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Does the Market Need to Be Made Social?

By Gisela Stuart

The short answer is 'no'. One of the points stressed by Ludwig Erhard, the man most singly responsible for Germany's post-war economic miracle and the 'father' of the Social Market, was that markets *are* social: their workings not only produce greater economic efficiency than any other economic system but they produce more benign social outcomes as well. Markets do not need to be 'socialised.'

Of course, some on the 'far left' don't even accept that markets are efficient in economic terms and practically none have ever grasped the role of markets in encouraging social mobility. Properly functioning markets allow the 'outsiders' – the unemployed and new companies – to get on the 'inside'. It is vested interests, the big corporations, big unions and (of course) the public sector, which resist markets.

More surprisingly, many of those who are not on the 'far left' and who do accept that markets produce the most efficient outcomes seem to feel that the starting point for desirable social objectives is to curb the purported excesses of so-called 'free markets.'

This is what happened in Germany. Erhard's successors started to take the economic miracle for granted. Governments took a larger role in the economy and taxes and expenditure increased. Since 1970, with the exception of a couple of years at the time of unification, Germany's GDP growth has averaged less than 2% a year – there was too much emphasis on explicit attempts to make markets 'social'. The recent recession was deeper in Germany than in Britain and although Germany has performed well in the past year, output is still below the pre-crisis level.

Erhard's post-war success was all the more remarkable in that it was carried out in the face of opposition at home (where German business was keen to restore pre-war cartels) and against a background when most other countries, including Britain, were doing the opposite and socialising their economies.

For decades after World War II, Britain's relative performance was abysmal, irrespective of which party was in power. This was changed by the Thatcher administration, warts and all, which itself took place against the backdrop of changes, led by the President Reagan, that were transforming the international economy. These included the deregulation of labour, capital and product markets, the spread of IT and the transformation (to varying degrees) of myriad countries into recognisably capitalist economies.

Many blame the recent crisis on the excesses produced by these developments. Certainly, there have been excesses on a wide front, by households as well as by banks. All sorts of institutions – including banks, rating agencies and accountants – have been incompetent, negligent or worse. However, the notion that the USA and Britain (let alone others) were engaged in some form of experiment in nineteenth-century *laissez faire* is risible and anyone moaning about 'light touch' regulation can never have seen the handbook of the Financial Services Authority (FSA).

The undoubted excesses resulted from mistakes in the middle of the 1990s by policy-makers who failed to understand the consequences of the re-emergence in the last decade of the twentieth century of a genuine form of international capitalism. The technological advance, innovation and rising productivity that was associated with reinvigorated capitalism (particularly in America, but elsewhere too) should have led to a falling rate of inflation (if not the price level). The failure to appreciate this allowed central banks to congratulate themselves on hitting inflation targets while every other monetary indicator was flashing 'red'.

The biggest culprit was Alan Greenspan at the Fed but he was closely followed by those who created Economic and Monetary Union (EMU) which produced an asset price bubble on top of anything 'made in America'.

Inappropriately low interest rates meant that spending by households and businesses was brought forward from 'tomorrow' to 'today' but when 'tomorrow' arrived budget constraints of households (the need for current and future income to cover current and future expenditure *plus* today's debt) meant less money to spend at the very time that additional new investment by business was adding to supply. The only way the merry-go-round could continue is with even lower interest rates. And the fiscal and monetary stimuli in response to the inevitable bust are alternative ways of bringing forward spending.

If there is to be a return to 'normal' including more 'normal' (i.e. higher) levels of interest rates, which are necessary if the balance of spending between today and tomorrow is to be consistent with household budget constraints, then rates of return on investments need to rise so that businesses can be profitable at more normal levels of interest rates. This requires policies that encourage the proper functioning of free markets – the 'social market' as understood by Erhard – but policy makers (and electorates) seem more inclined to move in the opposite direction.

