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A Tax Response to the Executive Pay Problem

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A TAX RESPONSE TO THE EXECUTIVE PAY PROBLEM

Boston University School of Law Working Paper No. 11-50
(October 14, 2011)

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David I. Walker *

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TABLE OF CONTENTS

I.	INTRODUCTION	3
II.	THE EXECUTIVE PAY PROBLEM	5
	A. The Magnitude of U.S. Executive Pay and the Increase over Time	5
	B. Explaining Excessive Executive Pay	7
	C. The Negative Consequences of Excessive Executive Pay	10
	1. Who Bears the Cost of Excessive Executive Compensation?.....	11
	a. Corporate Income Tax Incidence: Theory and Evidence.....	11
	b. Is the Corporate Tax Incidence Analogy Sound?	13
	2. Effect of Excessive Executive Pay on Corporate Investment	15
	3. Infection of Other Executive Labor Markets	16
	4. Impact on Growing Inequality of Wealth	16
	5. Distortion in Executive Labor Markets	19
III.	A TAX RESPONSE TO THE EXECUTIVE PAY PROBLEM: A SURTAX	20
	A. An Overview of an Executive Pay Surtax and its Benefits.....	20
	B. The Impact of a Surtax on Executive and Corporate Behavior.....	23
	1. Executive Labor Supply and Income Elasticity	24
	2. Incidence and Economic Effect of an Executive Compensation Surtax	26
	a. Incidence	27
	b. The Economic Impact of Surtax Gross Ups.....	30
	3. The Creation of an Executive Pay Target or Focal Point.....	32
	4. Avoidance and Other Responses.....	33
	a. Compensation Design from a “Global” Contracting Perspective	33
	i. ISOs versus NQSOs.....	34
	ii. Other Equity Based Pay and Deferred Compensation	36
	iii. Non-Taxed Perquisites.....	39
	b. Organizational Form	41
	c. Career Decisions	43
IV.	A TAX RESPONSE TO THE EXECUTIVE PAY PROBLEM: INVESTOR TAX RELIEF.....	44
	A. Why Investor Tax Relief?	44
	B. Investor Tax Relief Design Issues.....	45
	1. Matching the Effect and Incidence of Pay Excesses	46
	2. Protection against Surtax Gross Ups	47
	3. Salience and Persistence	48

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A Tax Response to the Executive Pay Problem

4. Other Issues	49
V. REGULATORY ALTERNATIVES	50
A. Coercive Regulation.....	51
1. What Coercive Regulation Might Look Like.....	51
2. Pros and Cons of Coercive Regulation (Relative to Tax)	53
3. The Inefficiency of Coercive Regulation More Generally (Relative to Tax).....	53
B. Enhanced Disclosure.....	57
C. Amend I.R.C. § 162(m)	57
VI. CONCLUSION	59

I. INTRODUCTION

Many observers believe that the executive labor market in the U.S. functions poorly.¹ At many public companies, senior executives exert excessive influence over the pay-setting process, and the outside directors who are charged with negotiating pay arrangements on behalf of shareholders lack the tools and incentives to bargain effectively.² Given the interconnectedness of the market, even well-governed firms must augment pay in order to attract and retain talented executives.³ The result, under this view, is systematic market failure with executives receiving more compensation across the board than they would in a well-functioning market.⁴

This Article accepts the premise of market failure and considers potential regulatory responses. To the extent that commentators have focused on regulatory responses to date, their proposals generally have been aimed at improving the pay-setting process by, for example, increasing board independence or giving shareholders greater influence over the process.⁵ These are admirable goals, but this Article takes a more direct tack. After all, despite improvements in board composition and processes and in the transparency of executive pay disclosures, there has been no apparent slackening in the growth of executive pay.

This Article focuses specifically on the issue of excessive pay levels that result from deficiencies in the executive labor market.⁶ Excessive compensation is objectionable on several grounds. First, and most obviously, it strikes many as unfair that executives receive more compensation than they would in a well-functioning

¹ Lucian Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002); GRAEF S. CRYSTAL, IN SEARCH OF EXCESS (Norton 1991); Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. OF ECON. POL'Y 2, 283 (2005); Lucian Bebchuk, Yaniv Grinstein & Urs Peyer, *Lucky CEOs and Lucky Directors*, 65 J. FIN. 2363 (2009); Lucian Bebchuk & Robert Jackson, *Executive Pensions*, 30 J. CORP. L. 823 (2005); Marianne Bertrand & Sendhil Mullainathan, *Agents With and Without Principals*, AM. ECON. REV., May 2000, at 203 [hereinafter, *Agents*]; Marianne Bertrand & Sendhil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are*, 116 Q. J. ECON. 901 (2001) [hereinafter, *CEOs*].

² Bebchuk et al., *supra* note X, at 766-74; Bebchuk & Grinstein, *supra* note X, at 300-02; Bebchuk, Grinstein & Peyer, *supra* note X, at 2373-82; Bertrand & Mullainathan, *Agents*, *supra* note X, at 208.

³ Bebchuk et al., *supra* note X, at 840-42; Bertrand & Mullainathan, *CEOs*, *supra* note X, at 916, 929.

⁴ Bebchuk et al., *supra* note X; Bertrand & Mullainathan, *CEOs*, *supra* note X.

⁵ Lucian Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43 (2003); Ran Duchin et al., *When Are Outside Directors Effective?*, 96 J. FIN. ECON. 195 (2010); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 873 (1991); Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283 (1998); Randall S. Thomas, *Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information*, 38 ARIZ. L. REV. 331 (1996); Robert C. Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too* (Harvard John M. Olin Discussion Paper Series, Paper No. 525, 2005), available at http://www.law.harvard.edu/programs/olin_center/papers/pdf/Clark_525.pdf.

⁶ Other commentators have focused on the impact of executive labor market deficiencies on compensation design. Bebchuk et al., *supra* note X, at 786-91 (arguing that executive compensation is structured to camouflage pay and limit outrage); Bebchuk & Jackson, *supra* note X, at 831.

market, and it is likely that excessive executive pay has contributed in a significant way to the growing inequality of wealth in this country.⁷ Second, from an efficiency perspective, one can think of excessive executive pay as an economic tax on investment in the corporate sector that inefficiently distorts capital allocation.⁸

Recognizing the existence of a problem and coming up with an effective solution are two different matters, however. Most commentators have shied away from the idea of capping executive pay, and for good reason: Regulators do not have sufficient information to effectively cap executive pay without creating massive inefficiencies.⁹ On the other hand, this Article argues that taxation might be a valuable tool for mitigating the adverse effects of excessive executive pay.

This Article proposes and analyzes a two-pronged tax response to the problem of excessive executive pay – the imposition of a surtax on executive pay in excess of a threshold combined with investor tax relief. If we assume that a surtax would have no impact on behavior, the imposition of a surtax would reduce the after-tax income of executives, which would directly respond to the unfairness of excessive pay and the effect of excessive pay on inequality of resources. Investor tax relief would tend to reverse the inefficient distortion in capital allocation that results from excessive pay.

It would be a mistake, of course, to blindly assume that a surtax would have no impact on behavior, but this Article argues that distortions created by a surtax are likely to be minor. Evidence on the elasticity of executive labor supply and taxable income suggests that a modest surtax on executive pay would have little impact on hours worked or on taxable income. By these measures, an executive pay surtax would be a relatively non-distorting and efficient tax. However, experience with other tax penalties directed at executive pay – in particular the “golden parachute” tax – suggests that a portion of the surtax might be passed on to investors through increases in pre-tax compensation. Any shifting in incidence would undermine the objectives of the surtax. There are reasons to think that executives’ ability to shift would be limited, and shifting could be mitigated by raising surtax rates, but shifting is a concern with a surtax proposal.

In addition, firms and executives might seek to restructure compensation to blunt the impact of the surtax. It is even possible that some public companies might go private or that private companies would be dissuaded from going public as a result of a surtax that was limited to public company executives. However, this Article argues that none of these concerns would be particularly serious or insurmountable.

Several forms of investor tax relief could effectively mitigate the inefficient distortion of investment that follows from the extraction by executives of excessive compensation. This Article considers both general and firm-specific relief targeted at

⁷ See *supra* note X and accompanying text.

⁸ See *supra* note X and accompanying text.

⁹ See *supra* note X and accompanying text.

the corporate and investor level. Given uncertainty as to who bears the cost of excessive executive pay and a variety of practical concerns, this Article argues that corporate tax relief would be preferable.

Of course, investor tax relief need not necessarily be linked to the imposition of a surtax on executive pay. Either regulatory response could be pursued independently. However, this Article makes the case for a combined approach, principally because of the risk that a portion of the surtax could be passed on to investors. “Refunding” the surtax proceeds to investors would ensure that distortions in investment were mitigated, and not exacerbated, by the imposition of a surtax.

The remainder of this Article is organized as follows. Part II describes a conception of the executive pay problem that motivates the regulatory responses that follow and provides a basis for their evaluation. This Part clearly lays out the negative consequences of excessive executive pay as well as the factors that purportedly result in market failure. Part III considers the first prong of a tax response – a surtax on executive pay – showing how a surtax would respond to the concerns associated with excessive compensation and demonstrating that the distortions created by a surtax would be minimal and manageable. Part IV takes up the investor tax relief prong of the proposal and is concerned primarily with the tradeoffs involved in designing investor relief.

Part V considers regulatory alternatives, with a particular focus on coercive regulation, such as pay caps. A considerable advantage of coercive regulation over the two-pronged tax response is that a pay cap is more difficult to avoid. However, the potential downsides of one-size-fits-all coercive regulation are simply too great for this approach to be seriously considered. The superiority of a combination of a surtax and investor tax relief as a regulatory response to the executive pay problem is reiterated in Part VI, which concludes the Article. In addition, this Part suggests that the arguments made in favor of a surtax could also be used to bolster the case for a very different regulatory reform that would not be addressed specifically at the executive pay problem, that is, increasing tax rates at the high end of the income distribution generally.

II. THE EXECUTIVE PAY PROBLEM

A. The Magnitude of U.S. Executive Pay and the Increase over Time

Executive compensation in the U.S. is high in both relative and absolute terms, is economically significant, and has increased markedly during the last several decades. According to a recent report, the median value of 2010 CEO compensation at the 350 largest U.S. public companies was \$9.3 million, an increase of over 10% from the

temporarily reduced pay levels seen during the financial crisis.¹⁰ Public company CEO pay has increased in *real terms* by 500% or more over the last 30 years.¹¹

The growth of executive pay can also be seen in the growing disparity between top executive pay and the compensation of rank and file workers.¹² In 1980, the ratio of average CEO pay to average rank and file worker pay was 42 to 1. By 1990, that ratio had increased to 100 to 1. At the peak of the dot-com bubble in 2000, the ratio exceeded 500 to 1. The ratio declined as executive pay moderated during the financial crisis, but even in 2009 it continued to exceed 250 to 1. The compensation of other senior executives has also risen dramatically over this period, much more substantially than the pay of rank and file workers, although not as dramatically as CEO pay.¹³

Executive pay is economically significant. U.S. public companies are required to disclose in their annual proxy statements compensation data for their “top five” executives, currently defined as the CEO, CFO, and three most highly compensated executives other than the CEO and CFO. S&P’s Execucomp database collects this data for executives at over 2000 public companies.¹⁴ For 2008, aggregate executive compensation for roughly 10,000 Execucomp executives totaled \$25 billion, an average of about \$2.5 million per top executive.¹⁵

Lucian Bebchuk and Yaniv Grinstein collected similar data for Execucomp listed executives over the 1993 to 2003 period, and they also estimated pay for U.S. public companies with market capitalization in excess of \$50 million that were not listed on Execucomp.¹⁶ For the entire period, they estimated that top executive pay constituted

¹⁰ Joann S. Lublin, *CEO Pay in 2010 Jumped 11%*, WALL ST. J., May 9, 2011, at B1 (reporting data compiled by the Hay Group). Average pay for this group of CEOs was \$10.6 million. Hay Group, *The Wall Street Journal/Hay Group Survey of CEO Compensation*, WALL ST. J., May 8, 2011, <http://graphicsweb.wsj.com/php/CEOPAY11.html>. See also Pradnya Joshi, *We Knew They Got Raises. But This?*, N.Y. TIMES, July 3, 2011, at BU1 (reporting on data from Equilar indicating that median 2010 pay for CEOs of 200 large public companies was \$10.8 million). CEO compensation is highly correlated with firm size. Kevin J. Murphy, *Executive Compensation*, in HANDBOOK OF LABOR ECONOMICS 2485, 2493 (Orley Ashenfelter ed., Elsevier 1999). Thus, it is not surprising that median pay for the largest 200 companies would be significantly greater than median pay for the 350 largest companies.

