WebMemo

Published by The Heritage Foundation

No. 2570
July 30, 2009

House Executive Pay Legislation Puts Pay Czar's Boot in the Door

David M. Mason

Understandably concerned over taxpayer-subsidized bonuses, the Obama Administration appointed a "pay czar" to oversee compensation at firms receiving substantial government backing, such as GM and AIG. Regrettably, the Administration did not stop with government-aided companies but proposed a sweeping plan regulating private-sector pay.[1]

On July 28, the House Financial Services Committee approved H.R. 3269, the Corporate and Financial Institution Compensation Fairness Act of 2009, introduced by Chairman Barney Frank (D–MA), to regulate pay practices in the entire financial sector. Further, the Obama–Frank plan moves toward comprehensive government regulation of private-sector pay, extending to rank-and-file employees. The plan represents the czar's boot in the door opening every American's pay to government regulation.

The Obama–Frank plan is misguided not because the private sector is perfect but because government dictates complicate and distort private-sector pay without addressing pay inequities. In fact, existing tax policy encourages the big bonuses that have spurred public outrage. Instead of regulating more, Congress should revise tax rules to make pay decisions tax neutral.

The Obama–Frank Plan: Three Bad Ideas:

1. *Say on Pay, but Nothing Else.* The Obama–Frank plan requires annual, non-binding shareholder votes on senior executive pay at most publicly held firms. There is nothing inherently wrong with a shareholder role in compensation decisions, but government-mandated pay disclosures, votes, and procedural requirements distort management–shareholder relations by focusing excessive attention on compensation. As a result, other important factors affecting corporate performance will suffer in comparison as management—and shareholders—have less time to give them the attention they deserve.
2. *Bureaucratic Compensation Committees.* The House bill requires that covered companies have independent board compensation committees with authority to hire outside compensation consultants.[2] The government "hint" and fear of liability mean nearly every compensation committee will hire government-approved experts to set corporate pay.

   Total independence in setting pay is at odds with the idea touted by those backing new pay rules that compensation should be aligned with long-term corporate interests. Prohibiting a CEO from participating in compensation decisions for other senior executives sacrifices a key management tool. While corporate executives cannot be allowed to simply set their own pay, excluding them makes compensation decisions a bureau-

This paper, in its entirety, can be found at:
www.heritage.org/Research/Regulation/wm2570.cfm

Produced by the Thomas A. Roe Institute
for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

The Heritage Foundation
LEADERSHIP FOR AMERICA

cratic exercise by outside consultants. This is a sure recipe for a mismatch between corporate goals and corporate pay.

3. *Government Pay Rules.* The House bill prohibits financial firms from paying incentive-based compensation that regulators consider risky. Unfortunately, experts disagree about what sort of compensation contributes to risk. For instance, the Treasury Department prohibits TARP recipients from granting stock options, believing they increase risk.[3] Yet one credible study indicates that stock options actually reduce risk rather than increase it.[4]

Moreover, details such as price, vesting, and exercise rights make significant differences in incentives created by options, which are only one of many forms of incentive compensation. Even if regulators had accurate ideas about how compensation creates risk, the detail required to implement those insights would require bureaucratic micromanagement of private-sector pay.

Not Just Fat Cats. While "say on pay" votes apply to top executives, other provisions of the Obama–Frank plan affect rank-and-file employees. Financial firms must report incentive compensation—including such routine items as commissions and performance bonuses—for every employee. Financial regulators could prohibit "unreasonable incentives" for any employees. If regulators think commissions are too high or bonuses are poorly calibrated, they can order revisions.

Rank-and-file employees outside the financial industry would not be regulated directly—at least not yet. But rules on senior executives influence how corporations pay other employees. Security and Exchange Commission (SEC) rules require corporations to explain the objectives, design, and elements of their overall compensation program in disclosing the pay of senior executives. Thus, new rules imposed on corporate compensation committees interact directly with overall compensation plans. Limits on top executives roll down to the rank-and-file.

Existing Tax Rules Distort Pay Practices. Corporate critics claim some compensation incentives (such as stock options) encourage managers to take undue risks affecting the entire company in order to meet personal performance goals. However, the emphasis on incentive compensation springs significantly from a 1993 law intended to *limit* executive compensation.

Section 162(m) of the tax code limits deductible salaries to $1 million but allows unlimited deductions for performance-based compensation. The result, as an SEC official noted, is that options exploded: "[T]he tax law tilted compensation practices away from salary…in favor of performance-based compensation to which the cap didn't apply, such as stock options."[5]

Moreover, the 1993 law produced the opposite of its intended results. Executive compensation increased, and the disparity between executive and rank-and-file salaries grew.[6]

Rather than removing perverse government incentives, the Obama–Frank plan attempts to solve problems caused significantly by existing regulation with more regulation. New regulations are unlikely to have a better result; most likely they will have

1. U.S. Department of the Treasury, "Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation," at *http://www.financialstability.gov/docs/regs/FinalReport_web.pdf* (July 30, 2009).
2. Most corporate boards have "inside" directors who are senior executive employees of the corporation as well as "outside" non-employee directors. H.R. 3269 requires that a committee composed exclusively of outside directors make compensation decisions.
3. Incentive payments are limited to long-term restricted stock. See U.S. Department of the Treasury, "Treasury Announces New Restrictions on Executive Compensation," February 4, 2009, at *http://treasury.gov/press/releases/tg15.htm* (July 30, 2009).
4. See Watson Wyatt, "Going Beyond Conventional Wisdom: Designing Executive Pay to Balance Risk and Performance," June 2009, at *http://www.watsonwyatt.com/us/pubs/insider/showarticle.asp?ArticleID=21310* (July 30, 2009).
5. Linda Thomsen, "Testimony Concerning Executive Compensation and Options Backdating Practices," testimony before the Committee on Finance, U.S. Senate, September 6, 2006, at *http://www.sec.gov/news/testimony/2006/ts090606lt.htm* (July 30, 2009).

The Heritage Foundation
LEADERSHIP FOR AMERICA

spectacular failures of their own. Policymakers should cover their ears and avoid any tempting siren calls for even more government regulation of private-sector pay.

Keeping the Czar's Boot out of the Door. Americans are understandably disturbed when taxpayer-supported companies pay outsized bonuses. But government regulation of private-sector pay is no solution. Existing tax law encourages excessive focus on executive bonuses. Additional government intervention will imbalance corporate governance and further distort pay practices.

Rather than dictating private-sector pay, policymakers should re-examine the pernicious effects of existing tax incentives on executive pay. Rather than increasing involvement in private-sector decisions, policymakers should make government policies neutral as to pay structures and allow private-sector owners and managers to design differing pay systems for different companies and objectives.

—David M. Mason is a Senior Visiting Fellow in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.

6. J. W. Verrett, "Unintended Consequences of Executive Compensation Regulation Threatens to Worsen the Financial Crisis," testimony before the Committee on Financial Services, U.S. House of Representatives, June 11, 2009, at *http://www.mercatus.org/uploadedFiles/Mercatus/Publications/New%20-%20JW%20Verret%20-%20House%20Finance%206-10-2009%20final.pdf* (July 30, 2009); Steven Balsam and David Ryan, "Limiting Executive Compensation: The Case of CEOs Hired after the Imposition of 162(M)," at *http://astro.temple.edu/~ryan/162m.pdf* (July 30, 2009).