

The Perverse Incentives of Modern Management Remuneration by Andrew Smithers.

### **Modern Management Remuneration Seriously Damages the Economy.**

Today the way senior management is paid damages the economy. In another paper we have shown that shareholders appear to have received no benefit from the massive rise in the pay of senior executives and the high proportion of their total remuneration that comes from option and bonuses. Independent of this, however, there is a strong economic case for reforming modern management remuneration practices.

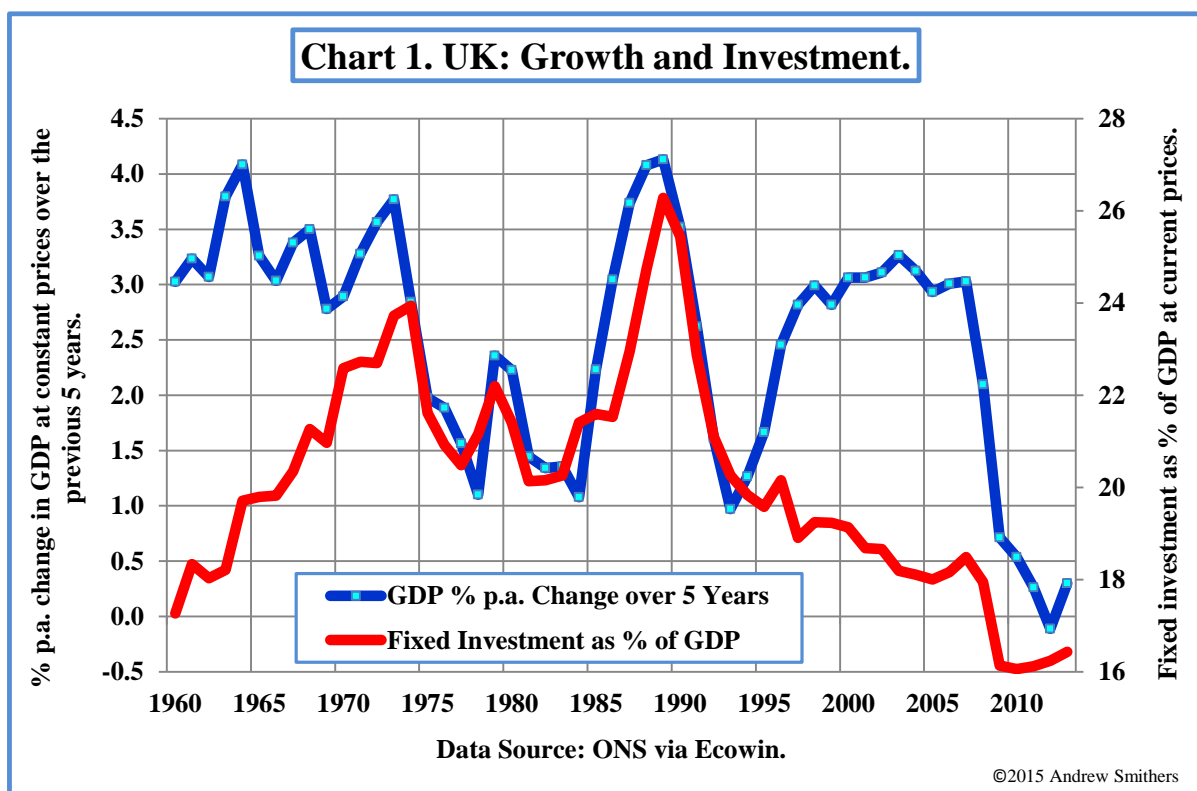
Incentives are designed to influence behaviour and we should not therefore be surprised by the marked change in management behaviour that has accompanied the change in the way management is paid. Whether the major part of senior executives' remuneration comes in the form of bonuses or options, the incentive effect is very similar. The metric of success by which they are judged varies and includes share prices, earnings per share and returns on equity, but all have similar effects. Very large changes in total pay result from relatively small changes in the chosen metric all of which are closely related to short-term changes in profits. CEOs and other senior managers spend on average only a few short years in office and, even if the payment of their bonuses is delayed, their performances are judged over a very short period of time.