¹¹ Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much*, 123 Q. J. ECON. 49, 51 (2008) (finding a 500% increase); Carola Frydman & Raven E. Saks, *Executive Compensation: A New View from a Long-Run Perspective, 1936-2005*, 23 REV. FIN. STUD. 2099, 2107 (2010) (finding an increase of over 500%).

¹² The following pay ratio data was retrieved from the AFL-CIO website. Executive Pay Watch: Trends in CEO Pay, <http://www.aflcio.org/corporatewatch/paywatch/pay/index.cfm> (last visited Aug. 1, 2011).

¹³ Carola Frydman & Dirk Jenter, *CEO Compensation*, 2 ANN. REV. FIN. ECON. 75, 77-80 (2010).

¹⁴ The Execucomp universe includes current and former members of the S&P 1500.

¹⁵ All the data reported herein are based on the Execucomp variable TDC1. TDC1 is a grant date measure of executive pay and includes salary, bonus payments, long term incentive payouts, perks, and the grant date value of stock options and restricted stock. Execucomp also includes a rough measure of realized compensation, coded as TDC2. TDC2 replaces grant date option values with realized option values. For this group of executives, aggregate compensation as measured by TDC2 for 2008 was \$28.4 billion.

¹⁶ Bebchuk & Grinstein, *supra* note X.

6.6% of the aggregate earnings of these companies.¹⁷ More importantly, however, they showed that this fraction was increasing over time. Between 1993 and 1995, top executive pay absorbed only about 5% of earnings. Between 2001 and 2003, the fraction of earnings devoted to top executive pay had increased to almost 10%.¹⁸

Bebchuk and Grinstein estimated that top executive pay at non-Execucomp firms with market capitalization in excess of \$50 million was, in aggregate, about two-thirds of executive pay reported in Execucomp.¹⁹ Assuming that this relationship still holds, a ballpark estimate for 2008 top executive pay for U.S. public companies with market capitalization in excess of \$50 million would be about \$40 billion.²⁰ Note, moreover, that these figures include only the top five executives at each company. There are likely to be more than five “senior” executives at many large, public companies, and thus this figure likely understates the aggregate amount of senior executive pay. Also, bear in mind that these figures represent annual flows to company executives, not one-time transfers.

Obviously, public company executives would receive considerable compensation in a well-functioning managerial labor market. Reciting the current levels of and growth in executive pay does not establish the degree of excessive compensation or even the fact of excessive compensation, but rather provides a base against which one’s perception of excess may be gauged.

B. Explaining Excessive Executive Pay

This Article is predicated on an assumption of market failure in the public company executive pay setting process. Its aim is to consider regulatory responses – in particular, a tax response – given that assumption. This Article is not intended to reopen the debate concerning the efficiency of this market,²¹ but in order to evaluate potential responses, it is necessary to understand in what ways the executive labor market may be deficient. This section will briefly review the efficient (sometimes called “optimal”) contracting view of the process and the managerial power view described by Lucian Bebchuk, Jesse Fried, and myself.²² Of course, one may conclude that the executive labor market is less than fully efficient, but that the managerial power view is not an adequate description. In such a case, some of the

¹⁷ *Id.* at 297.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ \$25 billion aggregate compensation for Execucomp executives plus 2/3 x \$25 billion = \$41.7 billion. Bebchuk and Grinstein’s data are reported in 2002 dollars. The \$50 million cutoff would be somewhat higher in 2008 dollars.

²¹ For an overview of the debate, see Symposium, *Management and Control of the Modern Business Corporation*, 69 CHI. L. REV. 729 (2002); John E. Core, Wayne R. Guay & Randall S. Thomas, *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142 (reviewing LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004)).

²² Bebchuk et al., *supra* note X.

analyses and prescriptions that follow might require modification. For the bulk of the analysis, however, the critical assumption is market failure, not the descriptive accuracy of a particular model of market failure.

The traditional conception of the executive pay setting process is the optimal contracting view first set forth by Michael Jensen and William Meckling.²³ Under their model, a board of directors that cannot perfectly observe the effort, focus, and effectiveness of its agent (the CEO) negotiates a contract that minimizes agency costs, which include the costs of 1) monitoring the executive, 2) bonding by the executive to maximize shareholder value, and 3) the residual divergence between the actions selected by the executive and share value maximizing actions.²⁴ Most of the theoretical and empirical literature on executive pay proceeds from the assumption that these arrangements are selected to minimize agency costs and maximize shareholder value.

However, many observed features of the executive pay landscape appear to be inconsistent with the share value maximizing, or optimal contracting, model of the executive pay process.²⁵ An alternative, managerial power view of the executive pay setting process posits that the outside directors who are charged with negotiating executive pay lack the proper incentives and tools to bargain effectively and that their independence is undermined by executive influence over the board and as well as by board dynamics that discourage dissent.²⁶ Under this view, executive pay is not simply a tool to combat agency costs; it is a product of the agency problem.²⁷ The managerial power view does not suggest that there are no constraints on executive pay. Under this view, the threat or reality of investor and financial press outrage plays an important role in disciplining compensation.

Of course, the managerial power view and the optimal contracting view of the pay setting process may co-exist, providing relatively more or less explanatory power at particular firms.²⁸ Moreover, under both theories there is an overriding cap on managerial value extraction that is determined by external market forces – markets for corporate control, capital, products, and even the managerial labor market. However,

²³ Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

²⁴ *Id.* Some degree of agency cost is unavoidable in the modern, widely-held corporation.

²⁵ BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note X; Bebchuk et al., *supra* note X; Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP., Summer 2003, at 71; Bebchuk & Grinstein, *supra* note X; Core, Guay & Thomas, *supra* note X; Frydman & Jenter, *supra* note X, at 89-94.

²⁶ Bebchuk et al., *supra* note X.

²⁷ Bebchuk et al., *supra* note X.

²⁸ Bebchuk et al., *supra* note X. A third view characterizes the compensation setting process as a team production problem in which the board serves as a mediating hierarch between competing stakeholders – the executives, employees, creditors, and shareholders – who make firm-specific investments in the company. This theory predicts that compensation arrangements would not be designed to maximize shareholder value, but to balance the interests of the stakeholders. See Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

A Tax Response to the Executive Pay Problem

proponents of the managerial power view argue that these external market forces permit considerable slack, leaving one to question the extent to which such forces actually limit executive rent extraction.²⁹

The managerial power view of the executive pay setting process suggests two major sources of inefficiency. The focus of much of the literature is on the distortions in compensation design that follow from an outrage constraint and the attendant costs.³⁰ Under the managerial power view, transparency and salience of pay are critical. If all channels of compensation were perfectly transparent and equally salient to investors, compensation design would be irrelevant under this model. Outrage would simply be a function of total appropriation, and, although total pay would remain excessive, firms would select compensation elements so as to minimize agency costs and maximize shareholder value. But appropriation is not transparent. Managers may be able to increase their pay by camouflaging compensation and avoiding outrage. Doing so, however, results in compensation choices that are not share value maximizing.³¹

This Article is focused on a second source of inefficiency. This inefficiency, which is more fully described in section C below, arises from the transfer to executives of excessive compensation and the distortions in investment behavior that result. In all likelihood, there is both a systematic and a firm-specific element to excessive compensation. Managers, boards, and negotiating processes are heterogeneous. Some boards may negotiate effectively with respect to executive pay. Importantly, however, as long as executives receive excessive pay at a substantial number of companies, pay levels will be systematically higher.

The reason is that companies do not set pay levels in a vacuum. Guided by compensation consultants whose primary role is to collect and summarize executive pay data, companies set compensation based on the pay practices of their peers, a process known as “benchmarking.”³² As a result, lax pay practices at some firms tend to drive up executive pay levels generally. The problem is made worse by the Lake Wobegon effect.³³ Because no board believes (or is willing to publicly admit) that its executives are below average, firms generally seek to pay their executives at or above

²⁹ Bebchuk et al., *supra* note X. For example, it seems quite clear that given the defensive mechanisms available to target management, the hostile takeover market would provide little disciplinary force on senior executive pay. See Henry G. Manne, *Bring Back the Hostile Takeover*, WALL ST. J., June 26, 2002, at A18.

³⁰ BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note X, at 64-66; Bebchuk & Fried, *Agency Problem*, *supra* note X, at 75-76; Bebchuk et al., *supra* note X, at 786-88; Bebchuk & Grinstein, *supra* note X, at 300-01; Core, Guay & Thomas, *supra* note X.

³¹ Bebchuk et al., *supra* note X.

³² See Bizjak et al., *Does the Use of Peer Groups Contribute to Higher Pay and Less Efficient Compensation?*, 90 J. FIN. ECON. 152 (2008).

³³ Lake Wobegon, of course, is radio personality Garrison Keillor’s mythical Minnesota community where “all the children are above average.” See <http://prairiehome.publicradio.org/>.

the 50th percentile of peer executive compensation.³⁴ This practice of benchmarking with targets at or above the 50th percentile leads to upward ratcheting in executive pay.³⁵ Perversely, the upward ratcheting problem may have been exacerbated by enhanced executive compensation disclosure requirements promulgated by the SEC over the last twenty years. Evidence suggests that enhanced disclosure may have done more to increase below average elements of pay at lagging firms than to reduce above average elements at “leading” firms.³⁶ The result, as my colleague Fred Tung recently suggested to me, is “market failure with an arms race.”

In sum, the managerial power view posits that executives extract rents as a result of inadequate bargaining by outside directors and slack in the capital, products, and corporate control markets. The effect of excessive compensation is felt even at well-governed firms given the prevalence of benchmarking, and the impact is exacerbated by enhanced disclosure and upward ratcheting. Nonetheless, despite benchmarking and ratcheting, there is heterogeneity in executive pay. Of course it is difficult to pinpoint the degree of excess compensation in any particular case, but some executive pay packages appear clearly excessive even as a relative matter.³⁷

C. The Negative Consequences of Excessive Executive Pay

As noted in the previous section, the managerial power view predicts that compensation design will be distorted as managers seek to minimize outrage and maximize their pay. Such distortions are obviously inefficient. This section addresses another set of inefficiencies that relate more directly to the increased transfer of value from companies to executives that results from market failure. It begins by

³⁴ Bizjak et al., *supra* note X, at 153 (finding that the vast majority of S&P 500 firms sampled “target[ed] pay levels at or above the 50th percentile of the peer group”). In addition, companies often select peer groups with an eye towards justifying high executive pay levels. See Michael Faulkender & Jun Yang, *Inside the Black Box: The Role and Composition of Compensation Peer Groups*, 96 J. FIN. ECON. 257, 259 (2010); John Bizjak et al., *Are All CEOs Above Average? An Empirical Analysis of Compensation Peer Groups and Pay Design*, 100 J. FIN. ECON. 538 (2011).

