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Paying the profit makers: the safety of the known

The news of huge salaries for television news readers and similar media "stars" got PETER EARL, professor of economics at Lincoln University, thinking about whether such high salaries are getting out of control.

HOW should we make sense of the burgeoning earnings of senior executives in the public and private sectors, along with high-profile signs of business expenses possibly getting out of control and severance packages the size of substantial Lotto wins?

The study of economics offers a variety of perspectives on this, which generally give a major role to the modern trend towards short-term business reporting and high accountability.

The analysis assumes that those who receive the high pay have no moral qualms about selling themselves to the highest bidder, even though the moral dimension may exert significant influence on the kinds of jobs people are prepared to do.

The traditional perspective offered by economics relates to "marginal revenue productivity" versus "marginal cost" — in other words, how much extra revenue arises following an increase in expenses.

Joe or Joanna Public might well be happy to read the television news for, say, $30,000 a year but if television personality John Hawkesby can add a million dollars more a year in revenue to the employing media enterprise, it could be worth paying almost a million dollars a year more than would be needed to get Joe or Joanna Public to do the job.

Even if Mr Hawkesby earns so much that his employers are only one dollar better off than they would be by having Joe Public read the news, they may still hire him because that extra dollar is still worth having.

The same goes for managers who can make a major difference to their employers' earnings through their skill or their connections. They are in a position to capture much of the extra net revenue they enable their employers to earn.

What stops exceptional performers from capturing all the extra revenue they generate is the presence of rivals who are prepared to do the job for less. Suppose Richard Long is the next best news reader and adds only an extra $750,000 in revenue but is willing to read the news for a mere $500,000 per year. This would leave $250,000 in profit. If so, Mr Hawkesby, despite his superior productivity, is now worth paying only $750,000, not $1 million, because he must offer the TV channel at least as good a net profit.

If, however, the third-best news reader generates $500,000 in extra revenue and is prepared to read the news for a mere $200,000, both Mr Hawkesby and Mr Long will have to lower their demands.

For all the would-be news readers, the crucial question is how much they can earn in other jobs. Clearly, if Mr Hawkesby's next best earnings come from radio and amount to only $500,000, he might be prepared to read the news for only slightly more than this, leaving the TV station with nearly $500,000 profit.

A major problem here is that those who hire the big revenue generators cannot be sure how far they can limit their offers without losing the desired employee.

Even if (and it's a big if) the person's impact on revenue can be identified with confidence, it may be very difficult to guess the total worth of the job to the person in question — reading the news may open up opportunities for earnings from other sources — and/or the next-best alternative the person might be able to get.

Suppose Mr Hawkesby's next-best earnings are really $600,000 and the TV station, in ignorance of this, offers him only $550,000. If he rejects the offer and the TV station then (just!) succeeds in hiring Mr Long for $500,000, a very expensive mistake has been made. If Mr Hawkesby had been offered $600,000, profits would have increased by $400,000, whereas hiring Mr Long now adds only $250,000 to the profit.

Cautious managers, worried about profits and wary of such risks, could well end up offering more than they need to, leading to escalating pay for the superstars.

The concern with profits has a lot to answer for in explaining the Hawkesby saga. There are many attractive-looking people who could acquire skills in reading from an autocue with appropriate sensitivity, humour and so on, if only they were given the chance.

In principle, the threat from this possible competition should stop existing news readers from capitalising on their crowd-pulling potential. But, in the short term, their departure could cause a substantial loss of advertising revenue, so the board of a TV station facing short-term reporting requirements is unlikely to be able to make credible threats to the established superstars.

Matters might be rather different if TV station boards were appointed on a long-term basis, with members' terms expiring at different times and a major part of the remuneration being an end-of-contract performance bonus based on the whole period of service.

These remuneration packages are often inflated in part by the riskiness of such careers. If an executive is fired after making a spectacularly unsuccessful business decision, it might be very difficult for them to find a similar job ever again. Since the person would seem over-qualified for lesser jobs, the result may be a forced-early retirement.

Given this risk, one would step up into such a job only with a very major increase in salary that would cushion the costs of retirement if one ended up "carrying the can".

A basic problem here is that high-level decisions are often taken in the face of uncertainty and ambiguity and it would be very difficult to demonstrate what would have happened if a different choice had been taken.

Consequently, the market has a huge problem in separating bad luck from bad judgement where an executive has not been taking decisions at that level for very long and has not, therefore, been able to demonstrate that most of the time his or her judgement is good.

If the present day demands for accountability lead to the likelihood that senior staff will not be given a second chance, they will demand much higher remuneration than they would under a system that was prepared to judge them over the long term.

Likewise, those with good track records will seem less risky to hire and, if they are in short supply, they will be able to bid for high pay even though they have their track records to fall back on if a decision goes wrong.

"Talking heads" may not run such risks associated with the complexity of the business environment but they do run risks of falling out of fashion and getting into a downward earnings spiral as they are demoted to lower-profile jobs. The fall and fall of Kiwi Derryn Hinch on (and from) Australian current affairs television illustrates this well.

Problems of information are at least as important in the story of high pay as the competence of those who receive it. Writings on the "economics of superstars" make it clear that high earnings may be commanded by those who are widely known to offer a product that is adequate and free of risk.

The point is much the same as that which explains the mass consumption of McDonald's hamburgers. To many, they may not be the pinnacle of hamburger cuisine in terms of taste, but you know where you are with them, just as you do when switching on to a familiar news reader or buying a Madonna CD in preference to one by an unknown artist.

It might well be that many professors of business subjects could run a company, if invited to do so, at least as successfully as Sir Selwyn Cushing and would be prepared to give it a go for a fraction of the cost. However, since they are not known quantities in this context and mistakes could be expensive, they are not asked to demonstrate their ability. Hence, they never build up a track record and never get asked. That's why the same, safe "high-profile" names figure time and again in appointment announcements. People have "brand equity", just like that embodied in the maxim "No-one ever got fired for buying IBM".

• *Prof Earl notes that, despite writing many books on business strategy and consumer psychology, he has never been asked to serve on a corporate board.*