performance in Australia, and no significant relationship between them in the United States.

Significantly for economic efficiency, executive reward levels within a nation appear to have no relationship to share-market returns and a negative relationship to GDP growth, although this result may be influenced by the United States. The United States executive labour market pays significantly more than in other countries, even for similar sized firms, and has had lower GDP growth in the period when executive rewards reached their highest levels.

Even worse, there is some evidence to suggest that in the United States above average executive rewards may be a marker for risk of corporate collapse. There is insufficient data to prove a relationship, although high executive reward and risk of collapse both appear to be linked to poor corporate governance. A rational share-market investor would seek to avoid investing in United States corporations that pay their executives above the average market rate. It has been suggested that this result may be due to large executive bonuses. When combined with “golden parachute” clauses in contracts, they act as perverse incentives for executives to adopt high-risk strategies with corporate assets.

As to what criteria should be appropriate for setting the level of executive rewards, in the absence of any evidence supporting a different approach, social norms for salary differences in groups should apply to executives. There are consistent relationships in both Australia and the United States between the average and the highest paid members of occupational groups, whether due to holding leadership positions and/or exceptional skill. Based on these relationships, executives should be paid a maximum of six to eight times the average reward for group members, or nine to thirteen times the lowest rewarded group member. This would equate to an upper reward limit of $480,000AUS in Australia and a similar level in the United States in 2009 dollars. This would suggest a huge reduction in executive reward levels is required for them to meet social norms. Current CEO reward levels exceed these norms by a factor of twelve in Australia (CEO
rewards 110 times average wages rather than 8 times) and by an extraordinary factor of thirty-four in the United States (CEO rewards 275 times average wages rather than 8 times).

The current level of executive rewards is partly an unfortunate (for shareholders) historical accident, with the introduction of executive contracts linked to share prices coinciding with the dramatic increase in share prices in Australia and the United States during the 1980s and 1990s. This still does not explain why executive reward levels have risen in comparative terms for almost thirty years. There was some evidence that the rate of increase in executive rewards halted briefly during the global financial crisis of 2008-09. However they still remain far higher than the average income for any other profession, and several times higher than executive rewards prior to the 1980s.

9.2 Distributive Justice

Turning next to the philosophical conclusions arising from this inquiry, the question of executive reward levels exposes a number of weaknesses in the contribution based desert theories within the field of distributive justice. In considering rewards for executives as corporate leaders, we need to understand the general case of rewards for leaders of groups engaged in joint activities. This case has not previously been considered in literature on desert theories. These have tended to focus on the questions of sharing rewards between rich and poor individuals, and the actions of the state or institutions in dealing with individuals. They do not deal with how groups or institutions should internally reward their members.

This is a major omission from desert theories of distributive justice since in practice the majority of cases of deciding rewards will be dealing with individuals within groups. Whether rewarding members of private corporations, government departments, sporting teams, universities or churches, working within a group context is the predominant case for most human activities, rather than individuals in isolation. Any desert theory of distributive justice that cannot be applied within groups has limited practical application.

We have examined the question of rewards under contribution-based desert theories because they most closely resemble actual labour markets, and because they also equate
to the attitudes of the general public. In considering contribution based rewards for leaders of groups we are immediately confronted with a problem in determining how to allocate a share of the group’s social product to the desert base of the group leader. There is no obvious way to define the marginal product of any group member, including the leader, for a group action. Presumably the desert base of the leader is based upon the change in social product from the group in implementing their leadership action upon the group. We cannot allocate the entire change in social product because that ignores any potential change in contribution from other group members. Hence we have no absolute way of determining the group leader’s contribution to the social product.

We might compare the group’s performance to that of another group to adjudge the leader’s impact. However we then have two other problems. First, we are assuming that the difference in the two groups’ performance is due to the actions of the leaders. Second, we only have a comparative measure of performance, not absolute. For example we can say that leader of productive group A should be 50% better rewarded than leader of unproductive group B. But we still cannot say what that appropriate reward level for the leaders of A or B is in absolute terms. We therefore also cannot say whether the reward level is economically efficient.