³⁵ Bizjak et al., *supra* note X, at 155.

³⁶ For example, Grinstein, Weinbaum, and Yehuda find that after enhanced disclosure requirements for perks, firms that provided a low level of perks compared with their peers increased perks in the second year after enhanced disclosure was mandated, while firms that provided a relatively high level of perks did not reduce them. The authors provide additional evidence suggesting that the increase in perks by formerly low-perk firms reflected actual ratcheting rather than simply increased disclosure. Yaniv Grinstein et al., *The Economic Consequences of Perk Disclosure* (Johnson Sch. Res. Paper Series, No. 06-2011, 2011), available at <http://ssrn.com/abstract=1108707>.

³⁷ Outliers exist at both the high and low ends of the executive pay spectrum. See, e.g., Gretchen Morgenson, *The Best and the Worst in Executive Pay*, N.Y. TIMES, Sep. 17, 2006, § 3, at 1; Daniel Costello, *The Drought Is Over (at Least for C.E.O.'s)*, N.Y. TIMES, Apr. 10, 2011, at BU1 (describing excessive CEO pay packages in 2010, including Viacom CEO Philippe Dauman who made \$84.5 million for nine months of work); Sophia J.W. Hamm et al., *One Dollar CEO Salaries: An Empirical Examination of the Determinants and Consequences* (Apr. 25, 2011) (unpublished manuscript, available at <http://ssrn.com/abstract=1796403>) (examining CEOs who receive \$1/year salaries, finding that a subset are not compensated through other means, and finding positive market reaction in this subset of cases).

considering who bears the cost of this transfer. It follows by examining the effect of this transfer on investment in the corporate sector, on executive labor markets outside the public company context, and on the growing inequality of wealth in the U.S.

1. Who Bears the Cost of Excessive Executive Compensation?

Corporate governance experts assume, explicitly or implicitly, that excessive executive pay comes at the expense of shareholders who bear residual corporate gains or losses.³⁸ Certainly this is true in the first instance. But the question is whether the burden is shifted as shareholders respond to reduced returns in the corporate sector. As I discuss at greater length elsewhere,³⁹ the assumption that shareholders bear the burden over both the short and the long term seems reasonable to the extent that executive pay is high at a particular company because of a particularly strong executive or a particularly ineffective board. It would be difficult for shareholders to pass on the cost of excessive pay in that situation to consumers or labor.

But it is less obvious that shareholders bear the long-term cost of executive pay that is higher across the board than it would be if the optimal contracting model provided a complete picture of pay practices. Systematically higher pay that results from lax governance at some firms, comparative benchmarking, and an executive labor pool that is infected by these practices might be analogized to a corporate level income tax. Like an actual tax, the economic tax created by systematically excessive pay reduces net shareholder returns, which may have an effect on the allocation of capital. If the analogy is sound, one might look to the extensive literature on the incidence of the corporate income tax for clues as to whether, or how, the cost of systematically excessive pay might be shifted.

Unfortunately, both the theoretical and empirical literatures on the incidence of the corporate income tax are inconclusive. Nonetheless, this literature suggests that it would be a mistake to assume that shareholders bear the entire long-term cost of an increase in the corporate tax rate and, if the analogy is sound, of a systematic increase in excessive executive pay.

a. Corporate Income Tax Incidence: Theory and Evidence

Early theoretical work on the incidence of the corporate income tax employed a closed economy general equilibrium model that included two sectors – corporate and non-corporate – and two factors of production – labor and capital.⁴⁰ The result under this model is that the incidence of a corporate tax, and, by extension, the incidence of systematically excessive executive pay falls not solely on shareholders but on all

³⁸ *E.g.*, Bebchuk et al., *supra* note X, at 785.

³⁹ David I. Walker, *Who Bears the Cost of Excessive Executive Compensation?* (June 23, 2011) (unpublished manuscript, on file with author).

⁴⁰ Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL. ECON. 215 (1962).

holders of capital in the economy.⁴¹ Joel Slemrod and Jon Bakija explain the model by analogizing to the imposition of a toll on one of two parallel highways.⁴² At first, those who drive on the road with the new toll bear the entire cost. However, over time, drivers abandon the toll road for the non-tolled road, which increases congestion and the cost of using the non-tolled road and reduces the congestion and cost of using the tolled road. In equilibrium, the total cost of driving on the toll and non-toll roads must be the same. Similarly, when a tax is imposed on investors in one sector of the economy, reducing returns to that sector, capital will shift into the non-taxed sector, depressing returns in that sector and increasing returns in the taxed sector, until after-tax returns equilibrate.⁴³

This model of corporate tax incidence is quite elegant but its assumption of a closed economy and fixed factors of production is unrealistic. Most of the theoretical work in recent years has been focused on exploring the incidence question under more realistic, open economy assumptions.⁴⁴ Under these models, if one assumes that capital is perfectly mobile internationally and that domestic and foreign traded goods are perfect substitutes, the incidence of an increase in the corporate tax, and by analogy of a systematic increase in excessive executive pay, falls primarily on the immobile factor of production – domestic labor.⁴⁵ The idea is that wages are based on the productivity of labor, which is a function of invested capital. So if capital moves abroad, foreign workers are better off, but domestic workers suffer.

However, incidence under these models is highly dependent on one's assumptions. If foreign and domestic traded goods are not perfect substitutes, the open economy model begins to look like the closed economy model and capital is predicted to bear the bulk of the burden rather than labor.⁴⁶

To complicate the theoretical incidence analysis further, Alan Auerbach has suggested several reasons that shareholders might be unable to shift the burden of a corporate tax under any of these models.⁴⁷ For example, to the extent that the

⁴¹ *Id.*

⁴² JOEL SLEMROD & JON BAKIJA, *TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES* 79-80 (4th ed. 2008).

⁴³ One may ask why workers bear none of the burden under the closed economy model. The answer, in a nutshell, is that the model assumes that workers receive pay equal to the marginal product of their labor and that the marginal product is a function of the amount of capital invested in the economy. Under this model, the total amount of capital invested in the economy is fixed and thus total returns to labor are fixed. See Harberger, *supra* note X, at 216.

⁴⁴ Alan J. Auerbach, *Who Bears the Corporate Tax? A Review of What We Know*, in 20 *TAX POL'Y AND THE ECON.* 1 (James M. Poterba ed., 2006); Jane G. Gravelle & Kent A. Smetters, *Does the Open Economy Assumption Really Mean That Labor Bears the Burden of a Capital Income Tax?*, *ADVANCES IN ECON. ANALYSIS & POL'Y*, 2006 Issue 1, art. 3; William C. Randolph, *International Burdens of the Corporate Income Tax* (Cong. Budget Office, Working Paper No. 9, 2006), available at <http://www.cbo.gov/ftpdocs/75xx/doc7503/2006-09.pdf>.

⁴⁵ Randolph, *supra* note X, at 26.

⁴⁶ Gravelle & Smetters, *supra* note X, at 10-12.

⁴⁷ Auerbach, *supra* note X, at 1.

corporate tax is a tax on economic rents, such as monopoly profits, or on other advantages that are specific to the corporate form, shareholders will not be able to shift the burden of the tax.⁴⁸ As Altshuler, Harris, and Toder suggest, given Auerbach's insights, it is possible that shareholders bear most (or even all) of the long-run costs associated with an increase in the corporate income tax.⁴⁹

Given the indeterminacy of the theoretical literature on corporate tax incidence, several economists have attempted to get at the question from an empirical angle. Most have found that an increase in corporate tax rates burdens labor, at least to some extent.⁵⁰ Unfortunately, empirical work in this area is also subject to criticism, and no economist that I am aware of considers the matter settled.

b. Is the Corporate Tax Incidence Analogy Sound?

Setting aside the indeterminacy of the theoretical and empirical results for a moment, we must consider whether the analogy between corporate tax incidence and the incidence of systematically excessive executive pay is reasonably sound. Consideration of the various underlying assumptions suggests that it is. An important assumption in maintaining the analogy between the corporate income tax and systematically excessive executive pay under the closed economy model is that the executive pay excesses do not infect the entire economy. In other words, it is important that investors be able to avoid an increase in executive pay by shifting capital to other sectors. This seems to be a reasonable assumption. There would seem to be numerous domestic investment sectors, such as real estate, that would not be tainted by excessive executive pay.

Another important assumption is that markets other than the executive labor market are reasonably efficient. There is little reason to think that market failure in the executive pay setting process results in inefficiencies in the products, capital, or (non-executive) labor markets.⁵¹

Moreover, the analogy between the corporate tax and excessive executive pay appears to remain strong as we move from a closed to an open economy setting. A systematic increase in U.S. executive pay that reduces returns on domestic shares should lead to an exodus of capital that reduces domestic wage rates in equilibrium. The degree to which this will be the case, and the degree to which domestic capital and

⁴⁸ *Id.*, at 25-28.

⁴⁹ Rosanne Altshuler et al., *Capital Income Taxation and Progressivity in a Global Economy*, 30 VA. TAX REV. 355, 361 (2010).

⁵⁰ Mihir A. Desai et al., *Dividend Policy Inside the Multinational Firm*, Fin. Mgmt., Spring 2007, at 5; Kevin A. Hassett & Aparna Mathur, Taxes and Wages, (Mar. 6, 2006) (unpublished manuscript, available at <http://www.aei.org/paper/24063>).

⁵¹ Although senior executives have an obvious interest in maximizing their own compensation, their interest in holding down non-executive labor costs should be similar to the shareholders' interest. . . . Bebhuk et al., *supra* note X, at 774; Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 553-57 (1984).

labor bear the burden, would depend on the substitutability of foreign and domestic traded goods just as it does in the corporate tax incidence analysis.

An open economy model would collapse into a closed economy model if changes in systematically excessive U.S. executive pay were matched abroad,⁵² but despite the fact that executives are more mobile internationally than rank and file workers, cross-country differences in executive compensation suggest that there is not a global executive labor market. Despite signs of growing convergence, cross country comparisons of pay practices suggest that U.S. executive pay remains exceptional, with U.S. executives receiving more compensation than their international peers at comparably sized companies and with U.S. executives receiving a much larger fraction of their compensation in the form of equity.⁵³ These differences do not in themselves confirm that U.S. executive pay is excessive. Some commentators have suggested that because of differences in ownership structure and/or culture, executive talent may be more important to the success or failure of firms in the U.S. than abroad.⁵⁴ Nonetheless, increases or decreases in systematically excessive executive pay in the U.S. are unlikely to be matched overseas.

In sum, setting aside the special cases discussed by Auerbach, the consensus of economists is that the burden of the corporate income tax in an open economy is shifted to a significant degree to non-corporate capital and to labor. But at that point the consensus ends. If the analogy between the corporate income tax and systematically excessive executive pay is sound from an incidence perspective, the incidence of the latter is indeterminate as well. Nonetheless, it is important to recognize that we should not simply assume that corporate shareholders bear the entire long-run cost of systematically excessive executive pay. Some and perhaps most of that cost may be passed on as shareholders shift their capital elsewhere in search of greater returns.