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The Economic (and Moral) Case Against Capping Directors' Remuneration

By Stephen Copp

Preamble

The perceived problem of very highly paid employees is subject to increasing political scrutiny. At the current time this is particularly so in relation to bankers' bonuses. However, for at least two decades, directors' remuneration more generally has been the subject of public policy debate. It is important that economists are primed with good economic arguments, but the moral issues are also important. This short article examines the economic and moral case against the control of directors' remuneration.

Introduction

The directors of the world's largest and most complex companies earn a lot. Tesco's 2010 accounts showed that its directors' total emoluments amounted to just over £25 million, ignoring for this purpose the voluminous additional information disclosed in the directors' remuneration report[1]. Yet group sales amounted to a staggering £62.5 billion; its net assets exceeded £14 billion; its operating profit £3.5 billion; it employed 287,669 people in the UK alone; and £98 million was awarded under its 'Shares in Success' scheme (free shares given to each employee who had worked at Tesco for a year or more)[2].

Such companies are regularly attacked for their supposedly shameful levels of directors' remuneration. One idea to emerge is that the remuneration of the highest paid in a company should be capped at some multiple of the lowest paid. The Hutton Review Interim Report[3] (whose remit was primarily the public sector), explored a 20:1 cap. The Church Investors Group Report[4] (which was concerned with the private sector), has suggested that the 'rule of thumb' for investors should be 75:1, between the top executive and the average pay of the lowest 10% of employees, reducing over time. A survey conducted for Compass in February 2010 suggested 76% of the public would support capping bankers' bonuses[5]. There is a real risk of a head of steam built on public anger leading to some form of general cap in the future.

Why are directors well-remunerated?

Adam Smith predicted in 1776 that there would always be 'negligence and profusion' in the management of companies because directors manage 'other people's money'[6]. This is the foundation of modern agency theory. Put simply, directors of a company are assumed to act rationally and therefore will be tempted to maximise their own interests, including their own remuneration, rather than shareholders' interests. Whilst there is much in principle that shareholders – who own the company – can do to restrain this, it is often assumed that they are prevented from doing so in practice. A collective action problem is thought to arise if shareholders *individually* have an insufficient incentive to act despite collective action being in the interests of all. Furthermore, shares are often held through intermediaries that are themselves large companies with directors and so such agency problems are multiplied. Accordingly, it might be expected that directors' remuneration would be excessive.

There are, however, serious flaws in this otherwise elegant approach. The most obvious has already been hinted at: the cost of directors is a bargain and a trivial business cost for the role they perform. Indeed, meaningful collective action could even be damaging for shareholders if it upsets a successful board of directors who are delivering what shareholders want – the maximisation of the returns on their investments. No corporate structure will ever be perfect, but it is certainly the owners of the corporation, and not government or regulators, who have the best incentives to develop structures that will ensure that directors pursue the aims of shareholders.

Care must be taken, though, to avoid unforeseen consequences of actions to deal with this perceived problem. For example, one common response to the agency problem is to require that directors be made part-owners of the company (by holding large amounts of shares). However, this can incentivise directors to manipulate the share price of their company, something achieved by the use, for example, of off-balance sheet finance, and which can lead to corporate collapse.

The reality is that there are very good reasons why directors' remuneration will be high: indeed, very high. In the case of the world's largest and most complex companies, it would not be unreasonable to assume that the supply of those with the actual experience and skills to govern such organisations would be scarce, not least because the companies in which it is possible to gain such experience and skills are relatively limited in number. In contrast, demand for such directors is more or less fixed, and ultimately such companies could easily afford to offer many times their current cost.

Why is a cap on directors' remuneration thought to be needed?

The underlying concerns about directors' remuneration appear mainly ideological and raise moral questions of fairness and justice. Economic justifications are sometimes given for limiting pay but, as noted above, if companies pay too much for directors it is the company's own money that is being wasted – and politicians are unlikely to be too worried about that!