Of contribution based desert theories, David Miller’s market rate theory⁴⁰⁰ seems preferable to determining marginal contributions for members of groups. Miller’s theory also contains useful definitions of exploitative markets. We may use these to judge the fairness of individual labour markets, including the executive labour market. Ultimately though Miller’s theory too does not allow us to define what an acceptable level of reward for executives (or any other position) should be. Rather, it defines market conditions in which we may be moderately confident that the reward offered is justified. The current labour markets for corporate executives in Australia and the United States do not satisfy Miller’s conditions.

This suggests that the use of compensation based desert theories would be preferable to contribution based desert theories in assessing rewards for members of groups, including leaders. Compensation-based desert is defined upon conditions of employment and opportunity cost that may be assessed for any position. There is no philosophical difficulty

in applying compensation theories to the case of corporate executives. Executive rewards would then depend on factors such as length and stress of working hours, difficulty of working conditions, years of study or experience required to qualify, and risk of dismissal.

Compensation based rewards would represent a profound departure from current practice for executive rewards, and require a fundamental re-evaluation of the extent of executive rewards in most western countries. No doubt corporate executive would still be found to be a challenging position deserving above average reward. However it seems unlikely that the actual reward level justified would be any greater than that for other professions requiring skill and responsibility.

9.3 Economic Theories for Executive Rewards

The question of whether current reward levels for corporate executives are justifiable has been answered emphatically in the negative for Australia and especially the United States. This leads us to the question of what are the economic causes of such high executive reward levels, and the economic theories used to justify them. In this we encounter a substantial conflict between protagonists of the rival market-based (alignment) theories and non market-based or market failure (management power) theories. Both have been used to explain trends in executive rewards. Both build on the understanding of agency theory, where the question of how to motivate and control executives to act in the interests of shareholders is an example of a principal – agent problem. Shareholders represent the principals and executives the agents.

The primary market-based theory of executive rewards, Jensen and Murphy’s alignment theory\footnote{Michael C. Jensen, and Kevin J. Murphy, “Performance Pay and Top-Management Executives.” Journal of Political Economy, April 1990.}, held that contracts with performance-based incentives could align the actions of executives with the interests of shareholders. As the performance of the corporation improved the share price would rise in value, and so the executive’s share-based incentive would rise in value. This would motivate the executive to improve the performance of the corporation. Alignment theory also relied on Fama’s Efficient Markets Hypothesis (EMH)\footnote{Eugene F. Fama, “The Behaviour of Stock Market Prices.” Journal of Business 38: (1965) pages 34–105.}, where it is assumed that markets are informationally efficient and thus are self-
regulating. If valid, alignment theory would allow the setting of economically efficient executive rewards, without the cost of external regulation. Alignment theory assumes that both share markets and the executive labour market are efficient, and that executive performance influences share price.

If, as Jensen and Murphy argued, the executive labour market is an ideal laboratory to test the ability of incentive type contracts to align the interests of principals and agents, then the evidence suggests that incentive payments do not align those interests, or their actions. The initial evidence cited by Jensen and Murphy in the 1980s was statistically weak. Over the next two decades the correlation between US executive rewards and corporate performance became weaker, until it is debateable whether any relationship can be identified at all. Jensen and Murphy’s dogmatic insistence on alignment theory in the face of this mounting contrary evidence cannot be defended.

A number of theoretical weaknesses in alignment theory were identified that explain this lack of confirming evidence. Firstly, unless the efforts of the executive can be proven to be the cause of corporate performance, it is circular reasoning, assuming cause and effect. Second, at best it can only determine whether the distribution of executive rewards matches performance in relative terms. It cannot determine whether the level of executive rewards is appropriate, which is precisely the issue in question, and which Jensen and Murphy have attempted to defend. For this reason, it is not possible to guarantee that alignment theory will lead to an economically efficient allocation of executive rewards. Finally, alignment theory uses simplistic assumptions about the motivation of executives, and fails to consider the adverse impact of income and substitution effects on the supply of executive labour. Compared to modern behavioural economic theories, or standard labour market economics, alignment theory does not adequately explain the executive labour market.