⁵² It is well recognized that the open economy corporate tax incidence models collapse into a closed economy model if all countries raise and lower corporate tax rates together. Matthew H. Jensen & Aparna Mathur, *Corporate Tax Burden on Labor: Theory and Empirical Evidence*, 2011 Tax Notes Today 111-13 (May 10, 2011), at 1083.

⁵³ See Brian J. Hall, *Incentive Strategy II: Executive Compensation and Ownership Structure* 6,7 (Harvard Business School Case Study, 2002) (providing data demonstrating greater total pay and greater equity pay for U.S. executives than for executives of similarly sized firms abroad but arguing that U.S. style pay practices are spreading internationally); Nuno Fernandes et al., *The Pay Divide: (Why) Are U.S. Top Executives Paid More?* (Dec. 17, 2010) (unpublished manuscript, available at <http://ssrn.com/abstract=1341639>) (finding that U.S. executives are paid more than their foreign counterparts and receive more equity pay but concluding that the differences are largely explained by firm, ownership, and board characteristics and by the riskiness of equity-based compensation); Randall S. Thomas, *International Executive Pay: Current Practices and Future Trends* 8 (Vanderbilt Law Sch. Law & Econ. Working Paper No. 26, 2008), available at <http://ssrn.com/abstract=1265122> (demonstrating that non-U.S. executives receive less total compensation and less performance-oriented pay, but also providing evidence of a shift towards U.S. pay practices).

⁵⁴ See Bebchuk et al., *supra* note X, at 842-3; Susan J. Stabile, *My Executive Makes More Than Your Executive: Rationalizing Executive Pay in a Global Economy*, 14 N.Y. INT'L L. REV. 63, 67 n.18 (2001) (citing IRA T. KAY, *CEO PAY AND SHAREHOLDER VALUE: HELPING THE U.S. WIN THE GLOBAL ECONOMIC WAR* 25) (1998).

2. Effect of Excessive Executive Pay on Corporate Investment

The incidence discussion from the previous subsection tells us something about the distribution of the burden of systematically excessive pay extracted by executives. The effect of these transfers on the inequality of wealth in the U.S. is discussed in subsection 4 below. This subsection considers the economic inefficiency that is associated with the transfer of excessive executive pay.

To the extent that shareholders are unable to pass the cost of excess compensation on through reallocation of capital, the result is a pure transfer. For example, if an increase in excessive executive pay reduces monopoly rents, it will not distort investment. Executives will simply capture a greater share of those rents, and investors a smaller share of those rents, than they did previously. However, to the extent that reduced returns on company shares cause shareholders to re-allocate capital elsewhere, excess executive pay acts as a brake on domestic corporate investment. Under the closed economy model, capital shifts out of the corporate sector and into the non-corporate sector. Under the open economy models, capital may shift abroad. Induced solely by excessive executive pay, these distortions are inefficient.

How exactly does this work? In the short run, of course, unexpected increases in excessive pay, say from an exogenous shock that loosens the outrage constraint,⁵⁵ are likely to be borne by existing shareholders. But over the long run, the prospect of excessive pay should be taken into consideration at the initial public offering stage, leading to fewer companies entering the public markets, because of the systematic nature of the excessive pay problem and the difficulty that promoters would have in bonding themselves to not taking an (inflated) market level of compensation. The prospect of excessive executive pay also would make it more expensive to raise money through a secondary stock offering, but secondary offerings are fairly rare occurrences for a variety of reasons.⁵⁶ In sum, to the extent that domestic corporate shareholders reallocate capital and do not bear the entire burden of systematically excessive executive pay, the extraction of that pay acts as an inefficient encumbrance on domestic corporate investment.⁵⁷

⁵⁵ For example, Bebchuk & Grinstein posit that the bull market of the 1990s loosened the outrage constraint which permitted executives to increase their compensation. Bebchuk & Grinstein, *supra* note X, at 300-01.

⁵⁶ Secondary stock offerings are generally thought to suffer from an adverse selection or “lemons” problem. Paul Asquith & David W. Mullins, Jr., *Equity Issues and Offering Dilution*, 15 J. FIN. ECON. 61, 74 (1986); Robyn McLaughlin et al., *The Information Content of Corporate Offerings of Seasoned Securities: An Empirical Analysis*, FIN. MGMT., Summer 1998 at 32-33; see generally George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970). *Contra* E. Han Kim & Amiyatosh Purnanandam, *Corporate Governance and Seasoned Equity Offerings* 5 (Feb. 22, 2011) (unpublished manuscript, available at <http://ssrn.com/abstract=1339642>) (finding no empirical support for adverse selection hypothesis).

⁵⁷ Note that the assumption that investors reallocate capital in response to extraction of excessive executive pay is not inconsistent with the argument that capital markets do not tightly constrain that pay. First, as the models suggest, in the new equilibrium that is established following reallocation,

3. Infection of Other Executive Labor Markets

There is a possible externality associated with excessive public company executive pay. The market failure in the pay setting process at public companies may spill over to private companies and possibly even non-profit organizations. In recent work examining executive compensation at portfolio companies held by private equity investors, Robert Jackson found no statistically significant difference between private and public company executive pay after controlling for firm size and the riskiness of pay packages.⁵⁸ Pay negotiations in the private equity setting should reflect arm's length bargaining,⁵⁹ but Jackson's finding of roughly equivalent pay levels in the two sectors does not rebut the notion that public company executive pay is excessive. It seems likely that private equity portfolio companies compete with public companies for executive talent and that the pool is dominated by the large public companies.⁶⁰ If so, private equity portfolio companies may be price takers and these investors may bear part of the cost of the inefficiency of the public company executive pay market.

4. Impact on Growing Inequality of Wealth

Inequality of wealth in the U.S. has increased markedly in the last several decades. Recent data suggests that growth in executive pay may be a significant contributing factor.

returns to capital in different sectors or markets are equal. Second, U.S. executives and company directors may have some diffuse interest in the amount of capital invested in the domestic corporate sector, but presumably this interest is secondary to other concerns – for the executives, the prospect of additional compensation; for the outside directors, managing outrage.

⁵⁸ Robert J. Jackson, Jr., *Private Equity and Executive Compensation 22-23* (2009) (unpublished manuscript, on file with author).

⁵⁹ Private equity funds are pooled investment vehicles that combine the business selection and management expertise of fund managers such as Blackstone, Carlyle, and KKR with passive investments by pension funds, universities, other institutions, and a few high wealth individuals. Steven N. Kaplan & Per Stromberg, *Leveraged Buyouts and Private Equity*, J. ECON. PERSP., Winter 2009, at 123. They acquire “portfolio companies” through engaging in leveraged buyouts of existing public companies or divisions of public companies or through the purchase of portfolio companies held by other private equity funds. *Id.* at 124-28. Private equity funds and the boards they create are active monitors and managers of these portfolio companies. *Id.* at 131-32. As a result, the fund managers should not be disabled by the agency problems that plague public company executive pay processes.

⁶⁰ David I. Walker, *Executive Pay Lessons from Private Equity*, 91 B.U. L. Rev. 1209, 1218 (2011). In addition, the public company and portfolio company pay numbers may not be perfectly comparable. Jackson finds that portfolio company CEO pay often includes a “deal bounty” paid to an incumbent CEO to induce his cooperation in facilitating the private equity buyout. Jackson, *supra* note X, at 48. Absent deal bounties, average portfolio company CEO pay might be lower than public company pay by a statistically significant amount. Walker, *supra*, at 1217.

A Tax Response to the Executive Pay Problem

The share of total U.S. pre-tax income (excluding capital gains) earned by the top 0.1 percent of earners increased from 2% in 1981 to 8% in 2008.⁶¹ During the early 1980s, pre-tax income inequality was only modestly greater in the U.S. than it was in Europe.⁶² Today that difference is dramatic.⁶³ In terms of income inequality, the U.S. now looks more like a developing country, with income inequality similar to that of Cameroon, the Ivory Coast, and Jamaica.⁶⁴ Although income inequality is to some extent a desirable result of a thriving, capitalist economy, at some level inequality becomes a serious policy concern.

Recent data provided by Jon Bakija, Adam Cole, and Bradley Heim suggest that increases in executive pay have contributed substantially to the growth in income inequality. Analyzing individual income tax data, these authors found that executives, managers, supervisors, and financial professionals accounted for about 60% of the top 0.1% of income earners in the U.S. in 2005.⁶⁵ Non-financial sector, i.e., “main street,” executives alone accounted for about 30% of the top 0.1%.⁶⁶ These authors also found that the larger group of executives, managers, supervisors, and financial professionals accounted for about 70% of the increase in the share of national income going to the top 0.1% of the income distribution between 1979 and 2005.⁶⁷

Excessive executive pay may contribute to income inequality from two directions. First, as demonstrated in the following figure, the growth in U.S. income inequality tracks the growth in public company executive pay. Of course, the growth in executive pay over this period does not necessarily result from market failure. This point is contested,⁶⁸ but for the purposes of this Article, I am assuming that at least a

⁶¹ Thomas Piketty & Emmanuel Saez, *Income Inequality in the United States, 1913-1998*, 118 Q. J. ECON. 1 (2003). A longer updated version was published in *TOP INCOMES OVER THE TWENTIETH CENTURY: A CONTRAST BETWEEN EUROPEAN AND ENGLISH-SPEAKING COUNTRIES* (A.B. Atkinson & Thomas Piketty eds., Oxford Univ. Press 2007).

⁶² Jon Bakija et al., *Jobs and Income Growth of Top Earners and Causes of Changing Income Inequality: Evidence from U.S. Tax Return Data* 72 fig.1 (Nov. 2010) (unpublished manuscript, available at

<http://web.williams.edu/Economics/wp/BakijaColeHeimJobsIncomeGrowthTopEarners.pdf>).

⁶³ *Id.*

⁶⁴ CIA – The World Factbook, <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2172rank.html?countryName=Nicaragua&countryCode=nu®ionCode=ca&rank=47> (last visited Aug 16, 2011).

⁶⁵ Bakija et al, *supra* note X, at 3, 51 tbl.3. In 2005, the income threshold for the top 0.1% of income earners (excluding capital gains), was \$1.25 million (in 2007 dollars). *Id.* at 15-16.

⁶⁶ *Id.* at 51 tbl.3. In an earlier study, Steven Kaplan and Joshua Rauh argued that public company executives accounted for too small a fraction of high income earners to explain much of the increase in income inequality. Steven N. Kaplan & Joshua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?*, 23 REV. FIN. STUD. 1004 (2010). However, Kaplan and Rauh were only able to identify the occupations of 17.4% of the top 0.1% of income earners. Bakija, Cole and Heim identify 99% of these individuals. Bakija et al, *supra* note X, at 1.

⁶⁷ Bakija et al, *supra* note X, at 3.

