CIHRM Opinion

Something rotten at the heart of executive remuneration

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It has been over three decades since Michael Jensen and William Meckling published in the *Journal of Financial Economics* one of the most widely cited research papers in economics and management (1). They presented to the business world a problem and proffered a solution based upon evidence. Witness the birth of executive remuneration as we know it today. The problem they identified, referred to as the principal – agent problem, is that executives' (agents) interests are different from those of owners (principals). In the modern corporation, where the owners of the firm are removed from day to day managerial control (i.e. a separation between ownership and control), this is clearly a problem of the highest order. How best to ensure that executives are acting in the best interests of shareholders? The corporation is not viable if they are not.

Control through contracts is one option – wielding the stick in effect. However, monitoring and enforcing contracts is costly and requires a co-ordinated response from shareholders when no such appetite or mechanism may exist. Moreover, how can one possibly capture the full range of contingencies of task that we demand of our executives in our modern complex organisations (particularly when executives know far more about the organisation than owners, and information is power let us not forget)? You can't reasonably, and any such contract would most likely fail anyway. The second option is to use incentives – offering a carrot for good behaviour. Incentives are, Jensen and Meckling's research suggested, the most efficient means of overcoming the principal – agent problem by aligning executives' interests with those of shareholders and, in doing so, ensuring that the integrity of the capitalist system is maintained, no matter the size, complexity or relative information asymmetry between executive and shareholders.

Thus the stage was set for an explosion in levels of executive remuneration as a result of the use of financial incentives to engage our most important employees to deliver productive outcomes for shareholders. Short and long term incentives, especially the latter, are vital to the interests of both shareholders and executives (and everybody else by extension, including government and the public), and their governance a key organisational priority. Fast forward two decades, Michael Jensen issued recently a *mea culpa* by acknowledging that high levels of pay associated with contemporary executive compensation practice are not driven by performance and reflect a 'profound loss of morality' (2). Indeed, we have witnessed increasingly over the past two decades a growing dissatisfaction from all quarters with the state of executive remuneration, with the growing disparity between average executive pay and average employee pay, with payment for failure and perceived cronyism between fat cats. In addition, it is far from clear that executives are performing better than they did thirty years ago.

The issues run deeper than a debate about contracts and incentives. There is something rotten at the heart of our social contract with our most important employees, of which the all too apparent dysfunctions of executive remuneration are merely symptomatic. Ayn Rand in her landmark novel, *The Fountainhead*, introduced the notion of *objectivism*, the premise of which is that self-interest is the engine of progress(3). Under objectivism, it is morally incumbent upon individuals to maximise their pursuit of happiness through rational self-interest; that respect for the individual, and individuals' rights, should be the governing principle of social organisation; and by extension, that the economic system of laissez faire capitalism should be governed by the invisible hand of market forces and not the visible hand of regulation or government intervention.

The principles of objectivism are, I believe, now a common place feature of executive remuneration and perhaps the organisation of society more widely (4). Individualism reigns supreme in our organisations and success is defined by the degree to which we, as individuals, are able to serve best our self-interested needs and desires. Perhaps inevitably, in our consumer culture, the bottom line of objectivism is maximising our potential to acquire the material benefits of success. The emphasis on maximising the material self-interest of individuals, whether it be in the boardroom of elsewhere, requires that we, as individuals, compete in a tournament each and every day in which, inevitably, one is either a winner or a loser (there is only such much pie to go around after all). The outcome of the tournament, where one stands relative to others, is the only thing that matters. Thus, we have come to depend upon the sorting effect of the tournament to determine the distribution of income between individuals, a supposedly objective process that is often iniquitous and might otherwise be better performed through social means within the community – indeed, as was the case in the past.

The tyranny of the tournament is all around us. In relation to executive remuneration, it means that executives across firms within, say, the FTSE 100, are engaged perennially in a remuneration tournament. Ironically, transparency of remuneration in the interests of governance encourages parity of pay increase between peer executives because disparity is manifest in black and white. A salary increase for one executive will likely lead to a ratchet effect for peers across all firms eventually. Such is the primacy of the cult of the leader within society currently (and it is very much ‘the leader’, and not leadership), that we must and do comply in order to retain their talent. The invisible hand does not result in an efficient distribution of income. For a variety of reasons, it is forcing inflation in pay across the board quite divorced from value – either value created or value destroyed. Thus, the relationship with value, what it means and why it is important – not least how we promote sustainable value creation *and* protect what value we have, has been subjugated to the tournament. We have taken the easy path. We, as a collective of individuals, have outsourced our judgment to an abstract process and we are living with the consequences economically and socially.

How do we redraw the social contract within our organisations and between stakeholders? Can we redefine success to reflect something more than merely the outcome of a tournament between individuals and between firms (what is Total Shareholder Return as a measure if not that after all)? Can we engage in co-ordinated collective action and ensure alignment of collective interest between all stakeholders (organisations, shareholders, government and the public) through means other than an appeal to financial self-interest? Will duty and stewardship come to matter more than self-interest and material gain? Can we impose this change on ourselves voluntarily, or will it require an exogenous event to force us to change – to do more than merely question the status quo, but to enact real change that represents an improvement to current practice?

Forgive me, but I fear that we, societally, cannot. Individualism, self-interest and the invisible hand still reign supreme despite the crisis of confidence caused by the very real pain of the very real recent financial crisis. I believe it is only through the visible hand of government intervention, in the form of regulation *and* education, that we might move forward for the betterment of all. So, Mr Cameron or Mr Brown, now that May 6th has been declared the date, what are you going to do come May 7th?

(1) Jensen, M & Meckling, W (1976), ‘Theory of the firm: managerial behaviour, agency costs

and ownership structure', *Journal of Financial Economics,* Volume 3, Issue 4, October, Pages 305 - 360

(2) The PBS business desk (2010): http://www.pbs.org

(3) Rand, A (1968), *The Fountainhead*, Penguin Modern Classics, Penguin Books, London

(4) The Economist (2005), Leaders: School for scandal; Management Education, London, February 19th, Volume 374, Issue 8414, Page 11