Companies last for much longer than the term of office that CEOs expect or usually experience. The risks run by companies have therefore a much longer time horizon than those of their bosses. Possibly the greatest single risk for companies is losing market share. This risk is reduced by competitive pricing and investment. The two are related. The latter reduces the risk that other companies, who invest more, will have lower production costs and will therefore be in a position to price their output more competitively. This is because new equipment embodies more up-to-date technology than older plant and has therefore lower costs of production. The key concern for managements is maximising the metrics which determine their pay and, the greater the bonus element in their remuneration, the greater will be their attention to those metrics and the less they will be concerned about the longer terms risks incurred by the companies they manage.

It is sometimes claimed that this attention to the short-term has benefitted shareholders. Whether or not this is true, it is irrelevant to the question of economic damage. Not everything which is good for shareholders is good for the economy. Weak competition is an outstanding example and the impact of modern management remuneration systems has important similarities to a reduction in

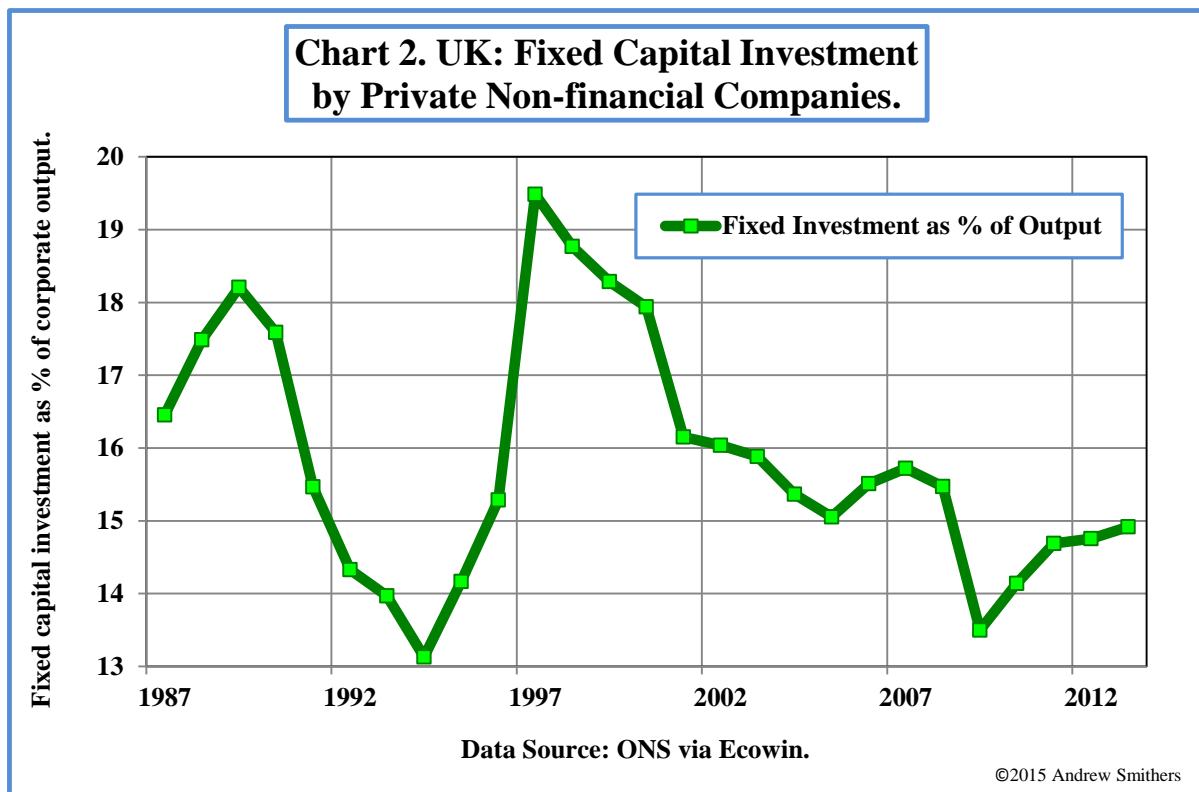
competition. In many industries companies have considerable short-term monopoly power. The change in incentives encourages management to exploit this more aggressively than before. They will therefore take more risks than before by keeping prices up and investment down. Particularly in the case of investment, these risks are long-term rather than short. Furthermore, if the incentive to push up prices and underinvest is widespread, as is the case with modern incentives, the short-term risks are reduced. The risk of losing market share is reduced if nearly everyone in an industry is seeking to boost prices and keep down investment.

