The super rich CEOs

23 May 2006

By JOHN GARNAUT
Sydney Morning Herald

One of the meta-stories of the 20th century is that the super rich fell back to earth. The 19th century industrialists saw their fortunes smashed by the Great Depression, two world wars and progressive income tax.

But, as illustrated last week by Macquarie Bank's annual executive salary pageant, the super rich are back.

The $A21.2 million paid in the year to March 31 to the bank's chief, Allan Moss, represents almost 2 per cent of the bank's annual net profit and a pay rise of 164 per cent over just three years.

His is not an isolated event.

New studies in Australia and the United States show the aristocrats and capitalists of the industrial age have been supplanted by the working rich, particularly the superstar chief executive officer.

"At the start of the 21st century, the income share of the richest 1 per cent of Australians was higher than it had been at any point since 1951," say economists Sir Anthony Atkinson, of Oxford University, and Professor Andrew Leigh, of the Australian National University, in the first detailed study of incomes of Australia's super rich.

"Much of this recent increase may have been caused by higher executive pay."

The ANU paper, The Distribution of Top Incomes in Australia, shows not all elite professionals have shared in these fabulous returns.

High Court judges have plunged from a multiple of 17 times average earnings in 1921 to just six times in 1988, before rising to almost eight times.

In that time, according to tax return data, top federal public servants had their relative wages cut from 10 times average earnings to less than five.

And politicians, whatever you might think of them, have seen their wages fall from 5.6 times average earnings in 1921 to 2.3 in 1988, before they rose slightly to 2.7 times average earnings in 2002.

Reliable historical data is not available for chief executives. But in the decade to 2002, Sir Anthony and Professor Leigh say CEO salaries of the top 50 companies rocketed from 27 times average earnings to 98 times. And they have escalated since.

Similarly, a study this year by John Shields, of the University of Sydney's School of Business, showed the 51 listed companies whose CEOs are members of the Business Council of Australia had given their chiefs a 564 per cent pay rise since 1989-90.

Macquarie Bank's chief explained his good fortune as "real social consequences of globalisation".

Presumably, Moss is hinting at a "superstar" theory, where elite lawyers, sports people and executives can rightfully earn escalating premium payments as they compete in a world market.

To some extent this must be true. American Bob Joss brought with him global management standards as well as a new global salary benchmark when he arrived to resuscitate Westpac in 1993.

Since then, top Australian executive salaries have closely tracked US salaries, albeit from a lower level.

Executives also point to the performance-based nature of their salaries, arguing that their salaries ensure executive and shareholder interests are aligned.

Moss, for example, earned a base salary of $670,604 - and then claimed the residual $20,506,183.80 as various performance payments.

Macquarie Bank's performance fees are more transparent than most. But academics are increasingly questioning the sort of performance that many companies are rewarding.

A University of Chicago study tracked CEO salaries at 50 American oil companies, where extraneous "luck" relating to changing higher oil prices could easily be distinguished from management performance.

The authors, Marianne Bertrand and Sendhil Mullainathan, found CEOs were paid handsomely for oil price changes in the 12 years of their study that prices rose.

"Chief executive pay in fact responds as much to a lucky dollar as to a general dollar," they said.

CEO pay also rose, however, in the five years when oil prices fell.

"This hints at an asymmetry: while CEOs are always rewarded for good luck, they may not always be punished for bad luck."

The authors present an alternative explanation for spiralling executive salaries: CEOs are uniquely placed to "capture" - or rig - their own pay-setting processes.

In this view, executives unduly influence their own boards and are constrained only by what their shareholders will let them get away with. If their salaries rise fastest when profits rise, it is because shareholders are more likely to turn a blind eye when they themselves are making money.

Dr Shields believes executive salaries have made a "major' contribution to widening income inequality at the top - and much of this is due to inefficient, if not ethically dubious, executive behaviour. "I don't accept the argument that says the pool of CEO talent is so minuscule that companies have to pay almost anything to get these rare human beings," he says.

Dr Shields says chief executives have inverted the lawful management structure whereby directors are engaged to control them.

"I tend to think of CEOs as behaving in the same way as traditional craft unionists: defining their own levels of skill, setting market rates for that skill, engaging in market closure and bargaining for premium levels of pay," he says.

Dr Shields says massive golden handshakes, post-retirement consulting fees and performance options that, bizarrely, can be hedged against risk, are other examples of executive " wealth by stealth".

Interestingly, hyperinflating executive salaries are an English-speaking phenomenon. Elsewhere, including Japan and continental Europe, executive salaries and the overall income shares of top earners have stagnated.

While Canadian executive pay cheques have generally mirrored the American trend, in French-speaking Quebec they have not.

In the United States, income inequality has widened at the bottom of the income scale as well as the top.

A study this year by Ian Dew-Becker and Robert Gordon for the National Bureau of Economic Research showed that fully one half of all America's productivity gains since 1966 had found their way into the salary packets of the top 10 per cent of earners.

The other 50 per cent of productivity gains filtered down to the bottom 90 per cent, where real wages fell.

Australian inequality is widening only at the top. Low earners have been protected by generous family welfare payments and wage-setting structures.

Nevertheless, the recent rise of the super rich has led some observers to worry about the social fabric.

"It's possible that this affects political outcomes: very skewed income distribution may allow the super rich to have a disproportionate influence on election outcomes," says Professor Leigh.

"In a deeper sense, there's the possibility that we split into two Australias: two groups that occupy different worlds, use different social services and have no interaction with each other."

Don't be surprised if pay packet talk migrates from the gossip pages to the centre of economic and social policy.