Annals of social sciences & management studies
ISSN: 2641-838X

Juniper Publishers
key to the Researchers

Opinion
Volume 7 Issue 1 - January 2022
DOI: 10.19080/ASM.2022.07.555703

Ann Soc Sci Manage Stud
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# Should Top Executives' Salaries be Capped? Lessons from a Swiss Popular Initiative

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**Submission**: January 06, 2022; **Published:** January 27, 2022

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**Abstract**

Should top executives salaries be capped? There is indeed considerable public support for this idea. In Switzerland, for example, an initiative against excessive top management remuneration, was voted on in 2013. Had the federal popular initiative "1:12 – for fair wages" been adopted, the Swiss constitution would have henceforth contained the following: "The highest wage paid by a company must not be higher than twelve times the lowest wage paid by the same company." This article addresses the main argument for and against such a wage cap from a socio-economic perspective.

## Opinion

### The Swiss 1:12 Debate

The proponents of a 1:12 wage cap in Switzerland pointed to exorbitantly increased top wages with no recognizable relationship to performance, to increasing income inequality, and to an alleged Swiss tradition of social equality and moderation. One of the characteristic pro posters illustrated greed on the part of top executives. The opponents described the initiative as "ideological experiment", "wage dictation", "further expansion of the socialist redistribution state", "envy", "class-struggle" etc. The top earners thought it wiser to stay in the background. Explicit approvals of huge wage spreads or demands for higher admissible maximum ratios were not made. The suggested ratio was only discussed by those in principle supporting initiative.

Prof. Marc Chesney, Vice Director of the Institute for Banking and Finance at the University of Zurich, for example, considered a ratio of 1:20 to be more appropriate. The opponents did not deny that top wages might be too high, but stated this only affected very few CEOs, so that there was no need for action. The opposition was primarily against undermining entrepreneurial freedom, interfering with private property and thus a challenge to the liberal economic order. However, the focus of the no-campaign was on the possible effects of the initiative on tax revenue and social welfare institutions. It culminated in the argument that if top wages were capped, government revenue would be lost, so that the initiative would reduce the scope for redistribution and finally harm the poor. Three quantitative studies were produced, two of which can be clearly assigned to one or the other camp (University of St. Gallen contra, Denknetz think tank pro), and one by the politically neutral KOF Swiss Economic Institute at ETH Zurich. Not surprisingly, the results diverge greatly. The University of St. Gallen study [1] quantified a worst-case scenario, assuming a dislocation of 5% of the affected companies to other countries and emigration of 10% of the affected individuals. The study by the Denknetz [2] came to a more positive result. In contrast to the St. Gallen study, income redistribution to poorer individuals was assumed and tax progression as well as the propensity to consume were taken into account plus a second-round effect due to the Keynesian income multiplier. In addition, the Denknetz scenarios did not expect migration of companies or individuals, arguing that among firms' location factors a legal maximum remuneration rule is comparatively unimportant. The KOF study [3] quantified the proportion of affected companies at 1.5% of all companies with at least three employees and a maximum ratio close to 1:300. Interestingly, the typical wage spread in Switzerland was found to be surprisingly low with a median of 1:2.2, much lower than 1:12. Hardly surprising, around 90% of those earning more than 12:1 were men, and most top earners were found in finance and insurance. In the end, the initiative was supported by a respectable minority of 35% of the voters.

### The economic point of view

Let us now look at the initiative from an economic point of view. If top salaries were to be reduced to 12 times the minimum wage

in the company (or any fixed proportion that effectively "bites"), what effect would this have on the value added of companies and the economy as a whole? One extreme case is that the value added drops by exactly the amount of the pay cuts. Managers' salaries correspond exactly to their contribution to value added, reflecting individual productivity. With salary cuts, managers will reduce their efforts or leave, and the companies have to hire less productive individuals. The other extreme case is that after the pay cut managers feel no less committed to their companies than before; or when companies have to find replacements for leaving top employees, the newcomers, who are satisfied with the 12:1 cap, have the same leadership qualities. The former is the microeconomic textbook scenario, the latter suggests that low-wage earners should benefit directly. The remuneration components exceeding 12:1 would then not be productivity wages, but scarcity rents that managers manage to collect; be it due to the media which mostly portray managers as exceptional talents, be it because of a managers' price cartel, or because of inadequate enforcement of the interests of the company owners. Also, corporations could be engaged in a PR competition of conspicuous consumption, who can afford the celebrity CEOs with the most exorbitant income claims. The empirical truth will lie somewhere between the extremes – even those who oppose wage caps admit the occasional "excess".

