

**Submission to  
Executive Remuneration Inquiry  
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As a retiree dependent on income from investments in shares in public companies and other financial instruments I welcome the opportunity to present to the Productivity Commission inquiry my views on proposals for reform of the regulatory framework for remuneration of executives and directors of public companies.

I have a Master's degree in economics awarded by the University of Chicago in 1970. My working life was largely devoted to economic analyses of a wide spectrum of regulatory issues in product and factor markets. I am a senior fellow in the Centre for Independent Studies, St Leonards, NSW. However, this is a personal submission.

Points about remuneration of Chief Executive Officers (CEOs) in my submission extend broadly to regulation of remuneration of other senior public company executives and to directors of public companies.

Like remuneration of other groups participating in tournament-like reward determination processes (e.g. professional sportspeople, entertainers, popular novelists, hedge fund managers, corporate lawyers) remuneration of executives of public companies has increased rapidly in recent decades to reach extraordinarily high levels.

However, it should be recognized also that public companies have generally performed well over time relative to other productive organisational forms: arguably economies in which public companies are a dominant organisational form (e.g. US, UK, Australia) have performed better over recent decades than those in which large private companies are more prevalent (western Europe). For example, productivity growth over the last decade or so has been substantially higher in the US than in Europe. This has been generally beneficial for shareholders and, importantly, the community generally. Significantly for this Inquiry there is a growing body of evidence in the economics literature that the performance of public companies is linked to both the talents of executives and to the strengths of their monetary incentives.

Two propositions are central to this submission.

- Tangible benefits, if any, for shareholders and the general community from imposing additional regulatory constraints on the formulation of remuneration packages for executives and directors of public companies will almost certainly be *small relative to* aggregate dividend payments, aggregate company profits and per capita GDP. Data on CEO remuneration from the *Australian Financial Review* show that total remuneration received by the CEOs of 75 companies from the top 80 Australian public companies by market capital value was \$421 million in 2007-08. According to panel data available to me, this was equivalent to 0.46 per cent of aggregate net after-tax profit of the companies they led. If the remuneration of these 75 CEOs had been cut to zero, and the proceeds added to

dividend payments, aggregate dividends would have risen from \$40,606 million to \$41,028 million or by just over 1 per cent. (While unrealistic, a pay cut of this magnitude would be equivalent to substantial cuts in remuneration for, say, the 10 most senior company officers.)

- In contrast, there are numerous ways in which constraints on the formulation of remuneration packages could produce unanticipated, perverse outcomes which could reasonably be expected to impose substantial costs on shareholders and the public generally.

Some ways in which constraints on existing processes for discovering, motivating and selection of executives and for structuring and setting remuneration could damage the performance of public companies include:

- impaired matching of executive talents with idiosyncratic requirements of firms;
- erosion of managerial incentives to pursue diligently the time-sequenced, multi-dimensional strategies required for profit-maximisation in large companies;
- impaired company leadership transitions;
- a shift of managerial talent out of public companies into other career-paths (e.g. private equity, owner-operated enterprises, politics); and
- because the prospect of the “prize” of becoming a CEO motivates people to aspire to be managers and, relatedly, creates incentives for sub-managers, the pool of aspiring CEOs may become smaller, with long-term consequences for management quality.

Over time any such outcome could potentially impose substantial costs on shareholders and the general community. Moreover, these costs could be very difficult to detect and therefore politically difficult to rectify in future. Also, costs might vary across firms and industries, perhaps producing windfall gains for some shareholders and losses for others.

In short, while the “upside” for shareholders and the public generally from a change in the regulatory framework for appointing and remunerating public company executives is almost certain to be small, the danger is that the “downside” could be very much larger.

In forming its recommendations I urge the Productivity Commission to consider carefully the weight to be given to possible *intangible benefits* attributable to, say, satisfying “community expectations” and related public sentiments about executive remuneration because:

- history has shown that the “wider community’s perceptions” can be inconsistent with the public interest generally (e.g. trade protection was, and is still, believed by many to be beneficial);

- “the wider community” may not take adequate account of unanticipated, perverse consequences of regulations or consequences (e.g. effects of minimum wage laws on employment of low-skill workers), especially if consequences are difficult to detect, say, because of the time taken for consequences to be fully manifested (e.g. some zoning laws; costs to pet owners of restrictive licensing of veterinarians); and
- my understanding is that the Productivity Commission and its antecedents were established by governments largely to counter ill-founded “community perceptions” by providing governments with objective information required to achieve welfare-improving regulatory reforms.

In my recent experience, when people are given plausible reasons for high levels of executive remuneration (including plausible reasons for apparently large termination payments) and are alerted to potential perverse consequences of ill-conceived constraints on remuneration packages, their views on the issue frequently soften markedly.

Taking a wider, contemporary perspective suggests that current levels of executive remuneration are not necessarily excessive. For example, according to data published in the *Australian Financial Review*, the average remuneration for the 100 highest paid CEOs of Australian public companies in 2007-08 was approximately \$6.3 million. Remuneration for the top two, Rupert Murdoch (\$28.7 million) and Alan Moss (\$24.8 million) was less than the annual gross incomes for the same period of Kylie Minogue (\$40.0 million) and Russell Crowe (\$36.0 million) and comparable to Greg Norman’s earnings from golf (\$20.9million). Presumably the two entertainers incurred substantial management and production expenses. Nevertheless, it seems likely that their take home pay would have been similar to that of our most important business leaders who, over the last couple of decades, have led companies that have delivered many *thousands of millions* of capital gains and dividends to shareholders, even allowing for the recent stock market crash (for which the great majority of our CEOs were not even remotely responsible). Andrew Forrest’s wealth, derived principally from shares in a company he formed only a little over 5 years ago, rose to over \$12.8 billion in June 2008, subsequently dropping to around \$2 billion. If big incomes are a general problem, constraints on CEO remuneration alone seem discriminatory. More generally, because market mechanisms tend to be taken as granted the contribution public companies have made to the efficient use of resources and rising living standards can be easily overlooked.

Notwithstanding the difficulties of estimating expected future costs of perverse consequences, in my opinion, prior to recommending any change in the regulation of executive remuneration, possible sources of potential costs should be systematically identified, analysed and evaluated and unless Commissioners are satisfied that the tangible benefits for shareholders and the community generally expected from any given change are substantial, and clearly exceed expected costs, they should recommend that the *status quo* be maintained.

There may be a case for some change. For example to deter opportunistic extraction of funds from collapsing enterprises, part of an executive's remuneration package might be held for a designated period in escrow to be forfeited at the discretion of a regulatory authority in the event of company insolvency. However, the diversity of the idiosyncratic objectives boards aim to achieve in formulating remuneration packages, and the consequent multiple dimensions of such packages, increases the likelihood of perverse consequences of regulations for at least some companies. For this reason, any new regulation should be of the "comply or explain" form rather than binding.