The alternative non-market theory of executive rewards is management power, which has been expounded by Bebchuck and Fried\textsuperscript{403} and others. In this executives exploit the informational and bargaining asymmetries of their positions to increase their rewards. Various contract forms such as incentive contracts and share bonuses are simply means

of camouflaging this behaviour. In my view Bebchuk and Fried’s theory is theoretically sound and better fits the evidence than alignment theory.

The only aspect lacking from Bebchuk and Fried’s hypothesis is an explanation of how management power increased after the tightening of regulations on executive rewards that occurred from the 1990s onwards. That should have reduced executive power. My hypothesis is that increased management power can be explained by changes in the nature of share ownership. During the period of rapidly growing executive rewards, share ownership in Australia and the United States was becoming less direct. The majority of shares are now owned by institutional funds. The ultimate owners of corporations, the investors, are now three steps removed from corporate executives. This adds a layer of agency costs and raises the possibility of collusive games developing between fund managers, directors and executives. Management power has increased greatly in this environment of more complex, more remote, and more diffuse share ownership.

Proponents of market based explanations of executive rewards could argue that alignment theories have the advantage of being quantifiable, whereas management power is not quantifiable and could be subjective. However this is not sufficient reason to prefer alignment theory to management power explanations. A non-quantifiable theory that is logically sound and can explain the observed trend is still preferable to a quantifiable theory that is not logically sound and is not empirically valid.

9.4 Corporate Reform

The fact that actual rewards to corporate executives are higher than can be justified, and that this pattern has continued for three decades, suggests that there is a structural problem in the executive labour market. Normal market fluctuations do not explain the persistent nature of the problem. At no stage has the executive labour market appeared likely to correct itself. Market regulation is therefore warranted, in the public interest, and since it is likely to be much less expensive than the current cost of market failure, economically justifiable as well. Reform is required both to the executive labour market directly in the short term, and to corporate governance and structures to remove the causes of market failure in the long term.
In the short term direct limits such as salary caps on executive rewards are likely to be necessary. This is due to the large quantum of reduction in reward levels needed to arrive at a defensible level. Salary caps are ethically justifiable given the strong public interest. The salary cap limits proposed are at levels well above average incomes (six to eight times), and do not represent a hardship or injustice being imposed on executives.

In the long term reform of the nature of corporate governance is required. Such reforms need to be revolutionary not evolutionary. Current regulations consider market efficiency and fair competition but not the interests of stakeholders or the community. Corporate structures were not developed to achieve compliance with any overarching political or ethical theory but were developed to further commercial interests at the time. They were developed by corporate executives for the efficient control of the corporation by the executives. In that sense they remain highly efficient mechanisms, but their power is being used to benefit the interests of executives rather than shareholders. Regulation of corporate structures also requires change because the nature of share ownership has altered to make previous assumptions about the motivations of internal corporate stakeholders obsolete.

The solution is to reform the processes by which corporate decisions are made, and to reform the process by which corporate decision makers (directors and executives) are selected. The objectives are to make the selection processes more representative so that all shareholders interests are proportionally considered; more inclusive, so that groups such as employees and the community are represented (especially in publicly listed companies); and more transparent, so that executive positions are filled in the same manner as other employee positions, and with similar conditions.

The difficulty is not in identifying the changes that are needed, but in gaining political approval for them. Economists already recognise in public choice theory that corporations use their lobbying power to influence government to benefit corporate ends. Agency theory tells us that corporate executives will use corporate powers to benefit their private ends. Putting the two together, a theory of executive influence tells us that corporate executives are likely to use their corporation’s lobbying power to benefit their private ends. This presumably would include lobbying to block efforts to reduce corporate executive power and cap executive rewards.
9.5 *Broader Implications for Capitalist Democracies*

The excesses in executive salary seen in recent years have reached the point where the credibility of free-market capitalism itself is now under question. This was demonstrated in a 2009 article by journalist Matt Taibbi published in Rolling Stone Magazine entitled “The Great American Bubble Machine.”\(^{404}\) The article was about the role of investment bank Goldman Sachs in the Global Financial Crisis of 2007/08, and previous financial crises. Taibbi described Goldman Sachs as follows:

“The world’s most powerful investment bank is a great vampire-squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells of money.”

