Should Executive Pay Be Regulated?

By Justin Fox
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Kenneth Feinberg, the Washington lawyer who had the thankless job of figuring out how to compensate victims of the Sept. 11 attacks, is now hard at work — as a "special master" appointed by the Treasury Secretary — figuring out how to compensate employees of corporations bailed out by taxpayers since last fall. The House and Senate are crafting legislation that includes "say on pay" shareholder votes on executive-comp packages and (in the House version) calls for regulators to vet incentive pay at financial firms on an ongoing basis. The Securities and Exchange Commission is for the first time attempting to claw back pay from an executive not because he did something wrong but because his company's earnings were improperly inflated by other execs.

In short, Washington is in the midst of a sweeping power grab over the compensation practices of corporate America. This makes me cringe, at least a little. The government's record at pay regulation is not encouraging. The wage and price controls of the Nixon era were quickly abandoned as unworkable. A 1993 attempt by Congress and the Clinton Administration to rein in executive pay by not allowing corporations a tax deduction on executive salaries above $1 million turned out to be an object lesson in unintended consequences. Because it exempted performance-based pay, the new limit accelerated an already-in-the-works shift toward using stock options as the main piece of executive compensation. Far from being reined in, executive pay — with help from a bull market in stocks — skyrocketed. (See pictures of TIME's Wall Street covers.)

When I run this example by Lucian Bebchuk, a Harvard Law School professor who has supplied much of the intellectual firepower for the current pay-regulation campaign, he has a ready retort. "When they run out of good, substantive arguments, they come to the argument of unintended consequences," he says of pay-regulation opponents. "We have seen the consequences of the lack of intervention in the last 10 years. We have lived with that experiment."

Fair enough. Certainly, at the government-supported firms where Feinberg will determine pay, the case for intervention is open and shut. They're taxpayer-supported entities, after all. Feinberg does face tough decisions, such as what to do about Andrew J. Hall, head of the moneymaking Phibro energy-trading unit of money-hemorrhaging Citigroup, whose performance-based contract could net him about $100 million this year. One can extrapolate from Feinberg's past performance, though, that the veteran mediator will come up with a decent compromise — that is, one that leaves everyone unhappy.

The case for limiting pay at corporations not on government life support rests on two main arguments, Bebchuk says. Top executives are supposed to answer to shareholders, but to a large extent they have been able to determine their own pay packages. Say-on-pay votes and other measures that empower shareholders and outside directors are meant to shift that balance of power. At banks, meanwhile, pay is simply one more risk factor that regulators should keep an eye on. "Once you accept that government is already regulating the business decisions of banks, I
don't know why this particular business decision to compensate should be exempted from intervention," Bebchuk says. (Watch TIME's video of Peter Schiff trash-talking the markets.)

Would this intervention be flawlessly executed? Of course not. But if ham-handed pay rules drive risky, highly rewarded activities out of big banks and into smaller firms — if big banks become boring again — that might not be all bad, since smaller firms presumably pose less risk to the financial system.

As long as we're talking about ham-handed measures, we might also want to consider the most ham-handed pay regulation of all — progressive income taxes. It cannot be entirely coincidental that the great explosion in executive and Wall Street pay began about the same time that Washington was slashing taxes on the highest earners. The top federal marginal rate plummeted from 70% in 1980 to 28% in 1988. (It's now 35%.) Some CEOs who are critical of the compensation status quo but who don't want government telling them how to pay people point to taxes as a possible answer. "I wish income was more equitable," the head of a big financial institution told me recently. "I have no problem with paying 50% taxes or more. But government meddling with compensation practices is a bad idea." Yes, raising tax rates would bring negative consequences: more incentive for evasion, less incentive for risk-taking and entrepreneurship. Lowering the top rate had its negative consequences too, though. It's a matter of which negative consequences we'd rather put up with.