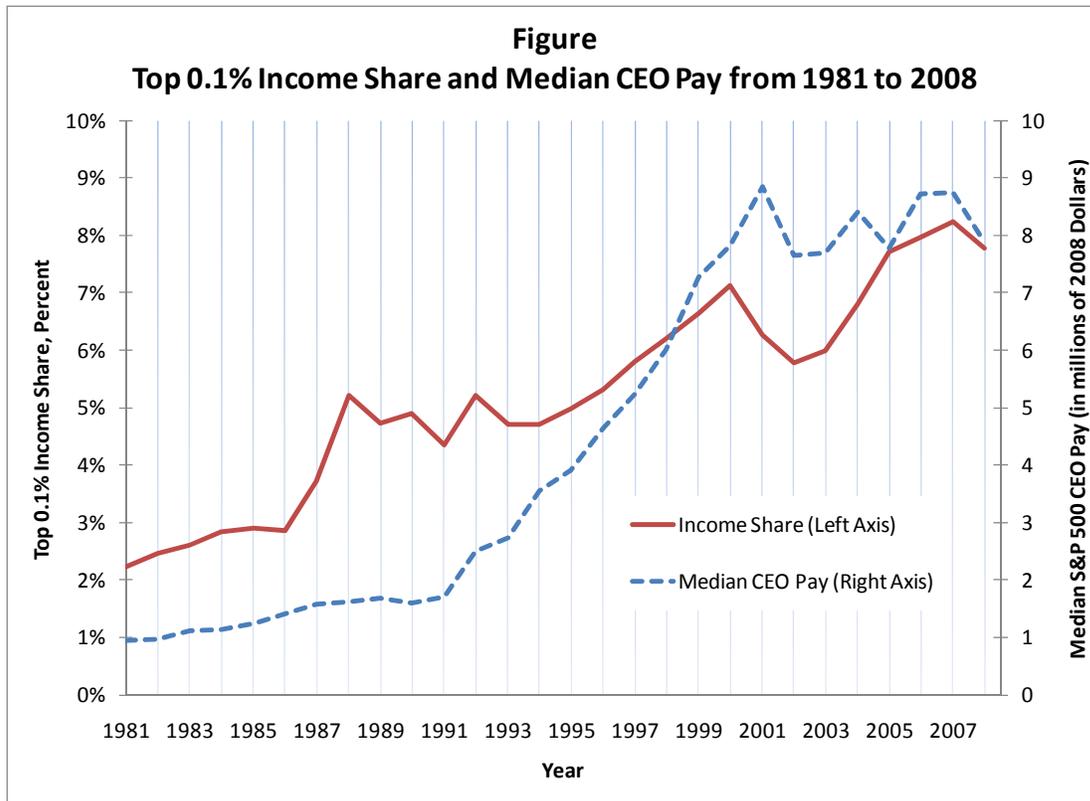
⁶⁸ Gabaix and Landier have proposed a model involving competitive matching of CEO talent and firms. The model predicts that average compensation should move with firm size, and the model explains the increase in pay over time, as well as cross-industry and cross-country pay observations. The authors find very little dispersion in CEO talent at the largest firms, but given the tremendous amount of assets

part of the growth in executive pay reflects market failure. Moreover, as suggested in subsection II.C.3 above, excessive pay in the public company executive labor market may infect the private company executive labor market. Thus, excesses in both markets may contribute to the growing share of income captured by executives.⁶⁹

under management and a multiplier effect, the model can explain large pay differentials. Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?*, 123 Q. J. ECON. 49, 50 (2008). The idea that small differences in talent are consistent with large differences in pay was also explored by Charles P. Himmelberg & R. Glenn Hubbard, *Incentive Pay and the Market for CEOs: An Analysis of Pay-for-Performance Sensitivity* (Mar. 6, 2000) (unpublished manuscript, available at <http://ssrn.com/abstract=236089>).

On the other hand, Bebchuk and Grinstein analyzed increases in executive pay between 1993 and 2003 and concluded that the growth in pay could not be explained by changes in firm size, performance, and industry mix. Taking the managerial power approach, they suggested that the bull market of the 1990s weakened the outrage constraint, allowing boards to increase executive pay, and that the design of equity compensation reduced the salience of this pay, permitting transfers of value that would have been inconceivable if paid in cash. Bebchuk & Grinstein, *supra* note X, at 283. In a similar vein, Murphy and Jensen, Murphy, and Wruck argue that the favorable accounting treatment of options in the 1990s led boards to systematically undervalue this form of compensation. Kevin J. Murphy, *Stock-Based Pay in New Economy Firms*, 34 J. ACCT. & ECON. 129, 143-45 (2003); Michael C. Jensen et al, *Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them* 39 (Harvard Negotiations, Org., and Mkt Unit Research Paper Series No. 04-28, 2004), available at <http://ssrn.com/abstract=561305>

⁶⁹ In the figure that follows, income share data was retrieved from The World Top Incomes Database, maintained by Facundo Alvarado, Tony Atkinson, Thomas Piketty and Emmanuel Saez, available here: <http://g-mond.parisschoolofeconomics.eu/topincomes/>. From 1993 forward, CEO pay data is from S&P's Execucomp database, and reflects median pay of S&P 500 firms, excluding financials and utilities. Data from prior years is taken from Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats*, 113 Q. J. ECON. 653 (1998) (1981-1991 data based on a sample of Forbes 500 companies) and Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. & FIN. 3 (2002) (1992 data for S&P 500 industrial companies). All pay data is inflated to 2008 dollars based on the CPI index.



Second, to the extent that excessive executive pay results in capital shifting abroad, reduced productivity of domestic labor, and reduced wage rates at the low end of the income scale, excessive pay would contribute to the growing inequality of wealth in the U.S. by reducing the denominator of the equation. In other words, excessive executive pay would result not only in the rich getting richer, but in the poor getting poorer, in both a relative and an absolute sense.

5. Distortion in Executive Labor Markets

Before moving on to consider a possible remedy for the excessive executive pay problem, I will briefly mention one other distortion that may result from the market failure. If executive pay is systematically higher than it would be in an efficient labor market, we should expect that the number of candidates for senior executive roles would be greater, as well.⁷⁰ MBAs or other individuals choosing between pursuing a career as an investment banker, lawyer, or corporate executive would tend to be attracted by the rents available to those who succeed in the competition to become senior executives.⁷¹

⁷⁰ Emmanuel Saez, *Direct or Indirect Tax Instruments for Redistribution: Short-Run Versus Long-Run*, 88 J. PUB. ECON. 503, 505 (2004); Cf. Carried Interest, Part II: Hearing Before the S. Comm. on Finance, 110th Cong. 1 (2007) (statement of Joseph Bankman, Professor of Law and Business, Stanford Law School) (arguing that the carried interest subsidy distorts career choice)

⁷¹ For evidence that MBA career choices vary based on market factors, see Paul Oyer, *The Making of an Investment Banker: Stock Market Shocks, Career Choice, and Lifetime Income*, 63 J. FIN. 2601 (2008)

III. A TAX RESPONSE TO THE EXECUTIVE PAY PROBLEM: A SURTAX

The primary aim of this Article is to describe and evaluate a tax response to the problem of excessive executive compensation. The idea is to combine a surtax applied to executive pay above a certain threshold with investor tax relief. The proposal responds to each of the negative consequences of excessive executive pay that were discussed in the previous Part. A surtax placed on excessive pay would reduce the after-tax income of executives, which responds to the unfairness of executives receiving excessive compensation, to the effect of excess executive pay on income inequality, and to the distortion in the executive labor market created by the existence of these rents. Using the proceeds of the surtax to provide investor tax relief would mitigate the inefficient distortion in investment incentives created by the extraction of excess compensation.

The two elements of this proposal – the surtax and investor tax relief – need not necessarily be linked. One could support one and not the other.⁷² Accordingly, this Part makes the case for the surtax, and the argument for providing investor tax relief is deferred until Part IV. However, that Part will argue that there are strong economic and political reasons to link these two elements in this context.

This Part begins by briefly outlining how an executive pay surtax might be designed and by describing why a surtax would help alleviate several of the problems associated with excessive executive pay. The bulk of this Part addresses the effect of a surtax in much greater detail, focusing on potential labor supply distortions, shifting of tax incidence, and avoidance. It concludes that there is reason to be concerned that a surtax might be partially “grossed up” by employers, but that otherwise a surtax would be a relatively efficient, non-distortionary tax.

A. An Overview of an Executive Pay Surtax and its Benefits

As envisioned in this Article, a surtax would be applied to compensation received by an executive within the taxable year in excess of a threshold. The surtax would piggyback on the existing tax treatment of executive pay. Thus, all elements of executive pay that are currently subject to federal income tax would be subject to the surtax, and the amounts subject to the tax would be exactly the same. The surtax would reach salary, annual bonus, long-term incentive plan payouts, the vesting of restricted stock, the exercise of non-qualified stock options, and the receipt of various taxable perks, such as personal use of corporate jets.

(demonstrating a relationship between MBA placement in the investment banking sector and the 2-year return on the S&P 500 as of graduation).

⁷² See *infra* note x [cross reference footnote citing Mirrlees].

The surtax could be set at a fixed percentage of all compensation in excess of a threshold, e.g., a 10% surtax on all compensation received during the year in excess of \$1 million, or the surtax could be graduated to apply higher surtax rates to greater compensation levels.⁷³ The surtax could be based on a single threshold that would be applicable to the executives of all U.S. public companies, or the threshold could be customized based on factors such as firm size. The surtax could be limited to executives of public companies, but, as discussed below, there are arguments in favor of applying the surtax (perhaps at a lower rate) to executives of large private companies and even to executives of non-profit organizations.⁷⁴

The idea behind imposing a surtax on executive pay is to extract a portion of “unearned” compensation. A surtax would be expected to produce revenue that could be redirected, but it would not be intended to change the level or composition of pre-tax executive pay. If the imposition of a surtax did result in downward pressure on executive pay, all the better; although, for reasons explained below, I would not anticipate that result. This section discusses the benefits of imposing a surtax under the assumption that the tax would be borne by the executives and would not distort executive behavior or compensation design. Those assumptions will be considered fully in subsection B below.

If these assumptions hold, the most obvious result of imposing a surtax on executive pay would be to reduce the after-tax compensation of executives subject to the surtax, offsetting to some degree the excessive pre-tax pay that results from the

⁷³ To provide a sense of magnitude, aggregate compensation in excess of \$1 million for each of the top five executives at over 2000 public companies included in S&P’s Execucomp database for 2008 was \$20.2 billion. *See supra* note x and accompanying text for a description of Execucomp coverage. The data reported in this note are based on the Execucomp variable TDC2. TDC2 includes the salary, bonus payments, long term incentive payouts, perks, gains on stock option exercise, and the grant date value of restricted stock. Each element aligns with taxable compensation except for the latter. Restricted stock is taxed on vesting, not grant. Nonetheless, TDC2 provides a reasonable approximation of annual taxable executive compensation.

Twenty billion dollars is a conservative estimate of aggregate annual public company executive pay in excess of \$1 million per executive. The database only includes information for the top five executives at each company. Some executives below this rank at very large companies receive pay above this threshold. In addition, the database only includes data on former and present S&P 1500 firms. Executives at some smaller public companies may receive compensation in excess of \$1 million per year.

Naturally, if we include executives of private companies, the aggregate amount of pay in excess of this threshold would increase further. Bakija, Cole, and Heim estimate that in 2005 there were slightly more private company executives earning more than \$1 million per year than public company executives and that in aggregate these private company executives captured a larger share of national income than the public company executives. Bakija et al, *supra* note X, at 51 tbl.3. Thus, it seems likely that including private company executives would result in a figure for aggregate annual executive pay in excess of \$1 million per executive of at least twice the \$20 billion figure estimated for the top five executives of Execucomp firms.

⁷⁴ *See supra* note X and accompanying text. The existence of multinational firms might create certain administrative challenges. The baseline assumption of this Article is that an executive pay surtax would be limited to citizens and resident aliens who already pay U.S. taxes on their compensation.

deficiencies in the executive labor market. A surtax would respond directly to the unfairness of executives extracting “unearned” compensation, and a surtax would mitigate the effect of executive labor market failure on income inequality. It is assumed that a surtax would not affect pre-tax executive pay, but that is irrelevant. The real concern is equality of *after-tax* income and wealth, not of pre-tax income per se. Thus, from an income equality standpoint, the imposition of a surtax would be equivalent to a reduction in pre-tax pay.

