The proposer's opening remarks

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For those of us striving towards a free society, a basic tenet is a respect for mutual agreements between consenting adults. In the absence of fraud or actual physical harm to either persons or property, adults should have their contracts respected by the state and not rewritten upon political whim. So the question is: is the current system of executive compensation fraudulent or does it impose physical harm on others?

Let us start with the harm. An argument often heard for limiting executive compensation is that it drove the financial crisis, which clearly harmed all of us. The best that can be said is that the evidence is mixed. The most compelling evidence is probably that presented by Rüdiger Fahlenbrach and René Stulz, who conclude from their empirical investigation that "there is no evidence that banks with CEOs whose incentives were better aligned with the interests of their shareholders performed better during the crisis and some evidence that these banks actually performed worse". Professors Fahlenbrach and Stulz also go on to demonstrate that bank CEOs, particularly those of failing institutions, suffered extremely large wealth losses. Of course, the interests of shareholders may not coincide with those of the general public.

In the presence of a government guarantee (implicit or explicit), the interests of both shareholders and management may be to "bet the farm". Given the widespread government guarantees of risk-taking in the financial sector, perverse pay schemes are to be expected. Which, then, is the more important driver here? The moral hazard created by government guarantees or the perverse incentive schemes that result? Limiting compensation schemes in exchange for an explicit guarantee is one thing; limiting them when there is no guarantee is quite different. Eliminating these government guarantees should be the preferred approach, rather than creating intrusive regulatory schemes that seek to control moral hazard, especially when those regulatory schemes have at best a mixed record, if not one of outright failure.

One possibility is that executive compensation arrangements do represent harm to a company's shareholders, given that such arrangements are negotiated between management and the board of directors. The massive literature on the separation of ownership and control need not be repeated here. It is sufficient to say that this possibility has merit. In this case, however, excess compensation, if truly present, is a symptom rather than the disease—and it would be more effective to address the disease. For instance, considerably more could be done to improve the market for corporate control. Eliminating the many obstacles, often pushed by government at the urging of management, to contesting the control of a company would be more effective than just targeting compensation. Subjecting management to a greater possibility of hostile takeovers, for one, would do much to realign the incentives of management with shareholders.

While I do not believe that a price being viewed as "excess" constitutes legitimate grounds, on its own, for government intervention, it is worth asking if, in general, the executive compensation of American publicly traded companies is indeed "excess". Recent growth in pay could simply reflect the efficient outcome of market processes. Carola Frydman and Raven Saks, for example, compare compensation growth with the growth in the stockmarket, based upon S&P companies. Their results show that since the 1970s, growth in pay has closely followed that of the stockmarket. Growth in pay has also tracked growth in firm size. As companies have become larger, and thus more complex and difficult to run, pay has increased accordingly. Given that larger firms can have significant, if not systemic, impacts on the economy if they are mismanaged (think Fannie Mae or GM), then paying considerably more for qualified management would seem common sense.

We should also be wary of the unintended consequences of government directing the executive compensation process. When Congress passed, and President Bill Clinton signed, a bill limiting the tax deductibility of compensation to $1m, except for performance-based pay, it helped shifted compensation towards options-based pay. Congress went so far, in the case of Fannie Mae and Freddie Mac, as to require, in statute, that their executive officers be paid a substantial portion of their pay based upon the "performance" of the companies. The track record of politicians in the area of executive compensation is hardly a good one. This should not be surprising, as the optimal compensation scheme is probably unknowable *ex ante*, and can be derived only by trial and error, a process generally unsuited for government.

A recurring reaction by politicians to the recent financial crisis has been to deflect attention away from the actual drivers of the crisis and instead focus on convenient targets. Executive compensation is just another example of that distraction. Given how badly politicians and bureaucrats have mismanaged our financial system—not to mention our fiscal situation—they are the last ones who should be tinkering with executive compensation.