Editorial

Dr Kurt Hornschild,
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"What do managers earn?"

Discussion has broken out in Germany over managers' earnings. It was sparked off as supervisory boards gave managing directors huge salary increases when the companies' shares were plunging on the stock market, the earnings situation was deteriorating and costs were being saved on the rest of the staff, in some cases very considerably. Public debate has thus also taken up a theme of current concern in economic research on industry, namely 'Pay managers to match achievement.' In analyses of markets and market failures a key assumption is usually that strategic decisions are made by entrepreneurs, that is, by persons who have to take the consequences of their decisions as their own capital is at risk, but as most companies, and not only the large ones, are run by managers, this assumption is hardly compatible with reality. Managers do have the same decision-making powers as entrepreneurs, but they do not bear a comparable risk. On principle they are in the same position as any other member of staff: that is to say that if they perform badly they can expect to be dismissed. The difference between the managers' contracts and those of the rest of the staff is that the managers are generally given high pay-offs if their contracts have to be terminated, so that in many cases their financial risk is zero, or only very slight. The argument that entrepreneurs are exposed to high risk applies almost exactly in reverse to managers. If we remember that managers can certainly increase their earnings by extending their power, and so their incomes, through takeovers and mergers it becomes clear how important efficient control of management activities is.

It is frequently argued that good managers are in short supply and their earnings level is a result of supply and demand on the market. That is undeniable, but it only becomes credible when the following conditions are met. There should be transparent criteria for assessing and controlling achievement, a competent supervisory board and separation of interests between the management board and the supervisory board. These conditions are very rarely fulfilled, however. In practice in Germany it is quite common for retiring members of the management board to join the supervisory board, retiring politicians are often given supervisory board posts to bolster their incomes, and banks delegate members of their own staff to the supervisory boards of companies although they are major financiers of these companies. The problem of management pay is certainly not specific to Germany alone, but the following case will show how urgently Germany needs up-to-date corporate governance to deal with this problem adequately.

The management of Deutsche Bahn AG has been given the task of privatising the former state enterprise. This is not an easy task, and it is only too understandable that in appointing the managers high standards of quality were set and the salaries offered were appropriately attractive. After all,

Deutsche Bahn AG is one of the biggest enterprises in Germany. An experienced and ambitious manager was found in Mr. Mehdorn. He instructed his staff to work out a new pricing system, which he then marketed. It was a crucial building block in his strategy for turning the enterprise round, and the expectations placed in the new system were correspondingly high. But it soon became apparent that the new price system was a flop. It was not taken up by customers and was so complicated that even the railway staff had difficulty in using it. Mr. Mehdorn admitted there had been mistakes, and promised a thorough revision. Up to that point there is nothing extraordinary about the episode. Anyone can make a mistake. But the response to the disaster is extraordinary. Two of Mr. Mehdorn's colleagues on the management board, who shared responsibility for the new system, had to go, but at the same time the supervisory board extended Mr. Mehdorn's contract. As his pay-off will thus automatically increase should his contract be terminated prematurely at some later date, he has actually been rewarded for his (lack of) achievement.

Far be it from me to criticise the achievements of individual managers; my concern is to find the reasons for the weak growth in the German economy. It has been going on for a long time now, and in this context it is appropriate to look at the role of our managers as well. It is too easy to argue, as they do, that envy is the main motive behind the criticism of their earnings level. In fact, we need a more in-depth analysis of the reasons why so many find this level unacceptable. The managers could quickly put an end to the discussion if they were willing to make the interrelation between earnings, achievement and responsibility rather more transparent. According to the slogan they themselves often cite, 'A due reward for achievement', there could then be no objection if managers' earnings in Germany were in future oriented more to those in such countries as the United States, where they are much higher. Fortunately, there have been initiatives from leading managers recently to work out a corporate governance code that allows observation of the relation between salaries and achievement. That is a glimmer of hope, but the delay in finishing this and the discussion at the same time over publication of managers' salaries show that there is, on the whole, still very little willingness to create more transparency.

In conclusion, one can only say there is need for reform in Germany on many levels. The case cited here is only one example suggesting that management failure may well play a part in Germany's economic gloom. As long as managers and supervisory boards are not willing or able to agree on the necessary regulatory framework for their very own field of activity they are substantiating this view.