

Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Additional Estimates

10 – 11 February 2010

Question: aet 61

**Topic: PC Report ‘Executive Remuneration in Australia’
– Efficiency of Executive Labour Market**

Hansard Page: Written

Senator CAMERON asked:

*At p.xxvi, the report points out that "certainly in some periods and for some CEOs, pay outcomes appear inconsistent with a **reasonably efficient** executive labour market." (emphasis added)*

1. Is "reasonable efficiency" an official concept in labour market economics? What does it mean? How far below "full" efficiency is it?
2. Is "reasonable efficiency" a standard of efficiency that the PC would be comfortable applying to labour markets for, say, unskilled school leavers, skilled tradesmen or semi-skilled automotive industry workers?

Answer:

1. Chapter 4 of the report notes that in the context of the market for executives, efficiency would require that firms hired the most suitable executives, paying up to the value of the contribution of the particular executive. It continues that in a ‘reasonably well-functioning market, differences in executive pay ultimately would reflect different levels of talent and ability in broadly similar jobs, as well as the different nature of jobs’. The use of the word ‘reasonably’ is a recognition of the fact that no market is ever ‘perfect’ in the sense of stylised textbook models — transactions inevitably involve costs. This is recognised in competition law, for example, which uses the related concept of ‘workable competition’. In particular, as the report notes, information asymmetries pervade the relationship between boards and shareholders and executives. Efficiency can be promoted by taking measures that reduce the effects of information asymmetries (such as governance arrangements, monitoring of executive effort by the board or incentive pay), but these measures themselves will have costs that must be weighed against the benefits.
2. As for executive pay, in the context of these markets, a reasonably efficient outcome would imply that pay levels broadly reflected the employee’s contribution in the workplace.