Market, Not Taxes, Should Dictate Pay

Higher taxes on executive salaries only mask larger problems with corporate governance and corporate democracy

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I have read with equal parts fascination and distress Michael H. Trotter's recent column, "Tax plutocrats to restrain their pay," in the Feb. 13 *Daily Report*. Mr. Trotter's basic premise appears to be that too many people are receiving "excessive compensation" in connection with their employment and that if the government were to tax away the advantages of this excess compensation by raising the top marginal tax rates, we could forever rid ourselves of the scourge of excessive compensation.

We, like Mr. Trotter, should avoid being drawn into any detailed consideration of the more prosaic and pedestrian aspects of this idea. For example, a painstaking sifting through Mr. Trotter's prose and statistics will yield no definition of the term excessive compensation. Apparently, excessive compensation is something that chief executives, hedge fund managers, professional athletes, rappers and rock stars receive. Playing to his audience, Mr. Trotter assured readers of this publication that his proposal would not affect the tax obligations of "most lawyers, other professionals, mid-range executives, actors, athletes, rappers and rock stars." (Notably absent from the categorical caveat was any mention of Big Firm first-year associates.)

Also conspicuously absent from the column was much in the way of explanation for why the federal government should modify its tax policy to stamp out excessive compensation. Other than a passing reference to diverting funds from shareholder equity and dividends, Mr. Trotter apparently assumes that we are to take it as an article of faith that excessive compensation, whatever it is, is bad and must be ended. Despite all of the number crunching offered up, none of the statistical analysis presented by Mr. Trotter is offered to justify his ideas, unless rates have been high before is thought to pass as justification.

No doubt, executive compensation has increased by most standard measures over the course of the past two decades. As Mr. Trotter notes, however, during the period from 1936 to 1969, "increases in executive pay were less than the wage gains made by the average American worker." So, arguably, executives have been playing catch up in the past 20 years, following a relative drought of 30 years.

The increase in executive compensation has hardly been an unrelenting upward trend in recent years. Actually, top executive pay moved downward for three years after 2000, before recovering slightly in tandem with the stock market in 2004. According to one report from the Cato Institute, "chief executive officer pay from the top 100 in Forbes … fell 54 percent from 2000 to 2003." And Mr. Trotter's own sources, Lucian Bebchuk and Yaniv Grinstein, "estimated that among the S&P 500 firms, average CEO pay fell 48 percent from 2000 to 2003."

The Cato Institute helped to identify some of the market forces that produced the increases in CEO pay experienced over the past 23 years: “Xavier Gabaix of the Massachusetts Institute of Technology and Augustin Landier of New York University found ‘the six-fold increase of CEO pay between 1980 and 2003 can be fully attributed to the six-fold increase in market capitalization of large U.S. companies during that period.’ CEO pay rises and falls with the global value of U.S. companies. That is what ‘pay for performance’ means. Stockholders foot the bill for stock-based CEO pay, not workers or consumers, and stockholders generally like it when the CEO makes money only if they do, too.”

Other market forces have also contributed to the increase in CEO compensation. For example, according to one of Mr. Trotter’s other sources, Frydman and Saks, in the past 20 years CEOs have, as a group, tended to be better educated and trained, more mobile and subject to greater demands and risks. (See, e.g., Sarbanes-Oxley).

So, CEO salaries, like those of avaricious artists and athletes, are established largely by the market. But then, why would we want the market to decide the value of work performed? Surely, some bureaucrat in Washington is in a better position to decide what pay is fair and at what point compensation for all workers—CEOs, athletes, rappers and the rest—is, by definition, “excessive.” Apparently, according to Mr. Trotter, there is an undisclosed number at which the taxes will be so high that employers will be unwilling to pay it, preferring to keep their money rather than paying it to the government, and at which point employees won’t care if they receive it, because their marginal benefit will be taxed into oblivion. This undisclosed number is the point at which compensation—apparently for everyone—becomes “excessive,” and your government (and Mr. Trotter) knows what that number is. We know this is so because the wisdom of government is manifestly obvious to all thoughtful observers.

Ignore what a particular worker has done over his or her career to earn what they receive because it is clearly true that at some point, it will just be too much. Disregard how the worker has performed or what he or she has sacrificed in that performance; at some point, it will still be too much. Forget that athletes’ income producing years end very early in life; never mind that musical artists and actors often invest a lifetime of deprivation to become an overnight success; overlook that CEOs often invest a lifetime of sacrifice, toil and struggle to rise to the top. There is a number where we can all agree—their pay is “excessive.” And that number will, by the way, be the same for all of them. (Perhaps in his promised future columns Mr. Trotter will explain what that number is and will disclose the methodology for arriving at it.)

As for me, I would prefer to leave it to the market—employer and employee—to decide the value of work performed. Call me conservative, but I tend to think that the buyers of services from CEOs, athletes and rock stars are in a better position to determine the value of those services than the IRS Division of Differential Deservedness or any other tax bureaucrat. If a corporation, a sports team, or a music label (all, presumably, sophisticated actors) is prepared to pay a huge amount of money for the services of a particular person, there must be some self-interest motivating them to do so.

If, indeed, the interests of shareholders of public companies interests are being betrayed by CEO compensation, then that is a symptom of a larger problem in corporate governance and corporate

democracy. Raising the top marginal tax rate for highly compensated executives would merely mask that symptom of the larger problem; it would hardly cure it. And raising the tax rates for athletes and rock stars is hardly going to help the shareholders of public companies. But then sorting out such details has never been the strong suit of those who use the blunt weapon of government to slay their beasts.

Given the evil we are trying to stamp out—I am still tying to figure out what that is—one is left to wonder: should government adopt a tax policy that is calculated to eliminate incentives for high-level executives to move up, to do better and to create value for shareholders? As unsavory as it may sound, some people work harder so they can do better. A tax policy specifically designed to create disincentives to enhanced performance is as misguided as it is dangerous.

Fundamental to Mr. Trotter's approach is the assumption that the government should use its taxing power to take away from citizens that which the government decides that citizen does not deserve. This is not about raising revenues. Mr. Trotter acknowledges that his notions are probably revenue neutral—although I think they would reduce revenues by creating disincentives for workers to earn over a certain amount that is currently taxed at nearly 40 percent. This is not about spreading sacrifice more evenly; Mr. Trotter fails to mention that the top 50 percent of earners pay 96.5 percent of all federal income taxes paid by individuals. This is about making everyone more equal by taxing away different pay for different commitment, sacrifice and performance.

The fact of the matter is that unequal pay is typically the result of unequaled effort, unequaled sacrifice and unequaled results. The confiscation of the premium received by top performers is an effort to make all participants in the market more equal, regardless of their results, their effort, or their sacrifice. The freedom of self-interested actors to make their own arrangements—to create their own relationships, to define the terms of those relationships and to reward their results as they see fit—should, according to this bit of unfortunate orthodoxy, take a back seat to this government created, defined and implemented move toward greater “equality.” Each step down this path we tread, the further we move from liberty, the more our rights will be in jeopardy and the greater the dominion of government over what we do, what we have and what we deserve.

But, at least, we will all be safe from people who receive excessive pay.