

# TAX-DEDUCTIBILITY AND EMPLOYEE ENTITLEMENTS AS MECHANISMS TO INFLUENCE EXECUTIVE REMUNERATION

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My submission deals with mechanisms that better align the interests of boards and executives with those of shareholders and the community, specifically with taxpayers and employees. The mechanisms of choice are tax-deductibility of executive remuneration and a paid-up trust holding all employee entitlements as they accrue as a prerequisite for bonuses and golden handshakes or handcuffs.

**CONTEXTS:** As the Commission considers executive remuneration, I ask that you keep in mind the big picture contexts in which the enquiry is being conducted and in which its recommendations will operate.

The enquiry is being conducted while the world economy is in meltdown due to the failures of business, finance, investors, workers, consumers and governments around the world. Greed, recklessness, ignorance, hubris and irrationality on all parts are all to blame.

Most of these wreckers of the world are now paying the price and will doubtless do so for many years to come. So it is inconceivable that they will repeat their mistakes with the same enthusiasm and stupidity when the world begins to recover. Hence, there is no point in slamming shut the regulatory door now that the horse has bolted. Instead, we need to focus on prescribing how to operate differently so this never happens again, by setting in place a framework of acceptable but not mandated behaviour. I advocate a more instructive approach to regulation rather than a draconian over-reaction, which is likely to be counterproductive for recovery in these fragile times.

Still, we need to ensure that any regulation that is put in place acknowledges that people and systems have short memories. While we can't imagine much speculative trade in CDOs and CDSs in the immediate future, they will doubtless rise again one day. Likewise, while executives are still smarting from the disgust and loathing directed at them over bonuses paid to them despite their culpability in the destruction of their companies, soon their hands will be out for ever bigger rewards for ever riskier decisions. Therefore, whatever regulatory framework is put in place today must be robust enough to discourage a repeat of the mistakes of the past.

**CAPITALIST PRINCIPLES:** To identify a reasonable, instructive regulatory framework that does not push governments to interfere with the operation of private enterprises in areas they know nothing about, I think a return to first principles is required.

***Business and Capitalism:*** It is a mistake to conflate the two concepts. Capitalism is an economic system with its own principles and perhaps its own natural laws, which can sometimes be quite brutal. Business is a sector within the capitalist system, and its success depends on how well it understands and respects the principles and laws of capitalism.

It has been argued that the current global economic crisis represents a failure of capitalism, but this is not the case. Rather, it is a failure of business to operate within the fundamental principles of capitalism and a failure of government to monitor compliance with those principles. The resulting chaos is the effect of capitalism's natural laws taking their toll. The global economic crisis is a triumph of capitalism over the Wall Street heretics who forgot or never learned the rules of capitalism and over the government groupies mesmerised out of all good sense by those heretics.

Fundamental to capitalism is the power of capital. The power of capital allows control of the means of production and labour to facilitate generation of more capital. Our present disaster occurred because

- too many people in business valued credit over capital and so accumulated huge debts instead of capital reserves and real assets;
- too many financial institutions invested not in material means of production but in the ingenuity of financial manipulators and in the intangible value of their instruments;
- too many executives, financial institutions, commentators, regulators and investors mistook huge business liabilities for growth assets; and
- too many boards and shareholders forgot that executives are labour, not owners of capital, so their remuneration should be treated as costs, not as entitlements, and should be linked only to their productive contribution to the accumulation of capital.

**THE CURRENT APPROACH:** I don't think anyone would argue that most Australian businesses have generally out-performed the world in meeting their obligations to shareholders, with a few glaring exceptions. They have done less well in meeting their obligations to labour.

Australian Governments have likewise out-performed the world in meeting their obligations as regulators of business and the economy, but there is room for substantial improvement, based on the lessons we have learned from the global economic crisis, and on anticipating Australian business sheepishly following the American example, after a time lag.

I urge the Commission in its enquiry to guide Governments to continue with their current approach to regulation but to beef it up in areas shown to be in need of more regulation -- in this case, executive remuneration.

What is admirable about the current approach, and what I think needs to be retained in any new regulatory recommendations, is the regulation of principles and frameworks for business rather than prescription of operating decisions. The government makes clear its expectations and limitations but does not prescribe how to operate within them. I think this approach needs to be preserved in any new guidelines or regulations.

**THE NEW APPROACH:** The main vehicle for enforcement of regulatory principles and frameworks should be the tax system rather than legal prosecution or civil action because governments in a capitalist democracy have no right or obligation to protect businesses or investors from themselves. They do, however, have a significant obligation to protect taxpayers' money.

I am not talking about protecting any bailout money or financial guarantees, which goes without saying. Rather, I am talking about protecting taxpayers from funding 30% of all the profligate and unproductive spending of businesses, which is encouraged and subsidised by the tax deductibility of excessive remuneration packages. Governments have both the right and the obligation to regulate business so that businesses' errors and extravagances are not paid for by taxpayers. In doing so, they help protect the economy more broadly by making remuneration profligacy more expensive for businesses.

**MY RECOMMENDATIONS:** With this in mind, I recommend

- a \$500,000 cap on tax deductibility of executive remuneration, including salary, superannuation over the statutory requirement, bonuses, share issues, termination payments, salary sacrifice and perks like private-use cars, personal or family accommodation, gym memberships, school fees, or non-essential office or home renovations.
- Performance bonuses paid only on achievement of specified, measurable objectives related to productive performance of the business; i.e., increases in turnover, increases in after-tax profit, increases in market share, increases in share value, increases in dividends, debt reduction, and meeting productivity, environment or safety targets.
- Performance bonuses paid only when the company is trading profitably.
- Performance bonuses and golden handshakes or handcuffs paid only when full employee entitlements are secured in an independent trust.
- Executive termination payments based on the same formula as applies to other employees.