Taibbi’s article is polemic and does not explain the technical causes of the crisis. Yet it clearly struck a popular chord, and was widely quoted\(^{405}\). The article was not a criticism of Goldman Sachs’ shareholders, but rather the behaviour of its executives, and in particular former executives with roles in government who had acted where they held clear conflicts of interest. It ends with a pessimistic view of the nature of current capital markets and the damage they have done not only to America and the world’s economy but to democracy as well.

We cannot entirely blame recent events only on corporate executives and the weaknesses of the governance systems and ownership structures they exploit. There is also a social dimension to the responsibility. While the majority of shares are now owned by institutional funds, some 30% of shares in Australia and the United States are still owned by private individuals. I do not suggest that small investors are able to significantly influence share markets or corporate behaviour. Yet clearly in the past decade, most individual investors were happy to accept the status quo while markets were rising. Most invested in corporations focused on short-term profits regardless of risk, and accepted the dividends that resulted. At the time the markets were rising few criticised the executives undertaking these strategies. Ironically, this would prove to be against those private investors own long term interests. Thus while the primary causes of excessive executive rewards are structural, they were reinforced by this self-serving yet self-defeating attitude to markets held by many individuals.

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\(^{405}\) At the end of 2010 a Google search for this title produced over one million matches.
Taibbi's deeply negative view of the nature of the individuals who comprise corporate executives is not isolated. Less colourful but equally damning criticisms were made of many other financial executives prominent during the decade since 2000. Examples included Fred “the Shred” Goodwin of the Royal Bank of Scotland, Charles Prince and Vikram Pandit of Citigroup, and Icelanders Bjorgolfur Gudmunsson of Landsbanki and Hreidar Mar Sigurdsson of Kaupthing, who effectively bankrupted their entire country as well as their own banks406. The widespread perception that executives have enriched themselves through irresponsible behaviour has greatly damaged the standing of business leaders generally. I agree with Taibbi’s general view of them, and consider that the current system of rewarding executives has had the effect of attracting many individuals who are inappropriate to be leaders.

Loss of trust in business leaders is more than simply a question of reputation. Capitalism relies on the voluntarily exchange of goods and services, with agents having confidence that they will either be paid for a service or that the goods will be received. Some degree of trust is thus foundational to capitalism. If business leaders cannot be trusted, the institution of capitalism is damaged as a result. This loss of trust leads to a reluctance to loan money, which was one of the direct underlying causes of the “freezing” of credit markets during the GFC407. It would seem that corporate executives did not trust each other any more than the general public now trust them.

The importance of trust in the functioning of economic systems has been understood since the days of Adam Smith, who described the nature of “civil society” in his Theory of Moral Sentiments408 that was the predecessor work to The Wealth of Nations409. Yet the period during which corporate executive salaries rose so dramatically was characterised by laissez fair capitalism where issues such as trust were sidelined to research in behavioural economics. In the wake of the GFC the importance of trust has begun to be reintroduced into economic theory, with works such as Animal Spirits by Ackerlof and Shiller410. In this

book not only is the necessity of trust for voluntary exchange to flourish acknowledged, but its opposites, bad faith and corruption, are identified as historic causes of market collapse.

The political leadership in western countries has also suffered a parallel loss in reputation. The massive financial losses suffered during the GFC led to large amounts of public funds being used to “bail-out” (rescue) insolvent banks and other entities deemed “too big to fail” in several countries. The consequent debts falling to taxpayers have created considerable public resentment. Although such actions may have been necessary in the public interest, they have been marked by sharp protests, and even riots in countries such as Greece. In many cases the public reaction to bail-outs has been so hostile that it has limited the ability of governments to respond to financial crises, notably in the United States in 2008411 and Germany in 2010412.

The public reaction is understandable in that governments were seen to assist rather than punish business leaders who caused considerable social harm. This is a classic example of moral hazard as defined by Arrow413, where a failure to make individuals accountable for the risks they incur might lead to a recurrence of such crises in future. Since the GFC incumbent governments have been defeated in most elections in OECD nations. Among G7 nations the USA, UK, Canada, Italy and Japan all elected new leaders in the election following the GFC in 2007/08 (France and Germany have not had national elections since 2007). The institution of government is now less trusted in western countries than it was before.