A reduction in competition will boost profits and, looked at exclusively from the narrow view of shareholders, there is no call for governments to seek to prevent an increase in monopoly power. Indeed, if what is good for shareholders were automatically good for the economy, then economic policy should be devoted to reducing competition. But rent-gouging monopolies do great damage to the economy, which is why we need to be alert to the risks of a fall in competition and have an active policy to prevent the rise of oligopolies. It is for the same reason that we need policies to counter the similar damage that is being done by the change in management remuneration.



As Chart 1 illustrates, fixed investment has fallen as a percentage of GDP and, in recent years, has been lower than at any time since 1960. The decline has been precipitous since 1990.

Data on the private non-financial companies (“PNFCs”) are available from 1987 to 2013 and, as Chart 2 shows, they have cut back on investment from 18.2% of their output in 1989 and 18.8% in 1998 to under 15% today.

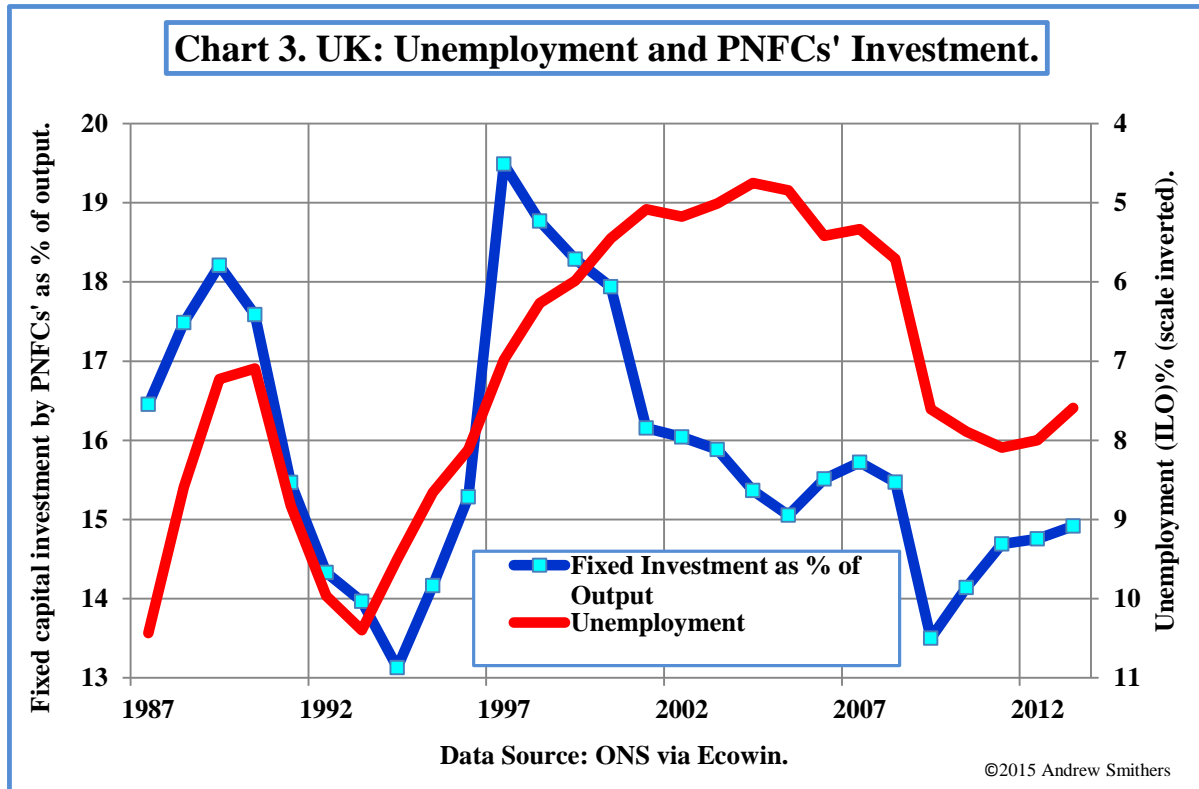


The cutback in PNFCs’ investment has taken place since the big change took place in management remuneration. As we should expect the change in the way CEOs are paid to reduce investment, this is strong evidence that such expectations have been supported by events.

