The four factors that decide how we feel about income inequality

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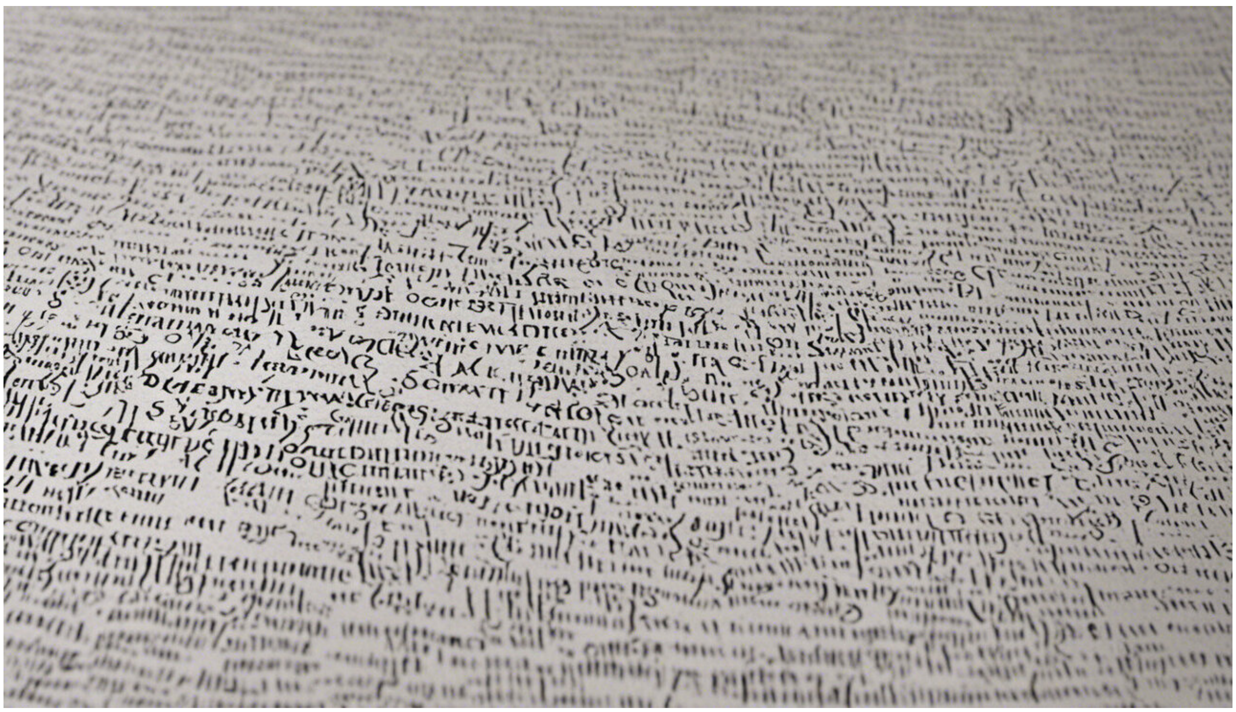

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Sometimes it is hard to nail down exactly how we feel about disparities between incomes, but emotions certainly run higher after a financial crisis and a few years of austerity. We might be furious that scandal-hit CEOs walk away with multi-million dollar packages but we can feel impotent in the face of the "market forces" we are told dictate such things. We might find easier targets among public servants, from GPs to councillors and head teachers, who have their "generous packages" revealed.

The academic literature on what people know about pay, and what they think is fair pay, can be summarised by three points. First, people are pretty well informed about the pay of different professions as compared to national averages. They know sufficiently what accountants and hairdressers get paid.

Second, nearly all believe that the differentials are too high: the top earners should receive less and the bottom earners more. People understand and approve of differences as a function of skill and responsibility but feel the gap between many professions and individuals is too big.

Third, if they are asked to start all over again and devise pay rates for different jobs, there are some surprises: many believe that currently well-paid jobs, such as TV news reading, should be paid well below the national average, while others, such as nursing, should be paid as much as judges. The belief is that things have got out of kilter for a whole range of historical reasons and need to be corrected. All the studies on fair pay show these results.

Relative values

Essentially, there are four issues that inform this debate and the first is about how executive pay relates to the money the rest of us receive. It is well known that satisfaction with pay is all about comparatives and not absolutes: that is, not how much you receive but how much you get relative to your comparison group. The question is, what exactly is that? There are both internal and external comparators. Most top executives prefer the latter and not the former, but it is the exact opposite for observers.

There have been strident calls from time to time to ensure that the top job is never paid more than 20, 40 or 100 times that of the average wage within an organisation. It can be rather embarrassing for the board to try to explain how one job is worth so much more than another.

Bosses, however, quite like social comparisons. They note the world is now one market and if you are not prepared to pay international market rates, there will be a mass exodus of talent to other countries. There are a lot of these threats but less evidence that they are ever put into practice. Remuneration committees report this all the time … unofficially, of course.

There is also the issue of how pay is determined. Who is involved and what mechanism should they apply? Is it an in-house remuneration committee, or should a review be conducted by an outside consultancy company? What sort of algorithm should be used? For instance, should it be based on some sort of performance measure? How is that to be calculated?

Distortions

Anyone interested in performance management knows how difficult it is to measure. You can choose some metric: time, money, quality, quantity, customer feedback, but there are three problems here. First, how do you avoid distorting behaviour – a classic example is bus drivers ignoring waiting passengers if they are measured by on-time performance. Second, how do you measure the contribution of others in a team? Third, how do you allow for macroeconomic forces that suddenly occur; should a CEO be rewarded just because China cuts trade tariffs?

Linking pay to the share price can also have serious and sudden unfortunate consequences. Cunning CEOs can sell properties or re-engineer (sack) middle management to make financials look good in the short term, only to have a later crisis. Performance, in other words, can be gamed, and only careful, transparent design can iron out the wrinkles. Appealing though it might be, it is unwise to link pay to shares as share prices are determined by so many factors

After working out the comparatives, and how pay is measured, we then have to decide what form the pay should take. Salary, bonuses, stocks? Should bonuses be subject to clawback if things go wrong? What about the perks: the house, the jet? What should be considered part of the total reward package? Most of the debate is about the end-of-year bonus, which may increase an executive's short-termist approach.

Rewards points

A big problem lies in explicit, usually numerically expressable, rewards. We all know that some jobs are more intrinsically rewarding than others. It is difficult to think what is rewarding about being a traffic warden, and easy to understand why craftspeople seem so happy. But how do you put a price on "quality of life". We seem only able to do it by "quantity of reward".

This should not be an insurmountable problem for social scientists who are familiar with those concepts. By developing a measure which incorporates job stress and strain as well as intrinsic rewards, it may be possible to replace the corporate remuneration committee with one that can better understand and calculate the diverse rewards of a job.

Finally, we have to consider whether pay should be confidential or made public? Members of the board can usually hide their salary, even though the CEO's is nearly always published. Should we also know, by right, the salary of board members and other highly paid employees? Perhaps publishing pay bands (like £100,000 to £150,000) would be a reasonable compromise?

In some countries, this data has to be made open so there is no way to make it secret. The best example is Norway, a country characterised by political stability and a general sense of fairness. Secrecy feeds conspiracy, but openness can bring outrage and fury. It could be argued, however, that a little bit of anger might be needed to drive any change at all in these factors which decide just how much pay inequality we are able to tolerate.

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