There is also a counter danger to the business community that needs to be considered. The resentment that follows any period of excess and inadequate regulation often leads to a desire to find scapegoats and reactionary over-regulation. There is now considerable popular sentiment in western countries for regulation of executive salaries. There is a danger that demonising the role of executives too greatly will deter capable individuals from entering the field. If corporate executives are also the entrepreneurs and creators of new wealth in our society, then it is not in the interests of society that their contribution is discouraged.

Now that corporations have grown to be the dominant force in the private sphere of most western democracies there is an urgent need to revisit their powers and the degree of accountability for decision makers within them. In this light, excessive executive rewards may be seen as a symptom of this broader and still growing problem. This creates an imbalance of power and influence in the hands of corporate executives compared to other citizens. Unchecked, this threatens to harm democracy itself in the long term.

Most theories of political philosophy for western democracies were developed in the eighteenth century before the advent of large corporations. They considered relationships between individuals and the State, but not between large private institutions and the State, or other individuals. Corporations have been granted unique forms of legal status, with legal rights to own property and defend property rights like a citizen, usually far greater financial resources to pursue them with, but without many of the individual responsibilities that fall to citizens within the same society. This obvious imbalance, combined with the ability of corporations to accumulate assets over more than a single lifetime, leads to the inevitable long term outcome that the size and financial power of corporations will greatly exceed that of even the wealthiest individuals. The power and influence accruing to the individuals gaining controlling positions within corporations will be correspondingly greater than the power and influence accruing to other citizens.

The powers held by corporate executives appear to have far fewer checks and balances on their abuse compared to comparable restraints on executive positions in the legislative, executive and judicial branches of government. Those individuals are usually subject to strict rules on their behaviour, financial interests and conflicts of interest, and use of information. Breaches of such rules are often criminal offences, subject to sanctions well beyond loss of employment or financial penalties. This is not to say that such powers are never abused, but the risk of abuse is a recognised problem and safeguards are added to minimise it.

Corporate executives are rarely subject to such constraints beyond those designed to protect the narrow financial interests of the corporation. This may include contractual conditions, and the need to comply with business regulations that ensure fair and efficient competition. Yet forms of abuse that might result in harm to individuals, or social or political harm, are rarely regulated. The global financial crisis has proven that corporations are now so large that abuse of their power has the capacity to do harm at the national and
even international level. The need to construct a new approach to corporate accountability is pressing.

In this regard economic theories that only consider the effect of executive roles on efficiency and returns to shareholders are wholly inadequate. The broader social and political consequences of these power imbalances has not been considered adequately in economic theory, or at all in the financial accounting literature that usually deals with executive rewards. Akerlof and Shiller\textsuperscript{414} have made an encouraging start on developing a broader theory of motivations for corporate agents. The need for such a theory is now pressing, as a thirty-year trend of failing to halt the growth in executive rewards has demonstrated.

This leads to a final and more general conclusion about the nature of academic inquiries into executive rewards. The topic is complex, requiring an understanding of disciplines such as economics, financial accounting, corporate governance, and political theory. Most of these fields have developed separately and have shown comparatively little inclination to pay serious heed to philosophical literature on ethics. Yet the need for input from applied philosophical ethics fields such as distributive justice is great. Without it, we have seen economists and financial accountants make technical analyses, then extrapolate them to reach normative conclusions, without an adequate normative framework on which to base them. Meanwhile the question of overwhelming interest to the community – the level of executive salary – has sometimes been ignored.

In closing, economists such as Friedman have argued that consideration of ethics is outside the scope of analysis of business behaviour, including the question of executive rewards. However as I have demonstrated, the opposite is true. Corporations have enormous ability to influence societies both socially and politically, as well as economically. With this power comes a moral responsibility to consider the consequences of their actions. In this context the ethics of executive salaries is important, and merits further philosophical investigation. The impact of economics on society has become far too important to leave to the economists.

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