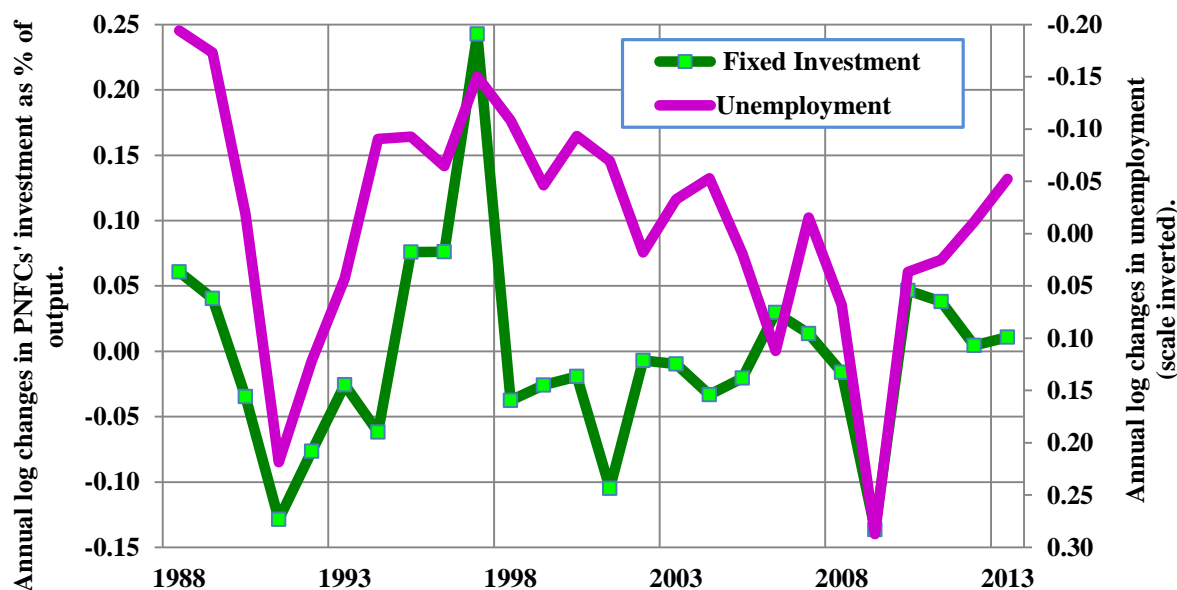
Nonetheless, it is clearly right that we should test this conclusion by looking at other possible causes of low business investment. Investment rises and falls with demand and will be held back if finance becomes more expensive. The cyclical position of the economy and the cost of capital should therefore be considered as possible causes for the low level of fixed capital expenditure.

Unemployment moves up and down with the cyclical state of the economy, but investment has been on a falling trend since 1987, while unemployment has also been falling (Chart 3). In cyclical terms, therefore, the economy today is more buoyant than it was in 1987. Despite this, capital spending by business has fallen. It is not therefore reasonable or sensible to blame the fall in PNFCs’ investment on the cyclical weakness of the economy. This view is reinforced by the fact that short-term changes in unemployment and PNFCs’ investment have been negatively correlated,

as Chart 4 illustrates (The coefficient of correlation being -0.57). The data therefore confirm that PNFCs' investment has in the past moved up and down with unemployment but there has in addition been an unrelated trend for investment to fall as a percentage of output.



