

Introduction

An inquiry into the Regulation of Director and Executive Remuneration in Australia is timely, given the rising sentiment against the free market philosophy.

It is hoped the Commission will dig deeper into why the inquiry was initiated, beyond the standard claims of greed and corporate excess. If it does, I expect it will find community opposition to corporate pay is about intense frustration at not being able to guarantee our economic futures. The Commission has a unique opportunity to set the record straight on this damaging emotional plea for control.

Free Market Philosophy

The free market delivers efficient outcomes that benefit the whole community. While this is a basic tenet of our policy framework, it cannot be known in advance what this actually entails. There is no way to pre-empt what consumers want and how much they are willing to pay for it. The stockmarket is efficient for the same reason. The revealed prices seen on computer screens and elsewhere are lagged, while predicted prices are yet to happen. The real share price is never known because it is happening now.

The dynamic process of flowing capital and other resources into those areas most valued is inscrutable, leaving us reliant on the classic metaphors of seminal thinkers like Adam Smith (self-interests provide for a benevolent “invisible hand”) and Friedrich Hayek (the economy, if left to its own devices, will achieve a “spontaneous order”). If all this weren’t true – and there was a formula for economic success or share prices could be accurately predicted – the market wouldn’t be needed in the first place.

The entrepreneurial spirit, having the same attributes, provides a consistent link between this big picture and individual market participants. A profitable business will use a certain degree of science based on quantitative analysis, but its ultimate success is thoroughly dependent on decisions that draw upon “artistic”, expert commercial judgement. As noted by the Commission:

Another reason given against prescription is that designing remuneration in practice is more art than science. Even in theory there appears to be no ‘optimal’ compensation design.¹

Our highest policy goal, being contingent upon an “X factor” that is unseen and beyond measurement, cannot be mechanised for the benefit of the community.

This has some obvious implications for governments and policy-makers. It’s difficult, for example, to convince the public to accept the efficacy of the free market when its essence cannot be seen or proved. It also means there is no way to force private enterprise to make the right decisions. How can this be done if there’s no way to describe beforehand what “right” actually is in a detailed, tangible way? Possessing an intuitive sense of efficiency or fairness doesn’t necessarily translate into an ability to define them. As Augustine of Hippo once lamented when attempting to prove the existence of time, this conflict can cause immense frustration.

If no one asks me, I know. If I wish to explain it to one that asketh, I know not. Yet I say boldly that I know.

My soul is on fire to know this most intricate enigma.²

¹ Banks, G. (2009), “The Productivity Commission’s executive pay inquiry: an update on the issues”, Paper presented at FINSIA forum, Executive Remuneration: new rules and regulation, Sydney, 3 June, p. 12.

² *The Confessions of Saint Augustine*, translated by Edward B. Pusey (1999), Modern Library, p. 253.

Government intervention meant to tackle market failure only makes matters worse. Apart from the inevitable confusion – why attempt to control what has been accepted as ethereal? – regulation is prone to kill the goose that laid the golden egg. The discretion required by the private sector to grow the economy, lift living standards and improve employment prospects is the very same discretion used to perpetrate the market failures that economic policy seeks to overcome. Regulation imposed to “fix” market failures, however unreasonable they may appear, must also compromise the upsides of capitalism.

Ironically, the Hilmer Committee, which was instrumental in opening up the Australian economy through the establishment of National Competition Policy (NCP), touched on the inseparableness of efficiency-enhancing decisions from those made for the wrong reasons.

... the challenge is to provide a system which can distinguish between desirable and undesirable activity while providing an acceptable level of business certainty.³

This complication was simply assumed away:

In addressing this challenge, the Committee starts from the position that there is already in place a regime which provides a basis for making the appropriate distinctions.

There is no such regime. Freedom used for good is the very same as that used for malevolence. And offering freedom on the condition it will be used for the right reasons is not freedom to start with. Further, it's illogical to endorse commercial freedom, constrict it and then expect all the upsides originally promised. Like Hilmer, such considerations have been disregarded, glossed over by rhetoric and propaganda designed to convince the public that regulation is a costless enterprise capable of solving any problem, including executives getting paid too much.

