

## DISCLOSURE OF EMPLOYEE REMUNERATION

by Roger Kerr

Executive Director, New Zealand Business Roundtable

A law is a blunt, costly and often unpredictable instrument. It should not be passed without satisfying at least three requirements - a clear identification of the mischief it is aimed at, confidence that it will address that mischief, and a belief that its benefits will exceed its costs. Ideally, all three should be the result of careful conceptual and empirical analysis.

The Companies Bill proposal for disclosure of employee remuneration fails on all three counts. This provision (clause 197(1)(g)) would require a company to disclose the number of employees (note that this does not cover directors) earning more than \$100,000 per year, in bands of \$10,000. Despite its wide-ranging repercussions, there has been no indication of what it is intended to achieve, and no analysis of its prospects for success or of the costs that it might entail.

**What is the justification for the proposal?**

The proposal possibly stems from a general belief that disclosure is a self-evident good, and the more of it the better. But this ignores the significant costs entailed. Unthinking acceptance of unanalysed propositions is irresponsible legislative practice.

Is the proposal intended to benefit investors? If so, as a universal, compulsory requirement it is misconceived. Investors are free not to invest in a company that does not disclose information they deem important. To attract lowest-cost capital, companies therefore have an incentive to provide the information investors require. If the market does not currently require such information to be disclosed, this probably reflects an assessment that it is of little net value. (In fact, as is explained later, it is likely to be of negative value.) Investors may not want this information to be made public, either to themselves or to anyone else. So what is it that prompts this departure from the demands of the market?

A similar response applies to any suggestion that the proposal will somehow protect minority shareholders and creditors. Investors do not have to invest if they do not want to, and shareholders, particularly in small, closely-held companies, may amend the company's constitution to require this disclosure if they so desire. Such stipulations seem to have been noticeably absent. Why is a law required to make the shareholders' decision for them?

Possibly, a type of 'keep them honest' rationale underlies the proposal. But there has been no indication of employee dishonesty that would either warrant or be affected by the proposal. Remember - the proposals concern the remuneration paid to employees, not directors. The legitimate target of a 'keep them honest' rationale is directors, not employees. Directors are the agents of shareholders, who have a right to know and approve their remuneration. There can be no objection to the disclosure to shareholders of directors' fees. But employees are not directors. They merely contract with the company for their services. Should companies have to disclose, in \$10,000 bands, all contracts worth more than \$100,000 per year with financial and engineering consultants? computer bureaux? cleaning contractors? vendors generally? everyone? If not, what is it that makes employment contracts so different, and how will their disclosure promote honesty?

Could it be, though, that the proposal is grounded in the government's or the public's 'right to know' such information? A greater irony would be hard to imagine. The principles of privacy of personal information have just been enshrined in the Privacy Act. Is it now intended to accept a proposal so completely at odds with these principles and their rationale?

It is no answer to say that individuals' salaries will not be known. In the case of small private companies (by far the majority of companies in New Zealand) it will be quite apparent whose salary it is that falls within a given band. Why should anyone have any right to know how much the local advertising manager, builder or computer consultant is earning? Even in larger companies, where there are many employees earning in excess of \$100,000 per year, it will not be difficult to identify those whose salaries fall within the top bands. A prurient interest in how much other - particularly successful - people earn does not found a 'right' to know that information.

Might it be that the proposal is born entirely of a primitive feeling that it will somehow put a lid on management incomes and that this would be a good thing? There appears to be no evidence to support such a conclusion. Indeed, it has been speculated, comparing the incomes of prominent figures in the United States with those of their Japanese counterparts, that disclosure acts to increase average incomes. Disclosure might operate as a form of union award table for executives, like the old award ratchet system, raising lower incomes to match those of (mis)perceived equals. Certainly, if New Zealand executives turn out to be paid significantly less than their overseas counterparts, the proposal will result either in an increasing leakage of talent from New Zealand or a general upwards movement in remuneration levels for senior executives in an effort to retain that talent.

In reality, what may lie behind the proposal is the traditional New Zealand forelock tug to 'overseas practice' under which some disclosure is required, at least from publicly listed companies. The current proposal is similar to the current Australian legislation. The United States has responded to recent populist hysteria by beefing up to absurdly complicated lengths its obviously circumvented disclosure requirements.

But if slavish adherence to perceived overseas trends is to be the determinant of 'good' law, two things should be noted. First, as part of a policy to reduce the burden of regulation on business, the United Kingdom dispensed with an almost identical requirement in 1989. Secondly, the Canberra government has recently pledged a re-write of Australia's recently enacted but almost unworkably complex and dense companies legislation.

#### Why the proposal should be rejected

Many of the companies leading New Zealand's economic recovery are doing so by having secured market niches in offshore markets. There is a growing realisation that New Zealand's relatively simple companies legislation is leading international advisers to recommend New Zealand over Australia and other countries as a place to do business. Any proposal which increases the complexity of our company law - particularly in sensitive areas such as personal income - threatens this investment.

Most significant, however, is the threat this proposal represents to the effective conduct of corporate business. It is in the nature of the corporate form that ownership (the shareholders) is separated from control (management). Potential therefore exists for the interests of management and shareholders to diverge. For example, managers may prefer enhanced job security to new business risks and so adopt a conservative approach, contrary to shareholders' aims. It is widely acknowledged that the most effective way to align the interests of management with those of shareholders is via performance-related remuneration packages, so that the financial health of management parallels that of their company.

Compulsory disclosure of employee remuneration, however, will inhibit the willingness of directors to institute performance-related packages - particularly at the most senior of levels, where it is most important. United States commentators have recognised that the inevitable attention and criticism that accompanies the publication of top salary levels decreases the willingness of boards of directors to adopt performance-related remuneration packages. This does not mean that pay levels are 'too high'. It merely recognises the criticism that inevitably accompanies revelations of 'what the boss makes', regardless of whether it is 'high' relative to the employment market and his or her performance.

If directors are unwilling to weather this criticism - and if there is criticism in the United States, where wealth is generally admired, it is likely to be far more frequent in a New Zealand society still characterised by a 'tall poppy' syndrome - they will be unwilling to relate remuneration to company performance.

The proposal, in other words, while conceivably designed to enhance management accountability, will actually have made the alignment of shareholder and management interests less achievable - with inevitable detriment to shareholder wealth and the New Zealand economy.

Finally, the direct costs of disclosing the information must be considered - not just the costs of collation and publication incurred by the companies, but the inevitable costs of attempts at avoidance and the efforts of regulators to bring offenders to heel. As the United States experience has shown, extensive and sophisticated drafting is required to keep up with the

increasing complexity of remuneration packages and the ingenuity of people seeking to avoid disclosure. The compliance costs entailed by the United States measures are considerable. But the alternative is patchy and routinely avoided disclosure offering a spurious promise of transparency which will only increase investor suspicion of corporate integrity.

The proposal, then, entails significant cost, delivers no identified benefits, has floated on a wave of feeling that, if it had any base at all, should have been focused on directors and not employees, is sustained by no underlying rationale, and, perhaps most distressingly of all, has been the subject of none of the usual pre-enactment consultation and dialogue that is the hallmark of sound lawmaking. All the indications are that it is fundamentally misconceived and contrary to New Zealand's economic well-being. Legislation should only be enacted for good reason, following informed debate, and in the belief that it will be of net benefit to society. This proposal scores zero on all counts.