**Chart 4. UK: Annual Changes in PNFCs' Investment and Unemployment.**



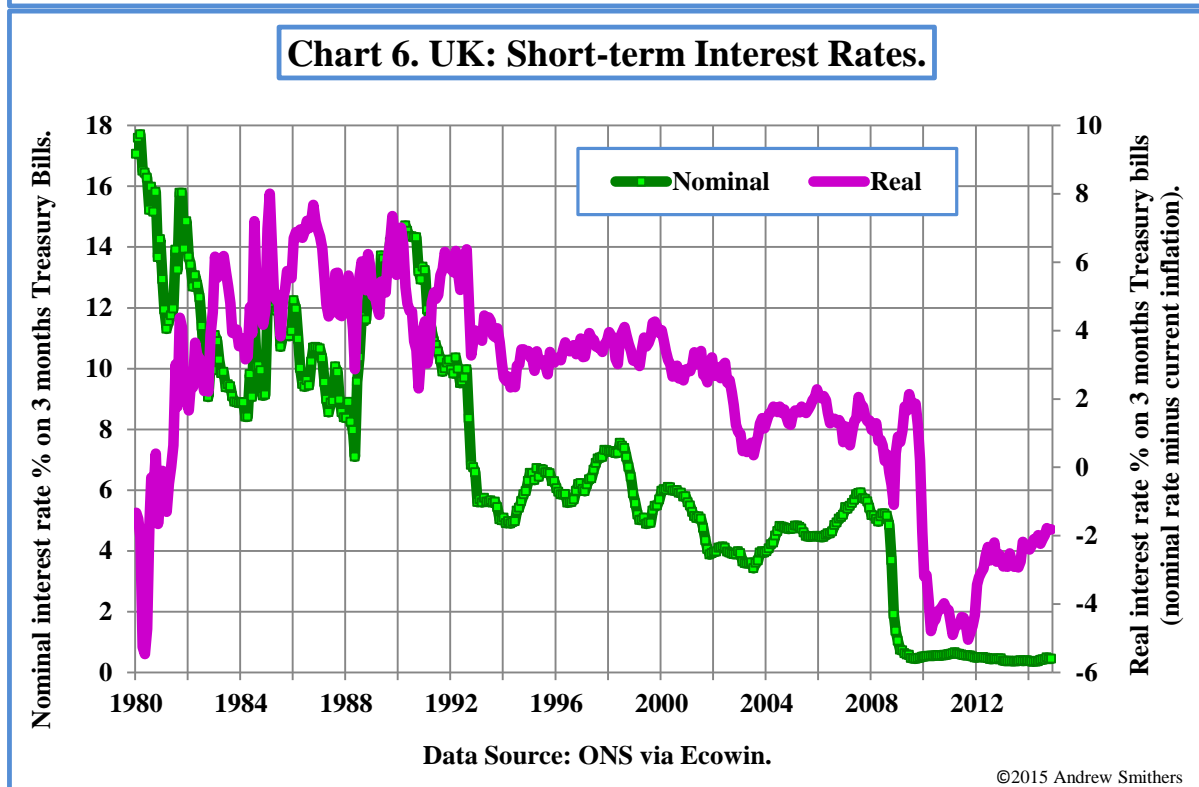
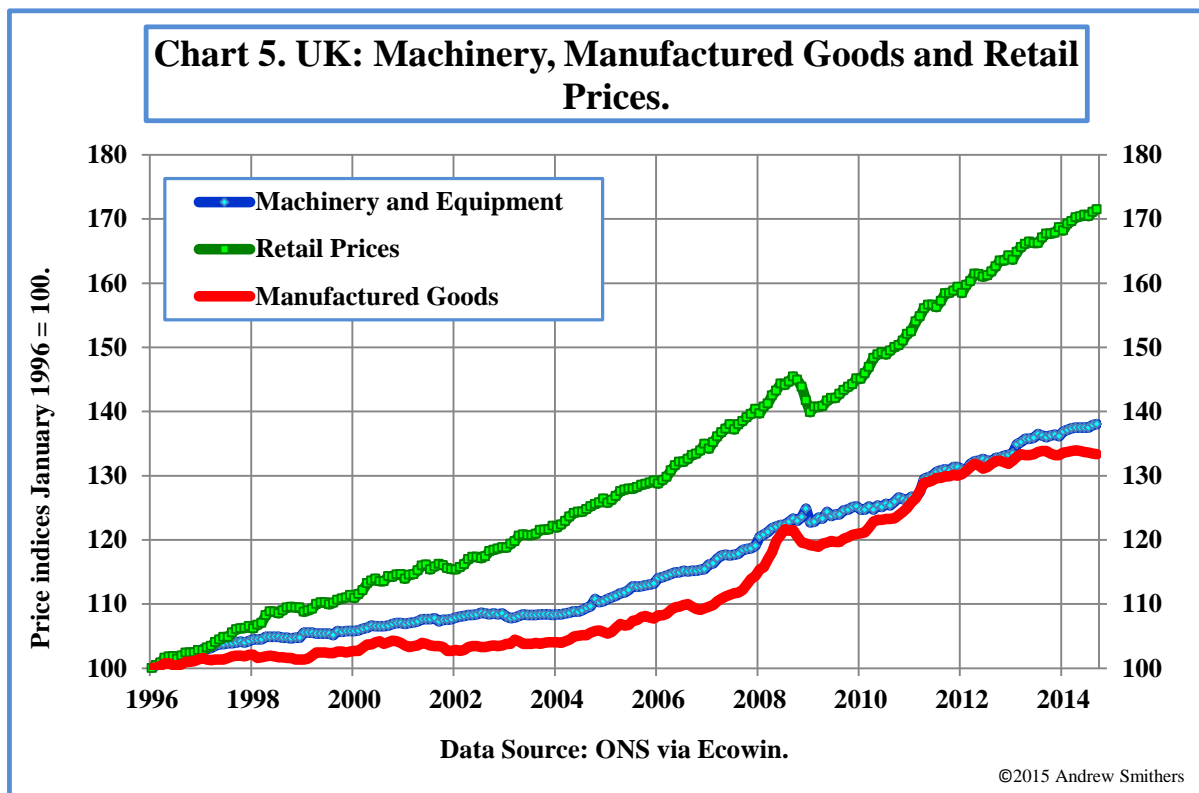
Data Source: ONS via Ecwin.