Risk

The global economic downturn has caused serious pain and suffering. It has brought into sharp relief the anguish and dismay of those taken advantage of by the likes of Storm Financial, Kleenmaid and Timbercorp. While such circumstances are regrettable and no reasonable person would deny those affected their anger, it is also important that any such empathy not be at the expense of the truth, however difficult and confronting this may be.

The “biggest global recession since World War II” wasn't caused by adhering to so-called neo liberalism, as claimed by the Prime Minister. Quite the opposite. The economic meltdown was due to key players, including governments, ignoring the real implications of the free market philosophy.

In America, policy-makers thought social disadvantage could be solved by distorting the home ownership market. China and the US thought they could lock in prosperity through the mutual underwriting of spiralling investment and consumption. Some clever bankers on Wall Street thought their futures could be secured by obscuring the risks associated with securitised financial products. This ignorance was then parlayed by other financial players (eg credit rating agencies) into a massive crash-landing of the world economy.

Much of the motivation behind this Inquiry stems from the same lazy thinking. Upset their expected returns have fallen short of where they “should have been”, many investors have had to, shock-horror, contend with unwanted inconveniences, like disposing of investment properties, reconsidering private school for the kids and delaying retirement. They want the unconstrained upsides, constrained downsides. Risk-based returns are fine provided the

³ Independent Committee of Inquiry into Competition Policy in Australia (1993) *National Competition Policy: Report by the Independent Committee of Inquiry into Competition Policy in Australia*, AGPS, Canberra, p. 69.

risk is not an unreasonable or unexpected amount. And government can sort out what this cap is and how it will be operationalised by its very clever and committed regulators.

The inexcusable behaviour of a select few, most of whom are overseas, has become an opportunity to vent our existential angst at not being able to bound life's uncertainties.

The government response is tired, typical and counter-productive. Politicians assume it's an electoral liability to admit to the ultimate ineffectiveness of regulation. What is government for if not to "protect" its people from uncertainty? Tony Blair was rare in his acknowledgement of the political quandary.

The structure of political combat tends to invite certainty, or at least a show of certainty, when that idiom is entirely inappropriate for discussing fine-grained risks and the balance of probability. There are trade-offs, dilemmas, balances between costs and benefits in every decision.

The pace of change in the world can be bewildering and breeds insecurity. Business is more globally competitive than it has ever been. With these new opportunities come new risks, new dilemmas.

A natural but wrong response is to retreat in the face of this change. To regulate to eliminate risk. To restrict rather than enable. But we pay a price if we react like this.⁴

While such acknowledgments are sometimes offered they are rarely accompanied by serious conviction. The institutional inertia overwhelms with a clear and uncontested presumption: modern democracy, through its legislative and fiscal powers, can deliver on all our hopes and dreams. On the issue of addressing the global recession at the G20, the PM briefly inferred there were no solutions only to then immediately offer feel-good statements, suggesting that, yes, something could and should be done about this terrible injustice. And the remedy, like a cure for cancer, is "just around the corner".⁵

Everyone said around the room there are no silver bullets in this. But you know, it's very easy to point to a glass and say it's half empty. What I would say to you in terms of what we have delivered today is an outcome that is more than half full. There's more work to be done.⁶

For much of our history, Australia has used legislation and publicly-owned enterprises to deliver perceived certainties. Service levels and prices were set for many essential goods, some were provided "free". For infrastructure in particular, key investment decisions (eg location of power stations) and employment levels were directly manipulated by government, giving the impression of economic certitude. Free market policies challenged such thinking, attempting to put an end to the façade that our economic destiny could be pre-determined and managed on our behalf by politicians and bureaucrats.

Australia's commitment in the 1980s to this ideology was patently half-hearted. By not working through the deeper implications of neo liberalism, the early successes of micro-economic reform have created the impression that future success can be guaranteed through the same formula. A bit more competition here, a little extra regulation there and sit back and enjoy the good living.

