Executive remuneration

Submission by Ian McAuley

Fellow: Center for Policy Development
Adjunct Lecturer in Public Finance, University of Canberra

I am making this short submission to point to areas of work that the Commission may find useful – areas that the Commission, with its expertise in mainstream economic analysis, may possibly overlook.

Within that mainstream I have already alerted Michel O'Donnell, Head of the School of Management, Marketing and International Business, ANU, of the Commission's inquiry. Michael and his colleagues have done a great deal of work on the relationship between executive remuneration and corporate performance. Unsurprisingly, they don't find much evidence for a positive causal relationship, and in cases, they find negative correlations. However, I will leave it to Michael and his colleagues to explain their findings to the Commission.

My concern is more with the social context of executive remuneration. In a postgraduate unit in general management I taught for many years, one of the topics I set for discussion was executive remuneration. The students were mature age, with a good deal of work experience, and all had undergraduate qualifications, including many with degrees or majors in psychology and sociology.

From my recollections, I will summarize three of the views emerging from those discussions:

1. *"Money motivates those who are motivated by money"*

A circular tautology, to be sure, but it does raise the question of whether the lure of high remuneration crowds out those who may be motivated by other considerations. Does high executive remuneration attract only those who can calculate the relationship between a firm's reported performance and their own remuneration?

In practical terms, the problem may not be the presence of perverse incentives for short term reported performance linked to executive remuneration, but, rather, the fact that the individuals are unduly motivated by these incentives. All of us, in our ordinary walks of life, face perverse incentives, but we generally find ourselves responding to other incentives and values, which override those perverse incentives. But, perhaps, if the perverse incentives are strong enough, they attract only those people whose other motivational systems are weak.

2. *"High pay for those at the top discourages effort by others"*

The notion is that such pay is de-motivating because it leads to the impression that the rewards of any individual's effort will accrue to others.

There is contradictory evidence of course, particularly in winner-take-all markets, where people falsely over-estimate their own chances of making it to the top. But even when many people are so motivated, there may be many others who believe the whole system is stacked against them, and engage in sabotage or sullen compliance as a reaction to what they consider to be an unfair distribution of rewards. "Sabotage" is difficult to research, for it rarely takes the form of overt acts of destruction. Rather, it is manifest in "sins of omission" which are likely to go undetected.

And, of course, there is the work of the game theorists who point out that in terms of evolutionary development it makes sense to punish those whose behavior violates our norms of fairness, even if such punishment is personally costly. Colin Camerer's work on behavioral game theory (published in a book of the same name) builds on earlier work by Tom Schelling, Robert Axelrod and others. That punishment may take the form of behavior which is effective in punishing the individual, but which has other undesirable consequences. It may be impossible (and undesirable) to suppress the desire for punishment of bad behavior, but it may be possible to reduce the likelihood of bad behavior.

3. *"They live in another world"*

In many industries, particularly those providing consumer goods and services, sound management is helped if senior managers live in the same world as their customers. (Imagine how Qantas would improve if its executives flew economy-class on their own airline!) For example, it appears that some of the differences in the corporate performance between Coles and Woolworth arose because executives in the latter were more familiar with the practicalities of supermarket shopping.

When people live in a "gated community", remote from their customers and other stakeholders, perhaps they lose touch with the realities of their businesses.

The above are issues where I claim no expertise other than an interest in behavioral and institutional economics, but I do believe they need to be studied in this inquiry. (A possible lead is Bruno Frey, who came to and spoke at the Commission's behavioral economics conference.)