Solid Energy: Shareholder versus Management Rewards

Keith Rankin, 15 March 2013

On 13 March, the story broke that the National-led government had, in 2009, asked its troubled State Owned Enterprise (SOE) Solid Energy to increase its dividend payments, even if Solid Energy had to incur more debt in the process.

This raises the question as to whether dividends are a cost or a benefit. And, if dividends are treated as a cost, then who does benefit when such a firm makes unusually high profits, and what are the economic implications?

If we consider a small private company there is no doubt that such profits belong to the owner, and that extraordinary losses are also born by the owner.

In a corporate context however, shareholders of established companies expect a stable dividend stream. Indeed, the strategy of paying steady dividends year-after-year keeps shareholders satisfied, and share prices relatively stable.

The government has revealed itself to be a shareholder of this type. It wants the companies it owns to pay consistently high dividends year-after-year, borrowing if necessary in the bad years and presumably saving in the good years. Government as shareholder is really no different from mum and dad shareholders. Regular dividends become a form of entitlement.

SOEs and private corporates alike must treat these dividends as costs; just as wages are corporate taxes are costs. The effect of the Treasury asking for a higher dividend is essentially the same as the effect of a unionised workforce asking for higher wages.

So who gets the benefit when there is a windfall profit? If the shareholders don't, then presumably the management does. This indeed is what John Kenneth Galbraith, in the 1960s, argued would increasingly happen when he contrasted the planning system of corporates with the market system of small private companies.

This emergence of management reward in large corporates created a 'bonus culture'. Thus, the very high corporate salaries in western capitalist countries, especially since the 1980s, initially represented the distribution of profits rather than the allocation of costs.

Eventually, bonuses came to be expected every year, and they too - like dividends - came to be treated as a form of cost. So what happened to windfall profits when both dividends and bonuses were, in essence, costs?

Surpluses were saved, but not in a passive sense. These new savings, neither paid to shareholders nor spent on buildings or equipment, were 'invested' in risky ventures, in speculative bonds and equities, and in financial derivatives. In other words, new branches within corporates tried to imitate Lehman Brothers. A classic example in the USA was General Motors.

The two classic periods of this play-pen behaviour, in our lifetimes, were Japan from 1986 to 1991, and western capitalist countries from 2003 to 2008. In New Zealand today we see similar traits in Solid Energy; shareholder expectations of high and stable dividends, an entrenched high-salary culture amongst management, and a propensity to deploy profits on speculative projects outside core business.

Once such speculative behaviour takes place, corporates' fledgling financial departments discover that huge returns can be made through borrowing and leverage. They could use company savings as deposits on speculative assets, and borrow the rest.

It happened in Japan first, in part because Japanese corporates were consistently the most profitable in the world in the early 1980s, and because they did not fully embrace the culture of paying super-sized bonus salaries to management. And it happened in a period in which Japan's currency had shifted from being undervalued to being substantially overvalued. Under those conditions, there was a huge boom in financial services; and the hitherto dominant export sector stopped growing.

We know what happened in Japan subsequently. Corporates were left with huge gambling debts following their financial excesses. They survived by quietly paying-down their debts over 15 years of 'balance-sheet recession', and by selling goods and services to a debt-tolerant government and to foreign buyers. Japan's export sector grew over this period despite this disinvestment.

In the west, certainly in Britain and the USA, corporates have been net savers for the last decade, either accumulating surpluses to speculate with, or paying down debt. It's not meant to be like this; firms are supposed to be insatiable borrowers. Households, and later, governments ran big deficits to offset these corporate surpluses.

In the case of Solid Energy, the New Zealand government, wishing to reduce its deficit, aggravated its mining corporate's deficits. Like Japanese corporates after their 1980s' excesses, Solid Energy faces many years correcting its balance sheet, doing what it was intended to do, mining and exporting coal.

Keith Rankin teaches economics at Unitec Institute of Technology