It's time that politicians had performance-related bonuses

By Theo Vermaelen

During the financial crisis, politicians across the spectrum have assailed bankers' bonuses. In a similar way, politicians should now use the sovereign-debt crisis as an opportunity to re-examine their own pay. The collapse of the largest Ponzi scheme in history, the European Social Model, is not caused by inappropriate bonuses, but by a lack of bonuses.

Politicians, as all government bureaucrats, get a fixed salary, which means that they bear no financial consequences of their decisions. The result is that politics attracts people driven by power and prestige, or occasionally by a sense of duty for their country. Moreover, there is also no board of directors who can fire "top management" if it underperforms. The voters are stuck with the people they voted for until the next election, even if opinion polls indicate a strong desire to get rid of them.

The result of this poor governance mechanism is that it encourages fiscal irresponsibility. In order to be (re-)elected, a politician has to buy votes with borrowed money. The cost of this excessive borrowing and spending is shifted to future generations, our children. Because our children don't vote, this process is not truly democratic. It also explains why markets don't believe that politicians will respect the Maastricht criteria, which try to reduce government spending and borrowing. Especially, as the governance mechanism of the European Union is based on punishing countries, not individual politicians. Collective punishment has never been a good instrument to motivate individual responsibility.

One way to improve governance within the European Union is to introduce the necessary financial carrots and sticks to make politicians behave more responsibly. This does not mean that being fiscally irresponsible will not be allowed, but it will come with a price. The fact that a price will have to be paid will make electoral promises of fiscal irresponsibility less credible and therefore less attractive. For example, Martine Aubry, leader of the French Socialist party has said that she will undo all anti-social measures (such as increasing the retirement age) proposed by President Nicolas Sarkozy if she is elected. If the electorate knows that Mrs. Aubry and her socialist friends would have to pay a significant personal cost if they live up to their promises, it becomes less likely that the electorate will believe these promises.

In order to change politicians' behaviour, the bonuses in case of good performance will have to be substantial. This may pose a political problem as the electorate would interpret any bonus scheme as a way for politicians to grab more taxpayers' money. The scheme, therefore, has to be imposed on all members of national parliaments by European law. The law would stipulate that in order to be able to stay in the European Monetary Union, all elected politicians have to accept to be paid in function of measures tied to the Maastricht criteria and other more refined measures of fiscal responsibility.

A more refined measure would include for example the salaries of government employees. If, as is the case in many countries, these employees cannot be fired and are replaced after retirement with new ones, their salaries are equivalent to perpetual government debt. This debt can be substantial. For example, France spends at least 100 billion euros (122.7 billion dollars) per year on salaries to government employees. If these salaries grow at say two per cent per year and are discounted at an interest rate of five per cent per year, it can be shown that the present value of such a commitment is more than three trillion euros, which is three times as large as the financial debt used to calculate compliance with the Maastricht criteria. If such a measure were would be tied to politicians' compensation, they would have a large incentive to reduce the number of government employees and/or privatise government services.

One critique against such a scheme is that politicians will now be motivated by greed, not by power and power may not be a worse motivator than greed. The difference, however, is that under my proposal, greed will encourage cutting government expenditure, while power encourages government expenditure. So, for ensuring financial stability greed works better than power.

A second critique is that it may encourage short-term gaming: A politician could reduce the deficit by increasing taxes this year, but the economic damage done through the tax increase will increase the deficit in the future. One solution would be that a bonus earned in a given year cannot be paid out but has to be "banked" and can only be paid out several years after the politician has left office. An alternative solution would be to pay higher bonuses if the budget gets balanced by cutting government expenditures rather than by increasing taxes.

A final problem with the measure is that wealthy people would care less about the money they make as politicians. Moreover, politicians can make extra money after leaving office by writing books and by giving speeches. Writing a book on ‘How did I balance the budget’ is likely less popular than a book that describes ‘How I saved the Planet’ by spending taxpayers' money. Therefore I would propose as an additional measure that elected officials have to put up half of their personal wealth as collateral against debt issued during their time in power.

One of the side benefits of this scheme is that it reduces the moral hazard of banks that are considered too-big-to-fail, or TBTF. The argument is that, without politicians with skin in the game, TBTF banks will always be bailed out. As a result, lenders will lend money to these banks at low interest rates and banks will engage in excessive borrowing and risk taking. However, if politicians were to see their personal wealth decline if they arrange a bailout, the likelihood of such bailouts will decline. This will in turn make lenders and banks more financially conservative and reduce moral hazard. This time, it will no longer be certain that any bank is too big to fail.

Under this new corporate governance mechanism, politicians would become the true captains of their ships: They will go down with it if it sinks, rather than safely watching from the shore. As a result, promises to be fiscally responsible will become credible. Battles against labour unions to cut pensions and welfare benefits will become battles for preserving a politician's personal wealth. Of course, he may well lose the next election as a result, but the financial rewards will compensate for the resulting reduction in power and prestige. And our children will be eternally grateful.

__Theo Vermaelen__ is Professor of Finance at INSEAD. He is also the Schroders Chaired Professor of International Finance and Asset Management.

This article was first published in the __Wall Street Journal online__.

Find article at
https://knowledge.insead.edu/economics-finance/its-time-politicians-had-performance-related-bonuses