The Political Economy of High Pay: Incentives, Bonus Pay and Social Norms

Tim Besley
Issues

• Pay reflects contracts struck between firms and workers (consenting adults).
• So when should we worry that such contracts do not serve the public interest.
  – Bear in mind that the tax system can be used to address concerns about income inequality
  – So should this be subjected to specific regulations and,
    • if so, what form should this take?
Issues

• High pay is a reflection of the way that we choose to organize and manage our economy and society.

• Complex societies require a web of arrangements which are stacked with "agency relationships"
  – Conflicts of interest are endemic
The Bigger Picture

• Ants

• Why the Disney move got it completely wrong.
The Smaller Picture

• Ants

• Why the Disney move got it completely wrong.
Hunter Gatherers
(The Myth of the Nobel Savage?)

- Not all human societies thrive on inequality
  - The Ache in the Amazon impose marginal tax rates of around 80% on each other.

- Acephalous organization
  - What hierarchical structures do we need and what are the pressing organizational problems that they solve?

- Maybe it is just the size of the group, the complexity of the tasks and the nature of social bonds between them.
Aristocracies
New and Old

• This has largely broken down as a model of political organization
• But arguably it persists in the economic sphere
• And the top paid are a form of aristocracy
An Economic Approach to Aristocracy

• Behind any plausible theory of Aristocracy lies weak governance:
  – Moral hazard problems in government with weak governance are enormous.
  – Great wealth can be created by having good government (particularly non-predatory government)

• As a form of political organization, aristocracy allows a small elite to consume those rents but the quid pro quo (in theory) is good government.
An Economic Approach to Aristocracy

<table>
<thead>
<tr>
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<th>Weak Executive Constraints</th>
<th>Strong Executive Constraints</th>
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<tbody>
<tr>
<td>No political dynasty</td>
<td>0.83 (0.17)</td>
<td>1.92 (0.16)</td>
</tr>
<tr>
<td>Political dynasty</td>
<td>2.17 (0.50)</td>
<td>2.10 (0.60)</td>
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High Paid Workers as Aristocrats
What is the justification?

• I am going to report on some research I have been doing with Maitreesh Ghatak which looks at some aspects of this.

• The more recent work was motivated by recent debates following on from the financial crisis.

• But our interest in the role of incentive pay in organizations and the social as well as private consequences of bonuses and incentive design predates this.

• In fact, we were originally asking questions about the role of incentives in public organizations and their justification.
Economic Approaches to High Pay

• Span of control and superstars
  – Some individuals can increase marginal products of everyone in an organization so we can justify pay on the basis of marginal productivity theory.
Bonus Pay

• But there is a lot of recent interest in the structure rather simply the level of bonus pay and the reasons for such high power structures
  – Supposedly this ties pay to performance.

• This is going to be the focus of the remainder of my presentation.
Justifying Bonus Pay

• Economic approach has four core ideas:
  – Delegated authority and non-contractible effort
  – Nature of motivation
  – Limited liability
  – Rent generation
Delegated Authority and Non-contractible Effort

• Complex social and economic organization makes extensive use of delegated authority
• And it is impossible to monitor and specify how such authority can be used
• Often the delegated tasks are complex and multi-dimensional
  – managing a financial portfolio
  – teaching kids
  – medical treatment
  – ensuring justice
The nature of motivation

*It is a just political maxim, that every man must be supposed a knave*

David Hume, 1711-1776
The nature of motivation

- Standard theories of incentive pay take Hume’s maxim to heart
- This is a very narrow view of motivation
  - Justified by a robustness principle?
- But may organizations try to select on motivation
  - The public service ethos
- Traditionally, social norms play a large role in regulating anti-social behaviour
- Psychological models reveal complexity in motivation beyond simplistic economic models
  - Is motivational crowd out an issue with economic rewards?
Limited Liability

• What rewards and punishments are feasible?
• Economic constraints
  – Human and physical capital endowment
• Social constraints
  – Debtors prison
  – Slavery and indenture
Rent Generation

• Activities generate returns some of which have private and others have social consequences
  – Standard approach sees private profit to efforts as the main source of rents
  – So sectors of the economy which generate highest economic rent will tend to have most incentive pay

• Sources of economic rent include
  – Innovation
  – Brand reputation
  – Luck
  – Government policy
Current Debates

• Financial sector has become particularly salient for obvious reasons
  – Public support
  – Poor governance (public and private)
Public Guarantees

• Government has systematically distorted supply price of risk capital
  – The welfare state
  – Specific guarantees (pension protection fund)
  – Bank bailouts
Consequences

• Who benefits from such guarantees?
  – Classic issue of incidence of a subsidy in public finance

• If entry restriction/scarcity
  – Then incidence is shifted to firms and workers in the financial sector.
  – So increase in bonus pay due to
    • Promotion of private pension saving
    • Guarantees induce greater incentives for risk taking
    • Competition for talent
Consequences

• Greater inefficiency
  – Bonus pay justified on grounds of increasing economic efficiency seems dubious.

• Greater inequality
  – A transfer from the state to a small elite of workers.
Solutions

• Jimmy Stewart is dead?

• Norms of ethical conduct as a form of self-regulation.
Solutions

• Taxation
  – Progressive taxation brings standard trade-offs but fails to deal with any of the specific issues.
  – Bonus taxation
    • blunt instrument unless all bonuses are rents to socially unproductive rent seeking.
    • But may have a role in dealing with specific form of inequality.
Solutions

• Regulation

• The strong governance solution
  – Regulator can try to look at *structure* of bonus pay.
  – Theory says that pay is distorted towards excessively high-powered incentives.
    • Would require bringing details of incentive contracts into the daylight at all levels.
  – But regulators only competent to deal with technocratic issues.
Firm Level Governance

• Probably not the main culprit
  – Banks and financial organizations were almost certainly behaving rationally given the incentives that they face.
  – But social consequences need to be brought into their objectives
    • CSR related ideas
Reorganization

• Reducing incentives towards risk taking motivated by public guarantees is important
  – Separation of activities could play a key role here.
  – Resurgence of interest in mutuality.
• But fundamental distortion of state capacity and subsidies remains.
• A paradoxical virtue of the fiscal crisis
  – Reduces the credibility of bailouts
Final Comment

• Is there a coherent alternative model?
• This is the first crisis of capitalism after the end of the communism
  – There is little appetite to retreat towards solutions involving large scale state economic management
  – The current fiscal crisis has underlined that this is as much a crisis of public management as of private management.
Final Comment

• What are they proposing?