**Tax-Deductibility Cap:** This approach has been criticised on the basis that when the US introduced such a cap on salaries, other forms of remuneration increased to make up for it. This is not possible in this case because everything a company gives to an executive for personal use, benefit, reward or enjoyment counts as remuneration. Just because an executive wants a gold-plated executive toilet or a car for his wife or an apartment in another city or a weekly flight home, the taxpayer should not be up for 30% of the cost. Taxpayers get no benefit from a company's largesse to its executives and are perfectly entitled to set a limit on their subsidy of the costs of executive remuneration. Companies can still pay whatever they like, but it comes off their bottom line, not out of taxpayers' pockets. To sweeten this cap for business, fringe benefits tax (and all its administrative nightmares) could be abolished for anyone receiving remuneration more than \$500,000 (to avoid double taxation).

**Bonuses for Performance:** This is basic good business and avoids rewarding risk-taking, short-term thinking and mistakes. It is very difficult to justify bonuses that are not based on quantifiable data, and it is very difficult to call them *performance* bonuses when they are paid for costly failures or when a company is in trouble. Ordinary workers are used to being given measurable objectives against which their performance is assessed, even though they rarely receive bonuses even remotely comparable to executive bonuses. Why shouldn't executives face the same measurable targets and accept their achievement as the basis for their bonuses and even future pay rises?

Bonuses for senior executives are a distortion of the bonuses that used to be paid to partners in privately-owned firms, like partner-owned legal, accounting or medical practices, and commission paid to sales employees. When partners brought in more business that increased the capital holdings of the firm, they rewarded themselves with bonuses that were closer to dividends than commissions. When sales people brought in new business or increased sales, they were rewarded, as employees, with a small piece of the extra capital they were generating for the company to acknowledge their productive contribution. Both partner bonuses and sales commissions are consistent with capitalist principles. Multi-million-dollar bonuses for executive *employees*, especially for incompetence or risky behaviour that diminishes a company's capital value, are closer to a rubles-and-dachas approach to communist remuneration of its unproductive oligarchs.

*Trading Profitably:* Companies with bad balance sheets, high costs, overloaded with debt and under-capitalised should not be rewarding executive performance that put them in that position. Debt-funding executive bonuses is profoundly uncaptalist. Executives are labour! Executives are a cost! Shop floor employees who aren't paying their way are shown the door. Executive employees get a bonus! How fair is that?!

*Meeting Employee Obligations:* Companies have claimed they have contractual obligations to pay multimillion-dollar bonuses and termination payments, even to executives who have driven the company into a ditch. But in the same breath they claim they cannot possibly afford to put aside funding for their contractual and award obligations to ordinary workers, e.g., holiday pay, long service leave and redundancies.

When companies fail to meet their obligations to ordinary workers, taxpayers pick up the tab through the government redundancy fund and Centrelink benefits. Again, totally unacceptable. The government must protect taxpayers from such obligations by requiring that before any company can pay executives bonuses, golden handshakes or handcuffs, it first must establish an employee trust not under its control to hold all employee entitlements as they accrue, including golden handshakes and golden handcuffs. In the absence of such a trust and fully financed worker entitlements, no bonuses or signing or termination payments are allowed.\*

This is taxpayer protection and also simple good business. If a business cannot meet its full financial obligations to its workers, it should not have workers. It is not the employees' responsibility to fund the employer just to have a job. That's indentured servitude. The idea that workers should put at risk their entitlements for no benefit is another form of servitude, with an employer using employees' funds without their consent or benefit.

*Termination Payments:* I recommend that termination payments be prohibited in executive employment contracts. They make executive contracts too much like pre-nups. Executives, as employees, should be paid for their labour and performance only. They should not be paid bribes to stay or go. But executive contracts should have grounds for termination like any other employment contract.

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\* The government may also want to set up a master trust into which small businesses can deposit their entitlements. The government may also refuse to trade with any business that is not fully paid up on its employee entitlements.

Executives made redundant should have only the same entitlements as other employees, which they are. Executives being dismissed for poor performance or misdeeds can challenge their dismissal in the courts like any other employee.

The idea that people should get a big payout when they voluntarily leave a company or complete a contract is particularly irrational in the face of arguments that huge remuneration packages are necessary to *retain* star executives. There is no benefit to the company in termination payments. You have to pay executives a lot to stay and you have to pay them a lot to go?! They are employees! You pay them while they work, not when they stop!

In any case, termination payments for whatever reason (including court awards for breach of contract) fall within the \$500,000 tax deductibility cap. Golden handshakes, golden handcuffs and HR failures should not be on the taxpayers' tab.

**COMPETITION FOR TALENT:** We also need to challenge the notion that limiting companies' ability to remunerate executives will diminish talent and excellence. Not if everyone faces the same limits and obligations. That's a level playing field. If some companies are financially more able than others to attract better executives through better pay or bonuses, tax deductibility notwithstanding, then that is capitalism at work. If you have more capital, you can buy better labour to build better profits. If a modest Australian enterprise cannot afford to pay the same for its talent as a mega-enterprise in America, then that is capitalism at work. There is no reason why Australian taxpayers should foot 30% of the bill if the Australian enterprise wants to compete foolishly.

We also need to keep in mind that unemployed executives and masters of the universe are likely to be pretty thick on the ground once local and overseas institutions and corporations complete the housecleaning, downsizing and falling over inevitable as a result of the economic crisis they have wrought. So executive supply (especially from the US and UK) is likely to exceed demand for a long time, which makes this a good time to reset remuneration expectations downward.