Thomas Edison once said: opportunity is missed by most people because it's dressed in overalls and looks a lot like hard work.

⁴ Blair, T. (2005), "Common sense culture, not a compensation culture", Official remarks, Institute for Public Policy Research, 26 May.

⁵ This inquiry itself is an excellent example of this straw-man strategy.

⁶ Rudd, K. (2009), Press Conference following conclusion of G20 Summit, ExCel Centre, London, United Kingdom, 2 April.

Regulatory Trap

As noted by the Commission, the “the modern corporation emerged largely to circumvent problems created by divergent interests of asset owners and their competing claims for profits”.⁷ It is not practicable for each shareholder to digest and then sanction detailed management information on key strategic financial and operational options. Though required under law to act in the best interests of the company, a board is essentially there as a specialised agent for shareholders.

It stands to reason that board decisions, such as appointment and remuneration of the CEO, involve some level of expert judgment. Even if shareholders were furnished with all the quantifiable information provided to directors, there would, consistent with the discussion above, still be an “unseen” component involved. This “gap” should be filled by the expert value add of directors.

Acceptance of all this leaves shareholders with a simple choice: either trust the board or move your capital elsewhere. It makes sense to question directors and substantiate the quantitative aspects of the decisions required of them, but it doesn’t make sense to attempt to control them, especially on highly artistic issues like appointment and remuneration of the CEO.⁸ Human nature, being what it is, has led emotionally-charged shareholders, aggrieved by individual performance or caught up in public outrage, to agitate for measures designed to force companies to make the “right” decisions.

At this juncture, investors often enlist the support of government to counter their perceived powerlessness against an evil conspiracy involving directors, over-paid executives and remuneration consultants. The comments made by Andrew Murray to the Commission are typical.⁹

Because many directors and boards have not been acting in the best interests of shareholders in remuneration practices, and because shareholders have found it difficult to respond effectively to that situation, shareholders must be given the means to assert their will.

The will here is to control – it has very little to do with efficiency or fairness.

The alternative – and more plausible – take on this is the market for executives and their remuneration is sticky because a significant proportion of investors are unwilling to actively manage their portfolios according to the free market belief that there is no formula for success. They concoct market failure arguments and lobby government for an “easy” solution rather doing the hard work of liquidating their equity and moving it elsewhere.

When this call to action is received, governments and their burgeoning regulatory ranks unthinkingly fall into the same trap. Politicians struggle to tell the truth in a systematic, uncompromising fashion, as they fear being perceived as heartless and unreasonably black-and-white. Over-rational policy-makers are inclined to believe there is an “answer”, while regulators are expected to carry out their duties according to the unquestioned assumption there is a “system which can distinguish between desirable and undesirable activity while providing an acceptable level of business certainty”.

Having forgotten – or, more likely, having not accepted in the first place – the implications of free market principles, no-one wants to be reminded there is no pre-determined solution.

⁷ *Ibid*, p. 11

⁸ Calls for shareholder votes on remuneration belie the emotive reasons behind the request. Why only focus on remuneration when there are potentially more material decisions made by a board (eg major new investments, industrial relations, advertising)?

⁹ Submission # 28.

Instead, the artistic part of the commercial decisions that drive the market is objectified so futile questions can be posed in lieu of dealing with reality.

While potentially offering short-term succour for pain and suffering, a penchant for the wishful thinking embodied in questions like “Should a CEO get paid X?” always leads to a muddle, often at the cost of distracting us from vigilantly upholding the truth.

If asked, a board should, assuming it understands the true nature of efficiency, respond that its assessment of the best CEO and how much to pay them is right because it is in the best position to make such an assessment. Plain and simple. Of course, this has become unacceptable to our growing social democratic sensibility: “we cannot simply hope that individual market participants somehow magically do the right thing”.¹⁰ Any suggestion by a corporation or industry body that commercial discretion is the key to making the marketplace what we all want it to be, is instantly dismissed as evidence of the kind of self-interestedness that justifies the original call for greater regulatory control. Hugh Morgan noted the greedy-bastards-would-say-that-wouldn't-they dilemma faced by business when he helmed the Business Council of Australia.