An additional benefit of reducing after-tax executive pay would be to mitigate the distortion in career choices that likely results from excessive executive compensation. The assumption at this point is that a surtax would not affect the behavior of *existing* executives, but that does not mean that it would not affect the behavior of MBA recipients and other individuals who would consider corporate management among a number of potential careers. In all likelihood, a surtax would affect career decisions. Over the long term, it seems reasonable to assume that individuals consider relative after-tax rewards in making career choices.⁷⁵

Another advantage of a surtax (versus, say, a cap on executive pay) is that a surtax would produce a fund that could be used to provide investor tax relief or simply to reduce other distortionary taxes, such as the labor income tax.⁷⁶ Use of those funds is discussed in Part IV.

A surtax applied to executive pay would not be unprecedented. Currently, I.R.C. § 4999 imposes a 20% surtax on “golden parachute” severance payments received by executives that exceed a certain amount.⁷⁷ Of course, an alternative way of providing incentives through the tax code is to limit deductibility at the corporate level. I.R.C. § 162(m) limits the deduction for senior executive pay that is not performance based to \$1 million per executive per year, and § 280G disallows deductions for golden parachute payments that are subject to the § 4999 excise tax.⁷⁸ Commentators

⁷⁵ See *supra* note x [footnote citing Saez, Bankman & Fleischer].

Although the main thrust of the surtax is more redistributive than Pigovian, to the extent that the surtax helps to correct a flaw in the long-term executive labor market it is Pigovian. A Pigovian tax is intended to mitigate harmful externalities by causing actors to internalize these social costs. See ARTHUR CECIL PIGOU, *THE ECONOMICS OF WELFARE* (1920).

⁷⁶ N. Gregory Mankiw, *One Answer to Global Warming: A New Tax*, N.Y. TIMES, Sept. 16, 2007, at BU6 (arguing that revenue generation is one advantage of imposing a carbon tax over increasing fuel efficiency standards). Fullerton and Metcalf explain that revenue generation is not necessarily a benefit to the imposition of regulatory taxes. But if regulation creates scarcity rents it is better that the government capture these rents than that they be left with the regulated parties. Don Fullerton & Gilbert E. Metcalf, *Environmental Taxes and the Double-Dividend Hypothesis: Did You Really Expect Something for Nothing?*, 73 CHI.-KENT L. REV. 221, 232 (1998).

⁷⁷ I.R.C. § 4999(a) (2006).

⁷⁸ I.R.C. §§ 162(m), 280G (2006). Section 280G is discussed at greater length *infra* notes x-y and accompanying text.

generally agree that these tax incentives have not been successful,⁷⁹ and several have argued for their repeal.⁸⁰ However, stand alone repeal of these provisions is politically unthinkable, as repeal would appear to loosen the reins on executive pay. On the other hand, combining repeal of these provisions with the adoption of the surtax envisioned in this Article could be honestly and convincingly portrayed as regulatory reform rather than regulatory relaxation. The repeal of §§ 162(m), 4999, and 280G would be an attractive side benefit if it could be accomplished in conjunction with the imposition of a surtax.⁸¹

B. The Impact of a Surtax on Executive and Corporate Behavior

This section considers the likely effect of a surtax on executive and corporate behavior. To reiterate the point made above, the idea behind an executive pay surtax is redistribution, not behavioral distortion.⁸² If the surtax placed downward pressure on executive pay, that would be a bonus. In my view, a surtax would be deemed successful if it resulted in the extraction of a portion of the rents received by executives without materially affecting short- or medium-term corporate or executive behavior.

The behavioral effects of a surtax can be divided into three categories that will be addressed in turn – labor supply effects, shifting of tax incidence, and avoidance. This section concludes that distortions created by a surtax are likely to be small, quite small relative to the distortions created by coercive regulation of executive pay, an alternative considered in Part V. Putting this in terms of public finance theory,

⁷⁹ Brian J. Hall & Jeffrey B. Liebman, *The Taxation of Executive Compensation*, in 14 TAX POL'Y AND THE ECON. 1, 1-2 (James M. Poterba ed., Nat'l Bureau of Econ. Research 2000); Gregg D. Polsky, *Controlling Executive Compensation through the Tax Code*, 64 WASH. & LEE L. REV. 877, 881 (2007).

⁸⁰ [Wolk, others]

⁸¹ I thank Andrew Lund and Gregg Polsky for this suggestion. Each of the existing tax rules likely results in a burden on shareholders in the first instance and potentially on other suppliers of capital and/or labor if investors readjust their portfolios in response to these taxes. See Joy Sabino Mullane, *Incidence and Accidents: Regulation of Executive Compensation through the Tax Code*, 13 LEWIS & CLARK L. REV. 485 (2009).

⁸² It may be useful to compare the aim and effect of I.R.C § 162(m), which, unlike the surtax considered here, was intended to shape behavior. As noted above § 162(m) limits the deductibility of non-performance based pay received by certain senior executives, and this provision was a response to a perceived market failure that resulted in excessive “safe” compensation. Congress was concerned that executives, who at the time received their compensation mainly in the form of salary and guaranteed bonuses, were acting too conservatively and that their interests were insufficiently aligned with those of shareholders. Section 162(m) was not designed to produce revenue. It was intended to redirect compensation into stock options and other performance based pay, and it had the intended effect. In hindsight, of course, § 162(m) looks like a mistake. The tax rule may have contributed to the boom in stock options that 1) made executives extremely wealthy when the stock market took off in the 1990s, and 2) may have encouraged excessive risk taking in the financial sector that contributed to the 2007-2008 crisis. Hall & Liebman, *supra* note X [Bureaucrats], at 36 (finding that salary reductions post-1993 were more than offset by additional stock option grants); Polsky, *supra* note X, at 917-20 (documenting the widespread belief among informed observers that § 162(m) contributed to the options explosion, but also noting the lack of clear cut empirical evidence).

minimal expected distortion suggests that a surtax on executive pay might be a “good” tax, bearing low efficiency costs.⁸³ The primary concern arising from this analysis is that executive pay might be increased to compensate for the surtax. This “gross up” concern will play a role in thinking about surtax design as well as the optimal use of surtax proceeds in Part IV.

1. Executive Labor Supply and Income Elasticity⁸⁴

A surtax on executive pay would increase the effective marginal tax rate faced by covered executives. For example, at current tax rates, the imposition of a flat 10% surtax would increase the marginal federal rate to 45%, and increase marginal combined federal and state rates to 50% or more. One might be concerned that an increase in marginal tax rates of this magnitude might adversely impact executive labor supply, but economists have concluded that the labor supply elasticity for “prime-age males” is close to zero,⁸⁵ and this finding appears to hold even for high income taxpayers. For example, Moffitt and Wilhelm studied the response of high income males to the tax rate reductions enacted in 1986 and found no evidence that hours worked were affected by the rate cut.⁸⁶

Adjusting hours worked is just one possible response to changes in tax rates. Taxpayers might also respond by shifting the timing or type of income or by engaging in greater or lesser tax avoidance activities. In a seminal 1995 paper, Martin Feldstein argued that all responses to tax reflect deadweight losses, and stressed the importance of looking beyond labor supply effects.⁸⁷ Recent studies embrace this view and investigate the effect of taxes on the elasticity of taxable income (ETI).

High income taxpayers exhibit greater ETI than low or moderate income taxpayers, probably because high income taxpayers have more flexibility to shift the

⁸³ See HARVEY S. ROSEN, *PUBLIC FINANCE* 292 (6th ed. 2002) (explaining that the excess burden or deadweight loss of a tax is a function of the degree of distortion in behavior resulting from substitution away from the taxed factor).

⁸⁴ For a general overview of the evidence concerning labor supply and taxable income elasticity of high income taxpayers, see LOUIS KAPLOW, *THE THEORY OF TAXATION AND PUBLIC ECONOMICS* 80-90 (2008).

⁸⁵ Emmanuel Saez et al., *The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review*, *J. ECON. LITERATURE* (forthcoming 2011) (manuscript at 1, on file with author); Joel Slemrod, *Methodological Issues in Measuring and Interpreting Taxable Income Elasticities*, 51 *NAT’L TAX J.* 773, 774 (1998). These studies focus on male individuals as a proxy for primary wage earners. I would not expect any substantial difference in labor supply or taxable income elasticities between male and female executives.

⁸⁶ Robert A. Moffitt & Mark Wilhelm, *Taxation and the Labor Supply Decisions of the Affluent*, in *DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH* 193, 221 (Joel B. Slemrod ed., 2000). Moffitt and Wilhelm analyzed Survey of Consumer Finances data for male heads of households between 25 and 54 years of age in 1983. The mean AGI for their high MTR (or “rich”) subsample was \$169,000 in 1983 and \$287,115 in 1989, the second panel period. *Id.* at 205-206.

⁸⁷ Martin Feldstein, *The Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1986 Tax Reform Act*, 103 *J. POL. ECON.* 551, 552 (1995). See also Saez et al., *supra* note X, at 1 (noting that “under some assumptions all responses to taxation are symptomatic of deadweight loss”).

timing and composition of their income.⁸⁸ However, studies of executive responsiveness to tax rates have failed to find significant non-transitory ETI.

Austan Goolsbee examined the responsiveness of corporate executives to the increase in marginal tax rates that came into effect in 1993.⁸⁹ Goolsbee found a significant reduction in taxable income, but he found that the reduction was almost entirely attributable to acceleration in the exercise of stock options undertaken to gain advantage of the lower 1992 tax rates. Once he eliminated stock option compensation from his analysis, Goolsbee concluded that corporate executives essentially failed to respond to the Clinton era tax hikes.⁹⁰

Hall and Liebman replicated Goolsbee's analysis, extended it back through the 1980s, and concluded that the timing of option exercise was not explained by changes in marginal tax rates, but by stock market movements.⁹¹ Essentially, they found that executives exercise options following a big run up in stock prices. Nonetheless, on the question of the responsiveness of executives to changes in marginal tax rates, Hall and Liebman's findings were consistent with those of Goolsbee in that their elasticity results "fail[ed] to suggest large permanent effects of marginal tax rates on taxable income."⁹²

Eissa and Giertz generated elasticity results that were similar to Goolsbee's for the Clinton era tax hike.⁹³ However, their analysis of the Bush era tax cuts generated negative long-run elasticities,⁹⁴ and they concluded that their results, and Hall and

⁸⁸ Nada Eissa & Seth Giertz, *Trends in High Incomes and Behavioral Responses to Taxation: Evidence from Executive Compensation and Statistics of Income Data 2*, (Cong. Budget Office, Working Paper No. 14, 2006), available at <http://www.cbo.gov/ftpdocs/77xx/doc7711/2006-14.pdf> (citing studies). Eissa and Giertz generate ETI figures for high income taxpayers from IRS Statistics of Income data that are an order of magnitude greater than the executive ETIs. Bradley T. Heim, *The Effect of Recent Tax Changes on Taxable Income: Evidence From a New Panel of Tax Returns*, 28 J. POL'Y ANALYSIS & MGMT. 147, 156 tbl.4 (2009) estimates gross taxable income elasticities in excess of 1.0 for taxpayers with incomes in excess of \$500,000. His elasticity estimates for the entire population of taxpayers are not significantly affected by adding controls for shifting income from C corporation to S corporation form or across time, but he does not specifically address whether shifting may be contributing to the elasticities he finds at the high end of the income distribution.

⁸⁹ Austan Goolsbee, *What Happens When You Tax the Rich? Evidence from Executive Compensation*, 108 J. POL. ECON. 352 (2000). The marginal tax rate (federal only) on income in excess of \$250,000 increased from 31% to 39.6% in 1993.