©2015 Andrew Smithers

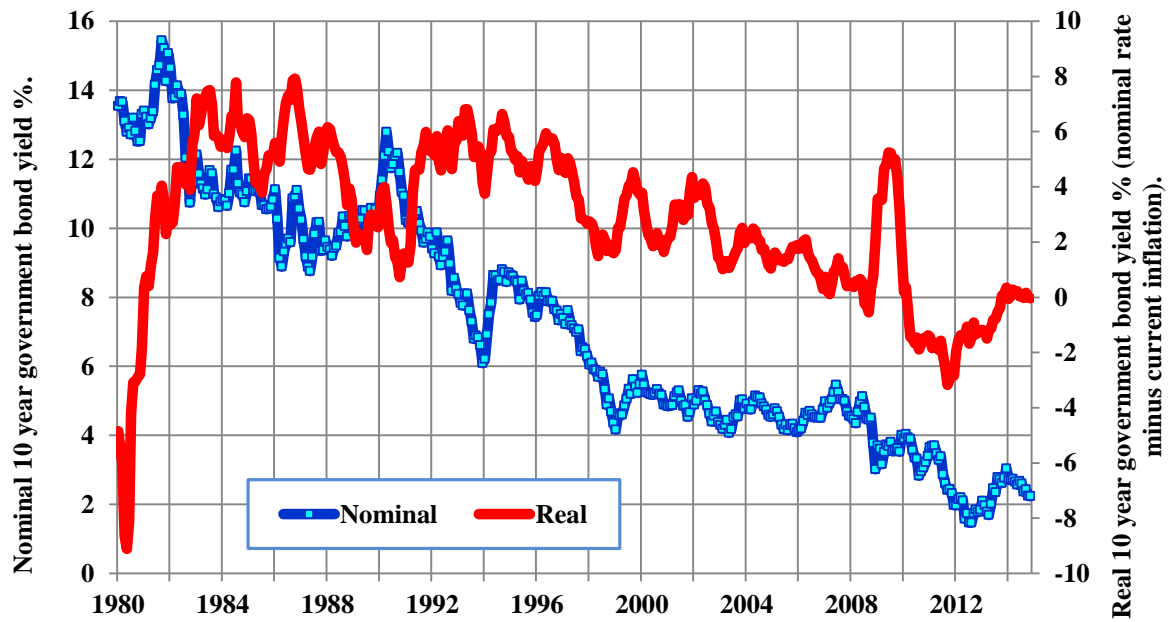
It is still of course possible to blame low investment on poor expectations about growth rather than the actual state of the economy. If this were a significant factor in holding back investment, we would find that such concerns were shown equally by quoted and unquoted companies. While data on this for the UK are not, as far as I am aware, available, the same revolution in management pay has been seen in the US, where such data are available. The important paper, which is shortly to be published in *The Review of Financial Studies*, by John Asker, Joan Farre-Mensa and Alexander Ljungqvist, *Corporate Investment and Stock Market Listing: A Puzzle?*, has shown that a huge difference has appeared in recent years in the level of investment by quoted and unquoted companies. It is clearly absurd to claim, as is nonetheless so often done, that companies are deterred from spending on new equipment by fears about future demand. If this were correct, it would have to be a concern that is restricted to quoted companies and to which unquoted ones are immune. It is clear that the difference does not lie in fears about economic prospects but whether the companies are listed. Listing matters because unquoted companies are more often controlled than quoted ones by investors with a long-term interest in the company's future. While this has always been true, the change in management remuneration has greatly magnified the difference in incentives and thus in the behaviour of the two groups.