At a superficial level, it is true that economics is primarily concerned with efficiency, rather than distributional questions – but efficiency has, in fact, a sound moral basis, especially when it is the outcome of voluntary exchange[7]. When it comes to remuneration, the starting point of fairness or justice should be that in the absence, for example, of duress, fraud or illegality, the law should respect agreements that parties, such as companies and directors, make. To appreciate the importance of this, one only has to identify the antithesis of this position: a country where a person is no longer free to buy or sell their property, goods or services as they see fit and where perfectly proper behaviour is subject to the public scrutiny of any lobby group or vested interest. There is a danger in responding to social pressures, which can be motivated by envy or jealousy. Worse still, by restricting directors' earnings we discourage them from exercising their moral capacity to do right or wrong with their legitimately high earnings and therefore give greater scope to government to cloak itself with the generosity that comes from its beneficence with other people's money.

What would be wrong with a cap on directors' remuneration?

The damage that may be caused by a cap on directors' remuneration will vary with the severity of the cap; whether it is introduced by regulation or other means; and whether indeed it really is a cap[8]. Some damage may only be discernible over time. Consider these, for example:

- UK companies might relocate abroad or seek overseas investment, paving the way for government to seek stifling international regulation.
- Once the principle of capped remuneration is established, vested interest groups are likely to mount an ongoing campaign for further reductions in the size of the ratio, with progressively greater damage.
- Merger activity by UK companies might be discouraged since directors would have little to gain from the responsibilities of leading a larger company or group, leading to the loss of economies of scale and leaving UK companies vulnerable to takeover.
- A crude 'one-size fits all' ratio might make it more difficult to recruit directors to work in sectors with predominantly low-paid workers because different companies have different staff profiles.
- A cap might damage effective corporate governance and lead to more corporate scandal or failure by distorting further the shape of the board of directors. There could also be a greater role for, say, the use of consultants who will not be subject to any cap.
- Corporate performance might be damaged if a cap discouraged performance-related pay.
- A cap might give rise to enforcement costs because it will encourage directors who feel unjustly treated to engage in avoidance/evasion.

Perhaps the most important problem is that a cap would stop price signals from operating. Let's say that a particular individual is worth £1.5 million a year to Tesco and £2 million to Morrisons. A pay cap might stop that individual from moving to the company where his productivity is higher. This is a 'lose–lose' situation. The employee does not get rewarded as highly and the individual carries on working in a company where his productivity is lower. Everybody suffers from this – the company's customers, its shareholders and taxpayers as the government takes in less tax revenue. Economists do not like 'lose–lose' situations and are therefore likely to continue to oppose remuneration caps.

1. For the 52 weeks ended 27 February 2010, see Tesco plc 'Annual Review and Summary Statements 2010'.
2. See note 1 above and http://www.tesco-careers.com/home/you/distribution/rewards-and-benefits/shares, which states they are held in trust for five years.
3. 'Hutton Review of Fair Pay in the Public Sector: Interim Report' (December 2010), see e.g. p. 96, where a preference was expressed for a 'comply or explain' approach instead.
4. R. Higginson and D. Clough, 'The Ethics of Executive Remuneration: A Guide for Christian Investors' (Church Investors Group report, March 2010), pp. 20–21, and the separate 'Summary', p. 4, which expresses this more clearly.
5. Compass, Direction for the Democratic Left Ltd, 'Never Again' (www.compassonline.org.uk, 2010), see the Appendix. The revised FSA Remuneration Code (published 17 December 2010) is beyond the scope of this article.
6. A. Smith, *An Inquiry Into The Causes of the Wealth of Nations* (Random House, 1937, p. 700).
7. See C. W. Maughan and S. F. Copp, 'The Law Commission and Economic Methodology: Values, Efficiency and Directors' Duties' (1999) *The Company Lawyer*, 20, 4, 109 at 114.
8. For example, voluntary action by shareholders is less of a cap and more of a negotiation!

