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The perils of fixing pay

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Past attempts to regulate executive compensation led to unintended consequences

This week's impassioned discussions of executive compensation have left some important points dangling.

With a few exceptions, compensation decisions are not legitimate questions of public policy. They are agreements between consenting adults. (Usually adults: I don't know who does the deciding in Justin Beiber's corporation. He must have one.) If compensation for the director of the Mint or Canada Post or any of our regional-development subsidy banks is the issue, we're all shareholders and entitled to an opinion on how these executives — who disturbingly frequently are former politicians with no evident expertise in the areas over which they will execute — are compensated.

To be sure, all private firms operate under a system of law and many are subject to advantages of incorporation that originate with the state. But leaping from that commonplace to the doctrine that the state therefore has the right to micro-manage the operations of all private firms is a little like believing that because the state-enforced rule of law allows us all to prosper the state may therefore decide what each of us will eat for dinner tonight. (Granted, that would be a stronger analogy if thousands of health bureaucrats weren't trying their level best to regulate our suppers.)

The related idea that because business decisions to spend on a deductible activity such as compensating executives affect the taxes paid by the rest of us therefore means all taxpayers are effectively shareholders in all businesses is simply the apotheosis of the perverted but pandemic view that every time the state deigns not to tax something it is providing that something with a tax-expenditure subsidy. According to this logic, if something is taxed, it's the state's concern, while if it's not taxed, it's the state's concern, too, because it could be taxed.

No doubt private boards that have been paying their executives well will be grateful to learn that some other boards have opted for limits on executive compensation so as to encourage the lesser-paid "grunts" on whom any business's success depends. But if commercial success really can be won by limiting executive compensation, you might think the practice would have become more common.

It's not necessary to suppose that all markets operate as frictionlessly as angels playing shuffleboard to believe business owners will be interested in any stratagem that will make their firm money. They hardly need the minister of this or that to enforce such methods.

Some executives have received bonuses even while firing or freezing the salaries of thousands of their employees? This is hard on the psyches of employees but if the firings or freezings are good for the firm, shouldn't the executives prosper? Some CEOs have made a botch of things but received large severance nevertheless? Well, what of it? A responsible board would do all it could — including spending money — to hasten the departure of a CEO who had screwed up badly. Money is especially necessary in such cases if employment law makes simple firing difficult or if, as in the United States, some forms of deferred compensation can be paid only when employment actually does end. What should we do? Confiscate compensation legally owed to the miscreant CEO?

Even if you do subscribe to the view that in the end everything belongs to everyone and the state should be unembarrassed about regulating executive or anyone else's pay, there is the question of how you do it without giving rise to unintended bad consequences.

It may surprise the Canadian Left to learn that the U.S. Congress has been trying for several decades now to curb "excessive" compensation. In the mid-1980s, fearful that incumbent managers were using golden parachutes to make takeovers difficult, Congress raised parachute taxes sharply.
The result in many cases was not to eliminate such parachutes but to sharply raise their cost, which of course made them even more effective as takeover inhibitors.

Similarly, in high populist dudgeon in the early 1990s Congress eliminated the deductibility of any executive salary greater than US$1-million, unless pay were related to performance. A first result was to give many executives an immediate raise to US$1-million, as such a salary now apparently had official Congressional approval. A second was to encourage a switchover to payment with stock options. Not long afterward, the same commentators who had been complaining about "obscene" corporate salaries began lamenting the "shortsightedness" of U.S. businesses that had abandoned the long view and were now fixated on maximizing next quarter's share price.

To be sure, many businesses decided to keep doing things the old way and pay cash salaries, even if this meant not being able to deduct the full cost. Other things being equal, that meant they paid more corporate tax. Who pays the corporate tax? Shareholders in part, certainly. But recent economic research suggests workers do, too, since businesses taxed more invest less, which means labour productivity and therefore wages don't grow as quickly.

Suppose Parliament decides no corporate executive may make more than 50 or 100 or 500 times what his or her lowest-paid employee makes. That should be good for the people who sweep the floors: If the boss wants a raise, they'll have to get one, too. But what if the boss decides it's better to outsource floor-sweeping or buy some Japanese floor-sweeping robots so as to eliminate a whole class of low-paid employees and thus raise the ceiling for executive compensation? Will we then have a ministry to regulate how businesses sweep their floors?

When you introduce a law that business people have a compelling incentive to find a way around, it's a safe bet they will — many times in ways you will not like.

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