The zero-sum game assumption ignores that lowering top employees' incomes can realistically be expected to dampen their enthusiasm, at least initially. In addition, given the global mobility of the corporations affected by such a wage cap, the top management could just resettle to a jurisdiction without such rules. As a result, somewhat less than 100% of the wage sum exceeding the cap will be available for redistribution. Those believing that managers are generally paid according to their contribution to company earnings will find a lower percentage plausible than supporters of the rental income theory. Orthodox economists, convicted that markets ensure efficient allocation, will tend to assume productivity wages. Adherents to the scarcity rents theory, on the other hand, can point to the observation that during the last few decades wage gaps have widened significantly and worldwide, but the relative increases on the upper levels of the wage hierarchy did not go along with more dynamic economic growth – quite to the contrary. The relatively moderate remuneration of top executives in the "golden age" [4] of the capitalist world from around 1950–70, went along with GDP growth rates that dwarf what came after. Also, the 2007 financial crises makes it doubtful that top earners in finance and insurance, were more capable then than during the first post WW2 decades. Why should this be different now? Top earners have then not become better to run a business, but to secure exorbitant wages.

Now, if corporate earnings are falling less than the capped wage bill, there is indeed something to be redistributed. Then the question is, to whom? Low wage earners would clearly benefit if it were management's intention to allow the same top wages when 1:12 comes into effect. Alternatively, companies could leave the lowest wages unchanged and use the reduced wage bill to improve their competitiveness by lowering sales prices. If competition works, this should result in a general reduction in the price level. Finally, the redistribution could also benefit the firms' owners. When company profits rise, higher dividends are indicated. It is difficult, if not impossible, to predict the magnitudes of these effects, but we would probably see some of each. The crucial question from a macroeconomic point of view is what the welfare effects of a 1:12 rule will be? Recall that the ultimate objective of economic activity is a "good life". Traditionally the utility of an economic subject is modelled as a positive function of the bundle of goods that can be acquired with income and as a negative function of the workload. It is also postulated that the benefits of individuals cannot be aggregated. Consequently, different economic outcomes can only be compared according to "Pareto optimality ", which states that an alternative outcome represents an improvement if and only if at least one individual experiences an improvement in utility without any individual facing a reduction. Accepting this, wage caps must be rejected. Notice that according to the Pareto criterion, redistribution can never have a welfare-increasing effect, whereas in practice, most if not all market economies perform at least some redistribution from top to bottom. The criterion is thus largely irrelevant in practice. Utilitarianism is more relevant for our problem. Already David Hume [5] stated: "A too great disproportion among the citizens weakens any state. Every person, if possible, ought to enjoy the fruits of his labour, in a full possession of all the necessaries, and many of the conveniences of life. No one can doubt, but such an equality is most suitable to human nature and diminishes much less from the happiness of the rich than it adds to that of the poor." Redistribution then increases the total welfare within an economy, based on what we now call the law of decreasing marginal utility of consumption. However, this does not consider possible welfare losses due to the emigration of high-income individuals or entire companies, which may have negative effects on those staying behind. Another question is what kind of world one would like to live in. Those to whom the liberal principle is important as an end in itself will reject legal interference in the wage structure. However, labour markets are often regulated in many respects, e.g. about legal working hours, overtime compensation, vacation claims, minimum ages and minimum wages, which makes the opposition less compelling.

What speaks in favor of a fixed minimum-maximum wage ratio? A more legitimate income distribution to the extent that top incomes are rents rather than productivity wages. In addition, a central finding of economic happiness research is that a higher income makes you happier, but the effect is largely temporary, as the aspiration level adapts upwards. Also the happiness individuals derive from their own incomes reacts negatively to the incomes of their peers, since these determine the aspiration level [6]. Accordingly, capping maximum incomes would make the


How to cite this article: Graff, Michael. Should top Executives Salaries be Capped? Lessons from a Swiss Popular Initiative. Ann Soc Sci Manage Stud. 2022; 7(1): 555703. DOI: 10.19080/ASM.2022.07.555703

unaffected individuals happier, even if there was no redistribution. For the directly affected top earners, the decisive factor is whether and how quickly the aspiration level adjusts downwards. Whether the overall effect would increase or decrease the efficiency of the economy or the happiness of the population is theoretically ambivalent. With a 1:12 rule, the few high earners affected by wage cuts would be worse off. For many others, wage increases may or may not result, but benefits are also drawn from the fact that the existing economic system and the income distribution that goes along with it are perceived as fairer.

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DOI: 10.19080/ASM.2022.07.555703

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