⁹⁰ *Id.* at 352. Excluding options, the elasticity was 0.14. *Id.* at 372.

⁹¹ Hall & Liebman, *supra* note X [Bureaucrats], at 2.

⁹² *Id.* at 41, n.19. As Goolsbee notes, "permanent" is a misnomer in this context. These analyses capture changes in income occurring over a few years. They do not capture changes in choice of occupation, the decision to retire early, or similar very long term effects of taxes. See Goolsbee, *supra* note X, at 366, n.15.

⁹³ The authors calculated a non-transitory ETI of 0.19 for a large group of executives and a non-transitory ETI of 0.73 for executives earning in excess of \$1 million. Eissa & Giertz, *supra* note X, at 52 tbl.4.1, 59 tbl.4.8. To put these figures into perspective, net of tax share elasticities in excess of 1.0 are considered high. An elasticity greater than $(1 - t)/t$, where t is the tax rate, would result in an inverse relationship between tax increases and revenue collection. Slemrod, *supra* note X, at 775.

⁹⁴ Eissa & Giertz, *supra* note X, at 52 tbl.4.1, 59 tbl.4.8.

Liebman's, could not be considered definitive given the variation in elasticities between periods and the generation of elasticities with signs that were the opposite of those predicted by theory.⁹⁵ In sum, despite some inconsistent results, the literature suggests that the long-run elasticity of the income of corporate executives to tax rate changes is modest, much less than the elasticity of high income taxpayers generally.⁹⁶

Goolsbee's analysis suggests that one response of corporate executives to changes in tax rates might lie in the timing of the tax realization of equity compensation. Although Goolsbee's findings and interpretation were contested by Hall and Liebman, it would not be surprising to observe accelerated exercise of vested, in-the-money stock options occurring prior to the imposition of a surtax on executive pay, assuming the lead time was adequate to arrange for early exercise. Such acceleration, however, does not seem particularly problematic as long as the surtax that is enacted is permanent.⁹⁷ First, as suggested by Hall and Liebman's analysis, the impact of marginal tax rates on option exercise may be of second order importance behind the impact of market movements generally. Second, even if exercise is accelerated at the margin, the result is simply the conversion of in-the-money options into stock, which may have little effect on executive incentives.⁹⁸

2. Incidence and Economic Effect of an Executive Compensation Surtax

A surtax placed on executive pay would be borne by the executives and their firms in some combination. In adopting a surtax, Congress could bar firms from explicitly compensating executives for the increased taxes, but could not prevent firms from increasing compensation to implicitly "gross up" covered executives. For several reasons, however, it seems unlikely that executives would be fully grossed up with respect to an executive pay surtax. Moreover, if one thought that partial gross ups were likely, the surtax rate could be increased to achieve the desired reduction in executive after-tax income.

⁹⁵ *Id.* at 2, 4.

⁹⁶ *Supra* notes X. Victor Fleischer suggested to me that the tournament nature of the executive labor market may help explain relatively low executive income elasticities. Over the long run, taxes may affect career decisions, but once an executive has entered into and succeeded in the tournament to become a senior executive, her labor supply is unlikely to be affected by changes in marginal tax rates. See Edward P. Lazear & Sherwin Rosen, *Rank-Order Tournaments as Optimum Labor Contracts*, 89 J. POL. ECON. 841 (1981) for a presentation of a tournament model of the executive labor market.

⁹⁷ Of course no tax rule is actually permanent, but the idea here is of a nominally permanent measure rather than a surtax analog of, e.g., a one-time tax holiday for repatriation of profits held outside the U.S. See, e.g., Kristina Peterson, TAX-REPATRIATION HOLIDAY GATHERS SOME STEAM, WALL ST. J. ONLINE, June 23, 2011, <http://wsj.com> (search "Tax-Repatriation Holiday").

⁹⁸ As stock options move into the money, i.e., as it becomes more and more probable that they will be exercised at a profit, they begin to look more and more like stock from an incentive perspective. RICHARD A. BREALEY ET AL., *PRINCIPLES OF CORPORATE FINANCE* 577 (9th ed. 2008). Of course, an executive who exercises an option may sell some of the underlying shares to satisfy the tax bill, but to the extent that the underlying shares are retained the incentive properties of in-the-money options and stock are similar.

a. Incidence

At first blush, one might think that there would be little risk of executives passing a surtax on to their firms. Given the extremely high income and wealth of public company executives, particularly of large company CEOs, one might think that pay levels serve more as markers of relative success and standing in the executive firmament than as limitations on consumption.⁹⁹ And, of course, relative compensation rankings would be unaffected by a surtax placed on executive pay. By this line of reasoning, one would expect executives to fully bear the impact of a surtax.

However, our experience with I.R.C. §§ 280G and 4999 suggests that the issue is more complicated.¹⁰⁰ Enacted in 1984, these two provisions disallow corporate level tax deductions for and impose an executive level excise tax on excessive severance or “golden parachute” payments. Golden parachute payments are excessive under the tax code if they exceed three times an executive’s average compensation over the five year period leading up to the executive’s termination due to a change in corporate control.¹⁰¹ Congress apparently intended that the restriction on deductibility and imposition of a surtax would limit golden parachute payments to three times average compensation, and, initially, that was the result. Over time, however, companies began to enter into golden parachute agreements that allowed for payments in excess of three times average compensation and promised to gross up executives for the excise tax, putting them in the economic position that they would have been in had §§ 280G and 4999 never been enacted.¹⁰²

In cases in which executives were able to negotiate gross up provisions in their golden parachute agreements, the executive level surtax was fully passed on to their firms. The executives who negotiated these gross ups generally faced the prospect of an extremely large after-tax payday, even without the gross up. Thus, the golden parachute experience undermines the argument that executives only care about nominal compensation.

⁹⁹ In a recent paper, Christa Bouwman finds that local geography affects CEO pay, and she presents evidence suggesting that envy better explains the geographic effect than does local labor market competition or the effect of leading firms in a local market. See Christa H.S. Bouwman, *The Geography of Executive Compensation* (Aug. 2011) (unpublished manuscript, available at <http://faculty.weatherhead.case.edu/bouwman/downloads/BouwmanGeographyOfExecComp.pdf>).

Alternatively, one might think that managers with power would already be extracting as much compensation as possible within the outrage constraint prior to the imposition of a surtax and that the adoption of a surtax would not enable them to extract any more. Hence, executives would not be able to pass the surtax on to their firms. This argument is explored further *infra*.

¹⁰⁰ David I. Walker, *Tax Incentives Will Not Close Stock Option Accounting Gap*, 96 TAX NOTES 851, 855 (2002).

¹⁰¹ The surtax on “excess parachute payments” is 20%. I.R.C. § 4999(a) (2006).

¹⁰² These golden parachute gross ups occurred despite the fact that the cost to firms often far exceeded the benefit to the executives, given the fact that the gross up payments were also subject to the excise tax and constituted non-deductible severance payments. Walker, *supra* note X [Tax Incentives], at 855.

A Tax Response to the Executive Pay Problem

So why would an executive pay surtax be less likely to be grossed up, or less likely to be fully grossed up? Without a convincing theory of gross ups, it is difficult to be definitive, but there are several differences between the golden parachute example and a compensation surtax that are suggestive.

First, it seems likely that a more specific provision, e.g., a surtax directed at one, specific element of compensation – severance pay – would be grossed up than a more general surtax. A board could conceivably conclude that a golden parachute equal to, say, five times a CEO’s average salary was required in order to create the right incentives for her to manage the sale of the company. The board might conclude that with a lesser incentive the CEO might resist a takeover in order to preserve her existing stream of compensation.¹⁰³ As a result, the board might conclude that a gross up that preserves the five to one ratio would be worth the cost.¹⁰⁴ A surtax that would be applied to all elements of executive pay would not create this kind of distortion.

Second, if one adheres to the managerial power view of the executive pay setting process, one would recognize that there are important differences between grossing up golden parachute payments and grossing up a general surtax on executive pay. Compensation is most salient when it is paid, and golden parachute gross ups would be paid only in the event of an executive’s termination in association with a change in control. At that point, the executive, and in all likelihood her board, would be departing. The constraint created by investor and financial press outrage over perceived executive pay abuses would have much less force on departing executives and overseers.¹⁰⁵

By contrast, a gross up, even an implicit gross up, of a general executive pay surtax would show up as additional compensation in publicly available proxy

¹⁰³ Corporate boards and compensation consultants argue that golden parachute agreements play a positive role in corporate governance by mitigating the incentives of incumbent managers to resist value adding sales of a company in order to preserve their personal economic and non-pecuniary benefits. See Richard P. Bress, *Golden Parachutes: Untangling the Ripcords*, 39 STAN. L. REV. 955 (1987).

¹⁰⁴ Similar explanations can be given for other specific tax gross ups. For example, companies have grossed up CEOs for taxes due on personal use of corporate aircraft in cases in which that use was mandated by corporate security policies. David Yermack, *Flights of Fancy: Corporate Jets, CEO Perquisites, and Inferior Shareholder Returns*, 80 J. FIN. ECON. 211 (2006). Although the dollars at stake would seemingly be small, a board might conclude that since it is requiring an executive to use corporate aircraft, fairness requires that the executive not bear the taxes.

Note also that the existence of a golden parachute agreement acts as a takeover defense, and the larger the after-tax cost of the golden parachute, the stronger the defense. Thus, executives of potential takeover targets might push even harder for gross ups given the multiplier effect of I.R.C. §§ 280G and 4999.

¹⁰⁵ The very act of entering into an executive employment agreement committing a firm to gross up an executive for an excess golden parachute payment might be thought to induce outrage. However, until recently, firms were not required to disclose the terms of gross up agreements in the executive compensation discussion and analysis section of their proxy statements. Employment contracts would have been included as exhibits to corporate filings, but gross up agreements buried in appended employment agreements would have been much less salient and much less likely to produce outrage than the eventual reported payments themselves.

statements and in executive pay tables published annually by the New York Times and the Wall Street Journal.¹⁰⁶ These pre-tax levels of pay are highly salient to investors and the financial press, and presumably the outrage constraint works, to the extent it works at all, at the level of reported, pre-tax compensation. It is not obvious why the imposition of an executive pay surtax would loosen the outrage constraint. Thus, it is not clear that executives would have the capacity to extract a gross up, if one accepts the managerial power view.¹⁰⁷

It is conceivable that outside directors might be willing to endure greater levels of outrage associated with grossing up an executive pay surtax if they felt that gross ups were in the shareholders' interest and that shareholder outrage was misdirected. Some outside directors might believe that the executives at their particular firms are not overpaid, even if public company executives are overpaid generally. Such reasoning would support a gross up. Thus, it would be important for Congress to stress the systematic nature of the executive pay problem – the idea that, given the practice of benchmarking, excess pay at poorly governed firms “infects” pay practices at well governed firms. In other words, directors would need to be convinced that even if their pay practices were beyond reproach, their shareholders were the victims of a failed market and must not be further disadvantaged by surtax gross ups.

Presumably, a Congress that adopted a surtax approach would explicitly bar gross ups. Congress might also require that compensation committee members certify in their annual proxy materials that the surtax played no role in deliberations over executive pay.¹⁰⁸ A bar would certainly prevent explicit, contractual, golden parachute-type gross ups. Moreover, an exhortation not to compensate executives for the surtax coupled with the requirement of an affirmative certification to that effect might increase the effectiveness of the outrage constraint and provide boards with an additional moral lever in refusing to gross up executives with respect to the surtax.