The arguments that we employ to shake the resolve of governments to rethink their re-regulatory ambitions are difficult to achieve traction. When we suggest, in the most deferential language, that we do not like what is being done, and that we will campaign against it, the amused response is: “Make my day!”¹¹

Contradicting what we know to be true about the market, governments endeavour to quell community disquiet by promising complete transparency across corporate time and space. The vain hope that subjective assessments can somehow be avoided only begs disaster and, as discussed above, contributed to the current economic chaos.

Rather than step back and question the sense of chasing something that can't be caught, governments typically send all stakeholders (including the public and themselves) further down the rabbit hole by demanding greater conformity with pre-determined requirements and increased transparency. The resulting intolerance of discretion engenders a tick-a-box culture that actively de-humanises the workplace and the wider market. Board and management are pressured and threatened to eliminate risk in a formulaic manner even when their commercial instincts inform them that the best way to protect their business and deliver what customers want is to act as if this can't be done.

The aversion to logic is driven by fear that admitting the truth would leave us defenceless against businesses willing to abuse the fact that regulation is ultimately useless. While a difficult truth, it surely doesn't serve us well to deny it.

Regulation mechanises decision-making, creating inefficiencies, resentment and confusion that drives the most vital factor – professional judgement – from the commercial process. This trend is then locked in by the institutional arrangements that treat any problem as being able to be solved by even more aggressive and extensive regulation. In an effort to balance the situation, the government then undertakes to reduce red tape in recognition of private enterprise's contribution to economic development and employment growth.

The mixed messages innate to the favoured “third way” paradigm is leaving many Australia corporations thinking they're in *Hotel California*: You can check-out any time you like/But you can never leave!

¹⁰ Rudd, K. (2009), “The global financial crisis”, *The Monthly*, Issue 42, p. 28.

¹¹ Morgan, H. (2004), “Civil Society, the Corporation and Regulation”, BCA Address to Committee for Economic Development of Australia, Melbourne, 22 March.

Appropriate Response

Good policy is not necessarily about giving people what they think they want (as suggested in an episode of *Northern Exposure*, that should be left to professional wrestling).

The Rudd Government is determined to ensure regulation of executive pay keeps pace with community expectations.¹²

And it's certainly not giving the impression they can have what they apparently want, when it's not possible. People can cope with the truth, provided it's delivered by those willing and able to live according to it.

The Commission has a history of flirting with the challenging facts about the free market, as evidenced by the Chairman's speech updating the Inquiry.

While the unease about executive pay is palpable, understanding whether or how government could assuage it without causing even bigger problems is not straightforward. (p.1)

This might simply reflect the difficulty of capturing something as subjective as 'governance' in observable metrics (p.5)

The most elementary, but also most important, step on the path to good policy is identifying the problem. That means in this case understanding *why* executive pay has increased, and whether the drivers are symptomatic of systemic distortions — across business generally and over time — or merely sporadic aberrations. (p. 4)

While closer to the truth, such comments still harbour doubt and equivocation – and thus add to the confusion.

If the Commission truly believes in the fundamentals of the market, then government fixing perceived issues with executive pay is not a matter of straightforwardness or otherwise. It's plain impossible. It doesn't matter how clever or righteous government and its regulators are, there is no way to avoid the trade-off that comes into play when intervention is preferred. Restrict commercial freedom and efficiency must be compromised. End of story.

Likewise, it is not feasible to capture something subjective in words and numbers. There's no "might" about it because that's what subjective means. It's an irrational statement that only re-enforces the key misconception people currently suffer.

The "problem" of how much executives get paid and whether they are worth it, can only be "answered" by first examining the higher-order problem: expectations regarding control and understanding.