Current demand and fears of future growth are therefore unlikely to have had a major impact on business investment, though management, hoping to deflect criticism of their pay packets, may wish to deny this.

The cost of capital should not be confused with the cost of capital equipment. The latter fluctuates cyclically with inflation, though as Chart 5 shows, equipment has over time become cheaper relative to prices in general.



**Chart 7. UK 10 Year Bond Yields.**

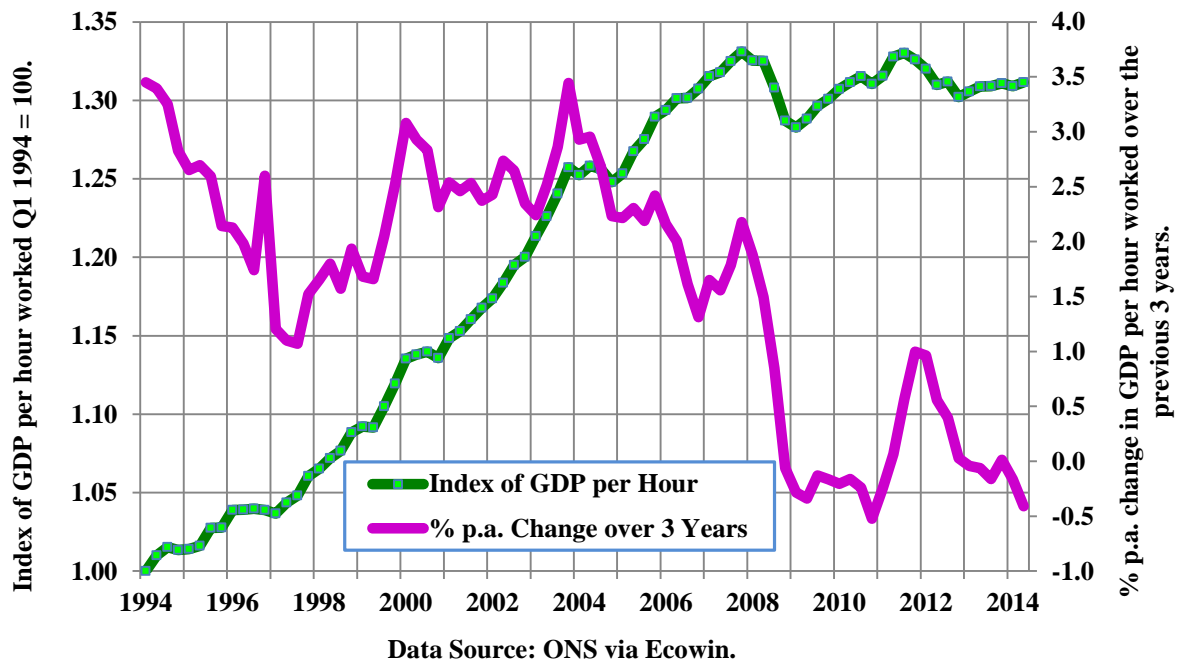


Data Source: ONS via Ecwin.

©2015 Andrew Smithers

The cost of capital depends to an important extent on short and long-term interest rates which, as Charts 6 and 7 show, have fallen in recent years to exceptionally low levels. Monetary policy depends crucially on the assumption that lower interest rates will stimulate demand largely through their impact on capital spending. Despite the fall in interest rates to an exceptionally low level, they have markedly failed to stimulate business investment in recent years.

**Chart 8. UK: Labour Productivity.**



The dramatic change in the method of remunerating senior management has sharply changed their incentives and has therefore changed their behaviour. By increasing the rewards judged by short-term profit related metrics, this was likely to reduce corporate investment which has short-term costs rather than benefits. As corporate investment has fallen sharply, this expectation has been fulfilled. Other explanations of the fall in investment do not hold up when examined. There is therefore a high probability that the change in management pay has had a marked negative impact on investment. This has been accompanied by and has probably caused the dramatic fall in labour productivity, which is illustrated in Chart 8 and which has been the most disappointing feature of the UK economy in recent years. If it continues, the prospects for growth over the medium-term are very poor indeed. A revival of business investment is therefore essential for the UK and the inhibition to it provided by the system of modern management pay needs to be changed quickly and sharply.