Research Note

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Do Australians benefit from our greater tolerance for inequality?

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In research published in 2014, Chulalongkorn University's Sorapop Kiatpongsan and Harvard Business School's Michael Norton use survey evidence to discover 'what size [income] gaps people desire'. They compare respondents' estimates of the income of people in different occupations – chief executive officers, cabinet ministers and unskilled workers – to their ideals for what those wages should be.

In the case of CEOs, measuring the desired gap by the ideal ratio of CEO pay to average unskilled worker pay, the researchers found quite a high degree of consistency across people from 40 different countries and from diverse backgrounds. Nonetheless, there was a surprising outlier – Australia. Responding Australians would like to see a ratio of 8.3 times.

The actual average across 40 countries is nearly half that, at 4.6 times. Australia's desired CEO/unskilled pay gap was the highest in the 16 countries for which the authors had actual pay data. Perhaps not so surprisingly, it was more than 400% higher than the desired ratio in egalitarian Nordic countries such as Denmark. One country in particular outside the group of 16 outdoes Australians in tolerating inequality – Taiwan – with a desired ratio of 20.

Apart from revealing a desire for equality, the study also reveals how out of touch with reality most respondents are. For example, the mean across 40 countries of survey respondents' estimate of the actual pay ratio was 10-fold, about twice the average desired ratio. By contrast, the actual ratio across the 16 investigated countries was 101, 10 times higher. For example, for the US respondents, the estimated pay ratio was 30, compared with the actual ratio of 350. In the face of such ignorance, these survey results make the case for abolishing the survey profession itself!

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Table 1. CEO-to-worker pay ratios: Ideal vs actual.

Country	CEO-to-worker pay ratio, 2009		Actual average compensation (USD), 2013	
	Actual	Ideal[a]	CEO	Worker
Australia	93	8.3	4,183,419	44,983
Denmark	48	2.0	2,186,880	45,560
Germany	147	6.3	5,912,781	40,223
UK	84	5.3	3,758,412	44,743
USA	354	6.7	12,259,894	34,645

Source: Kiatpongsan and Norton (2014), American Federation of Labor–Congress of Industrial Organizations (AFL-CIO) (2014).
CEO: chief executive officer.
[a]According to survey respondents from 40 countries.

The survey shows that if one is to survey anyone looking for responsible answers, Australians (and South Koreans) by far top the list with estimates that CEO pay is 41 times that of an unskilled worker (Table 1). This is almost half the actual ratio for Australia and thus closer than respondents in most other countries who typically had far higher error rates.

Perhaps we should be relieved that for most countries, these pay ratio estimates are substantially lower than the amounts company leaders actually earn. Would the truth stimulate more French Revolutions and huge hikes in tax progressivity? Sweden, for example, once had a magnificent marginal tax rate of over 105% for high-income earners. This lasted until the voters discovered that their most beloved best-selling author had lower take-home pay the more she earned!

Actually, ignorance is not a monopoly possession of the respondents. Some of the ‘credit’ must be attributed to those who conducted the survey and published the results. For example, it is meaningless to talk about CEO pay ratios without considering the size of the company. Typically, one finds that the larger the company, the higher the pay. If one uses raw pay numbers, each doubling of firm size increases pay by 30%. Since on average Australian companies are far smaller than in the US, our pay ratio falls way short of the US’ 350 times score.

This means we miss out on the ‘bargain’ to shareholders constituted by the highest paid CEOs at the largest US companies. Since pay far from doubles with each doubling of firm size, large-firm CEOs cost shareholders very little relative to market capitalization and earnings, in contrast to the small-firm.

In fact, some prominent CEOs such as the late Steve Jobs of Apple fame chose to be paid a notional USD1 rather than the hundreds of millions they contributed to shareholder value. Did they do this because of their love of shareholders and the average unskilled worker? No. George W. Bush reduced the tax on dividends from the personal marginal rate to a maximum of 15%.

But he still retained the double-taxation of company and personal income (unlike Australia). It then became more tax advantageous to receive dividends when one owned much of the company, as did Steve.

Why does CEO pay go up with firm size at all? Actually, this relationship largely exists because size becomes a proxy for success and thus managerial talent. Such talent, the Steve Jobs of this world, are in limited supply. If one controls for talent, then pay only increases by about 22% for each firm-size doubling.

My research with Jaeyoung Sung shows that firms compete for talent largely by raising pay for performance sensitivity, that is, by encouraging stock and option ownership. The reason for this is that typically only the managers themselves are aware of their own talent. With more ‘skin in the game’, their effective take-home pay is much higher and can amount to billions in some cases.

Smaller firms in particular cannot afford to pay as much in direct cash pay. Hence, we see sensitivity falling rapidly with increases in firm size. Larger firms can afford to pay more. For them, talented CEOs are a bargain.

The real message of the survey study for Australians is that we are more tolerant of *ex post* inequality, including pay outcomes, than are most other nations. This makes it easier for us to attract talented managers out of the limited global pool. Importantly, it means that outcomes for most Australians will be better than is the case in the rest of the world. We can expect our economy to continue to outperform.

But this will be true only for as long as the Australian Turnbull Government restrains its enthusiasm for raising marginal tax rates – much to the Nation’s long-term detriment.

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Peter L. Swan is in the School of Banking and Finance, University of New South Wales (UNSW) Business School. After visiting appointments at the Universities of Chicago and Rochester, and an Economics appointment at Australian National University (ANU), he gained a chair in the Australian Graduate School of Management, and was Foundation Professor in the Finance Department at the University of Sydney prior to returning to UNSW. He was awarded an Order of Australia (AM) in 2003 and elected a Fellow of the Academy of Social Sciences in Australia in 1997.