Without an unequivocal, constant reminder of the implications of the free market, people invariably latch onto the implication there exists a mechanism, a switch to be flicked or legislation to be passed, that will miraculously set things right. The fiscal stimulus policies of the Rudd Government are not harmful *per se*. What matters is how they're sold to the public. Giving the impression governments can fix things is dangerous, good intentions notwithstanding. The false sense of security engendered by the PM is exactly what caused the recession. And two wrongs don't make a right.

¹² Swan, W. (2009), "Productivity Commission and Allan Fels to Examine Executive Remuneration", Joint Media Release with Assistant Treasurer and Minister for Competition Policy and Consumer Affairs and Minister for Superannuation and Corporate Law, 18 March.

Unfortunately, the Commission is prone to the same intellectual errors. In 2003, the Commission Chairman claimed Australia's economic reforms, rather than being miraculous, were built upon something concrete and knowable. It was suggested that being able to measure the positive impact of tariff reductions and NCP on the economy meant the free market was a rational bet:

... much of the so-called 'miracle' of Australia's transformation from economic laggard can be attributed to simply removing the lead from our saddle bags.¹³

This is like saying it makes sense to wager New Zealand, freed of any handicap, would beat Georgia or Namibia in a competitive rugby match. Predicting the result is hardly the same as explaining how the annihilation would come about. Even a superior game plan or physical strength do not properly account for the ins-and-outs of the miraculous All Black spirit.

For all intents and purposes, the market is a miracle, "an event which cannot be accounted for as produced by any of the known forces of nature".

In a more recent speech, the Chairman put the case for evidence-based policy development.¹⁴

Evidence-based policy is necessary but insufficient. The free market has many tangible benefits, like greater wealth and employment, but its true value is ineffable. It therefore follows that developing good policy must also account for what can't be seen or measured. Financial modelling of the positives of NCP is counter-productive if not ultimately put into context of the market "miracle". Those hoping (inferred or explicit) to prove a decision efficient or fair through ever-increasing levels of transparency and technology-enhanced data, have forgotten the basics. Unfortunately, the resulting confusion creates a feedback loop that rarely allows one to see the senselessness of wanting to prove a belief system that includes an unfathomable component.

For the Commission to improve the framework for executive remuneration, it must first elevate the debate by promoting the idea that efficiency and fairness, while "things" we intuitively appreciate and know to be real, cannot be forced. The process that brings them to fruition is beyond our sight and understanding. Yes, there is a certain science involved, but when combined with the artistic aspects we are still left with "something" ethereal.

Legislation and economic policy should formally acknowledge that remuneration is inherently subjective and that any denial of this is a condemnation of shareholder value.

Conclusion

While understandable, the desire to end economic uncertainty – and various other contingencies in life – is a failed basis for making good policy, on executive remuneration or anything else. The reason is both simple and compelling: reliance on a formula for success leads shareholders, directors, management, politicians and everyone else to disengage, take their eyes off the ball and then make the kind of decisions that add to economic insecurity. To do what is efficient or fair we must be present, here in reality, not distracted by regulation that wrongly claims to be a solution.

This Inquiry provides the Commission with an opportunity to recast the debate over the value of so-called neo-liberalism. The current recession is due to governments and market participants actively contradicting the philosophy, not acting it out. There is nothing wrong

¹³ Banks, G. (2003), An address to the Forum on Postgraduate Economics, National Institute of Economics and Business, ANU, Canberra, 1 August.

¹⁴ Banks, G. (2009), "Evidence-based policy-making: What is it? How do we get it?", ANZSOG/ANU Public Lecture Series, Canberra, 4 February.

with the free market. The problem is people resent the idea that they cannot understand or control their economic fortunes, and politicians lack the courage to set them straight.

The Commission should take the PM at face value.

We cannot afford a public service culture where all you do is tell the Government what you think the Government wants to hear.¹⁵

Tell them the truth, in no uncertain terms, about regulation and what lies at the heart of opposition against the free market.

¹⁵ Rudd, K. 2008, Address to Heads of Agencies and Members of Senior Executive Service, Great Hall, Parliament House, Canberra, 30 April.