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Banking Reform – Making Banks Pay for Their Mistakes

By Andrew Lilico

Banks have often been regarded as a special industry when it comes to economic policy and regulation. The way in which they are networked has often led people to draw analogies between plumbing systems and the banking system. If one bank collapses, it can be rather like a burst radiator in a plumbing system – everything else within the system fails; there is an externality.

One solution to this is regulation to prevent bank failure. This is problematic for four reasons. The first is that it is costly to run any institution on a 'zero-failure' basis and it is customers who would bear that cost. There is a clear analogy with plumbing systems here: we do not have zero-failure radiators. Secondly, regulators are not omniscient and may do as bad a job as bankers at controlling risks: there is plenty of evidence for this from the recent crisis! Thirdly, in a competitive market, we want to allow institutions that do things badly to fail and other institutions to succeed. Fourthly, banks will not act prudently if they know they will be bailed out. There are other, more technical, reasons to avoid a zero-failure regime such as the fact that this would lead banks to become bigger and bigger, but the general argument against zero failure should be clear.

To extend the analogy with plumbing further, we need to find a way to isolate a failed bank and remove it from the system in an orderly way without the system as a whole collapsing – this is just like the plumber removing the failed radiator and quickly capping the pipes to stop the water escaping.

One problem is that it has become politically very difficult to have anything other than a 'close-to-zero' failure regime as far as depositors are concerned: this reduces depositors' incentive to monitor. Perhaps we could limit deposit insurance and remove altogether the incentives for other providers of funds to banks to take risks at the expense of taxpayers in general.

Here are key structural reforms required for the banking sector which will make this possible.

1. There could be two kinds of deposits offered by every bank licensed to accept retail deposits. Only one of these types of deposits, 'storage deposits', would be insured and they would have to be backed by safe assets. The other kind of deposits ('investment deposits') would not be insured. They will, of course, pay much higher interest rates.
2. In the event a bank becomes distressed it must be placed into a special administration scheme and the bank's bonds should be converted into equity to recapitalise the bank. So, if a bank has inadequate capital or is insolvent, but has billions in bonds outstanding, enough of those bonds are turned into equity that the bank does then have adequate capital. Conversion of bonds into equity is a well-established and normal part of administration in other sectors, but typically it happens by negotiation between the company and its bondholders: in this case, it would be automatic.
3. Investment depositors must rank ahead of bondholders as claimants on the assets of a bank. If a bank goes bust and its assets are liquidated, equity holders lose their money first, then bondholders and other providers of funds and finally investment depositors (so bondholders should get nothing unless depositors have recovered all their money).

4. Regulatory authorities and central banks must move away from guaranteeing the capital of investment depositors (i.e. from promising that depositors will not lose any money) to greater insurance of the liquidity of such depositors to prevent runs on banks. It is access to money that is key to a properly functioning banking system. It should be accepted that there is a degree of risk with regard to the capital of bank deposits but that risk would be limited by the fact that a bank's depositors ranked ahead of all providers of a bank's capital.
5. Central banks, regulatory authorities and finance ministries must distinguish clearly in their minds and procedures between central bank lender of last resort provision to solvent institutions (which is not a form of bailout but, instead, an integral part of a system that includes banks and a central bank) and treasury recapitalisation (which is nationalisation of the bank, and quite definitely is a bailout). As providers of liquidity, central banks must be the regulators of the activities of banks.

Competition cannot possibly operate in the banking sector without the possibility of firms going bust. We do not want banks to be regulated and forced to hold so much capital that they will never go bust – that would be deeply anti-competitive. The key here is the second structural reform which is designed to ensure that a bank which is insolvent is wound up in an orderly way. Those who have provided the capital to the bank should take the risks. This is the classic way to deal with externalities that arise from economic activity. Regulating that economic activity rarely succeeds; instead we should have legal structures so that the externality is internalised and the bank's capital providers (shareholders, bondholders and depositors) pay when things go wrong.

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