¹⁰⁶ To be sure, tax gross ups covering personal use of corporate aircraft and other perks are also disclosed in annual proxy statements. However, these amounts are included in a catchall “other annual compensation” category in the summary compensation table and, until recently, the gross up details were either buried in footnotes to the statements or not provided at all. *See* Regulation S-K, Item 402(c)(2)(ix)(B), 17 C.F.R. § 229.402(c)(2)(ix)(B) (2011) (requiring disclosure of tax gross ups in the “other compensation” category); Executive Compensation and Related Person Disclosure, Securities Act Release No. 8732A, Exchange Act Release No. 54,302A, Investment Company Act Release No. 27,444A, 2006 WL 2589711 (Sept. 8, 2006) (adopting amendments to the disclosure requirements for executive compensation that require separate identification and quantification of tax gross ups). An implicit gross up of an executive pay surtax taking the form of increased salary, bonus, or incentive pay would be disclosed in the appropriate pay category and presumably would be more salient.

¹⁰⁷ It is an oversimplification, but if executives have substantial influence over their own pay and if that pay is limited by an outrage constraint, one would expect executives to increase their pay up to that constraint. Pay would rise or fall only to the extent that factors internal or external to the company served to tighten or loosen the outrage constraint.

¹⁰⁸ *Cf.* 15 U.S.C. § 7241 (2006) (requiring CEO/CFO certification of the accuracy of financial statements).

The story of escalating executive pay over the last several decades is to some extent a story of a shift in norms that now permit executives to receive pay that is several hundred times that of ordinary workers. Agency problems have always existed in the modern public corporation, but presumably social norms helped limit executive pay prior to the 1990s. Properly crafted, an executive pay surtax might help re-establish norms of acceptable pay practices. At the least, careful attention to design should mitigate concerns regarding gross ups.

* * * * *

At the other end of the spectrum from excise taxes on golden parachute payments are general personal income tax rate increases. An executive pay surtax seems to fall somewhere in between, so before concluding this subsection it is worth considering whether executives are able to shift the incidence of general tax rate increases onto their employers. Eissa and Giertz suggest that one reason that executive income elasticities might be lower than those of high income taxpayers generally might be that executives are able to pass tax rate hikes on.¹⁰⁹ If executives do not bear the burden of rate hikes, these executives would not have the same incentives to shift income or otherwise avoid the tax. However, this story, while plausible, would presumably only work in one direction. Managers with power over their own pay would demand to be grossed up for tax hikes, but would not be inclined to pass on the benefit of cuts in their tax rates. Thus, the managerial power view suggests that executive elasticities would be low with respect to tax increases that are passed on, but would be significant with respect to rate cuts, which would be retained by the executives. There is no evidence, however, that the Reagan or Bush era tax cuts resulted in significant, positive elasticities for executives,¹¹⁰ and no evidence of which I am aware that executives pass on general rate increases to their employers.

In sum, while we certainly cannot dismiss the possibility that executives would be able to shift the incidence of an executive pay surtax onto employers, the surtax seems quite different than the executive-level taxes that have been fully grossed up in the past. Moreover, a properly designed surtax should not loosen the outrage constraint on executive pay and provide scope for pay increases that would compensate for the surtax. Finally, even in cases in which executive level taxes have been fully grossed up, the response was not immediate. To the extent that firms increased compensation to offset all or a portion of an executive pay surtax, the increases would likely be gradual, ensuring that current executives would bear a real reduction in after-tax pay.

b. The Economic Impact of Surtax Gross Ups

¹⁰⁹ Eissa & Giertz, *supra* note X, at 27.

¹¹⁰ Hall and Liebman included the 1981 and 1986 marginal tax rate reductions in their analysis and found non-transitory elasticities that were very small or negative. Hall & Liebman, *supra* note X [Executive Compensation], at 39-41. Eissa and Giertz examined the 2001 rate reductions and found negative elasticity. Eissa & Giertz, *supra* note X, at 3.

A Tax Response to the Executive Pay Problem

Taken in isolation, the imposition of a surtax on excessive executive pay that was partially grossed up would have two effects. Executive after-tax compensation would be reduced somewhat, but the existing distortions in corporate investment would be exacerbated. If executives were able to fully shift the incidence of a surtax onto their employers, the surtax would not reduce after-tax pay, but would more greatly exacerbate investment distortions. If one thinks that surtax gross ups would be complete and immediate, a surtax is simply a bad idea. However, if one believes that gross ups are likely to be partial, at most, and to occur gradually, if at all, one may favor the imposition of a surtax, particularly once one realizes that refunding the proceeds of a surtax to investors can ensure that distortions in corporate investment decisions will not be exacerbated by the imposition of a surtax, even in the case of a full gross up. Moreover, assuming that surtax proceeds are refunded to investors, the impact of a partial gross up on executive after-tax income (and investment decisions) could be offset by increasing the surtax rate. Investor tax relief is taken up in earnest in Part IV. It should be apparent from the discussion in this subsection, however, that ensuring that the imposition of a surtax would not exacerbate investment distortions provides a compelling rationale for linking investor tax relief to the adoption of a surtax.

Imagine a surtax imposed at a 10% rate on executive pay in excess of \$1 million per year. Suppose a CEO's total compensation for the year was expected to be \$2 million, generating a surtax of \$100,000. Absent any gross up, the surtax would reduce the executive's after-tax compensation by \$100,000, and \$100,000 would be available for investor tax relief or other purposes.

Now imagine that executives are fully grossed up for a surtax. Assuming a 35% marginal rate of tax on ordinary income, a full gross up would require additional pay of \$182,000.¹¹¹ This pay increment would cover the \$118,000 surtax on the entire grossed up amount of \$2.182 million and the additional \$64,000 tax at ordinary income rates on the gross up. At a 35% marginal corporate rate, the after-tax cost to the firm of supplying this gross up would be \$118,000.¹¹² Note that this after-tax cost is exactly the same as the surtax collected from the executive. In aggregate, refunding the surtax to investors would just keep them whole as long as corporate marginal tax rates and executive marginal rates (excluding the surtax) were the same.¹¹³ Moreover,

¹¹¹ The formula for determining the gross up amount (GUA) is as follows.

$$\text{GUA} = (\text{surtax rate} * \text{pay in excess of surtax threshold}) / (1 - \text{surtax rate} - \text{exec MTR on ordinary inc.}).$$

¹¹² Assuming repeal of I.R.C. § 162(m), there would be no question as to the full deductibility of the gross-up of the surtax. If I.R.C. § 162(m) were to be retained, the gross-up would need to be provided in the form of performance-based pay to ensure deductibility. But doing so would not be difficult. A firm could simply increase the number of shares underlying an option grant to provide a fully deductible gross up under I.R.C. § 162(m).

¹¹³ To be more exact, refunding the surtax to investors keeps them whole with respect to a full gross up as long as the firm's corporate marginal tax rate equals or exceeds the executive's marginal tax rate (excluding the surtax).

it is readily apparent that in the case of full gross ups, increasing the surtax rate would do nothing more than increase the circular flow of funds.¹¹⁴

Now suppose that executives are able to shift 50% of a surtax onto their employers. Under the facts above, the gross up would be reduced from \$182,000 to \$91,000. The overall effect in this scenario would be to reduce the executive's after-tax compensation by \$50,000 (relative to the no surtax, no gross up scenario) and, assuming that all surtax proceeds are refunded to investors, increase net investor returns by \$50,000.¹¹⁵

Finally, assume 50% shifting to employers but imagine that the surtax rate is increased to 20%. The end result would be a \$100,000 reduction in executive after-tax compensation and, assuming full refunding, a net \$100,000 benefit to investors, which, in aggregate, matches the economics of a 10% surtax with no gross up.¹¹⁶ To be clear, in the case of partial gross ups, the desired reduction in after-tax executive pay can generally be achieved by increasing the surtax rate, and refunding surtax proceeds to investors ensures that distortions in investment decisions resulting from extraction of excessive pay will be mitigated, not worsened. The two cases, are not identical, however. Nominal compensation in the 10% surtax, no gross up scenario remains at \$2 million. Nominal compensation in the 20% surtax, 50% gross up scenario increases to \$2.22 million. The implications of this difference for the design of investor tax relief are taken up in Part IV.

3. The Creation of an Executive Pay Target or Focal Point

Experience with § 162(m) suggests that the creation of an executive pay threshold for the purpose of imposing a surtax or a prohibition would have the unintended consequence of serving as an invitation to firms paying less than the threshold to increase pay levels. This is a drawback, but a fairly minor one. As we will see in Part V, the pernicious effect of unintentionally setting a pay target would be much greater in the case of coercive regulation because, in order to limit the inefficiency associated with one-size-fits-all compulsory regulation, caps on pay would almost certainly be set at a much higher level than thresholds for applying a surtax.

¹¹⁴ Suppose, for example, that the surtax was increased to 20% of pay in excess of \$1 million per year and that the executive is fully grossed up so as to receive after gross up salary of \$2 million. The gross up amount would be \$444,444. The surtax collected would be \$288,889. Incremental ordinary income tax collected would be \$155,555. The employer's after-tax cost of funding the gross up would be \$288,889.

¹¹⁵ In other words, the surtax collected and made available for investor tax relief (\$109,000) would exceed the after tax cost of providing the gross up (\$59,000, at a 35% marginal rate) by \$50,000.

¹¹⁶ Under the same assumptions as before, increasing the surtax rate to 20% implies a full gross up amount of \$444,444 and a 50% gross up amount of \$222,222. With pre-tax compensation of \$2,222,222 the executive would face a compensation surtax of \$244,444 (20% of \$1,222,222) and additional tax at ordinary income rates of \$77,777 (35% of \$222k) yielding total incremental taxes of \$322,222. Given the \$222,222 pre-tax gross up amount, the executive would be down \$100,000 after tax. The firm's after-tax cost of supplying the gross up would be \$144,444 (65% of \$222,222), which is \$100,000 less than the surtax collected from the executive.

As noted above, § 162(m) limits corporate tax deductions for non-performance based senior executive pay to \$1 million per executive per year. Section 162(m) was not designed to produce revenue. It was intended to redirect compensation into stock options and other forms of performance based pay, which remain fully deductible. In 1992 when § 162(m) was enacted, \$1 million per year was at the high end of the CEO salary range. Section 162(m) did have the desired effect of shifting pay into performance based channels, but it also acted as a focal point or target, as much as it did as a cap, on non-performance based pay. Following the enactment of § 162(m), CEOs who received salaries below \$1 million per year tended to receive larger pay increases, and CEOs whose pay was furthest below \$1 million per year tended to receive the largest pay increases.¹¹⁷ It appears that companies read § 162(m) as endorsement of CEO salaries up to \$1 million per year.

I will argue in Part V that the focal point problem is less pernicious in the case of a surtax than a pay cap. Nonetheless, the focal point concern would provide an argument for adopting a relatively low initial threshold for applying a surtax and gradually increasing the rate at higher levels of income.

4. Avoidance and Other Responses

Subsection 2, above, considered who, between firms and executives, would bear the burden of a surtax on executive pay. However that tension is resolved, firms and executives working together would have an incentive to avoid the surtax altogether if they could. This section considers possible avoidance strategies ranging from changes in compensation design or increased use of deferred compensation to shifts in organizational form. This section also briefly considers the potential impact of a surtax on after-tax incentives and on ex ante employment decisions.

a. Compensation Design from a “Global” Contracting Perspective

Myron Scholes and Mark Wolfson popularized a way of thinking about tax planning for executive pay that they called a global contracting approach.¹¹⁸ Their quite sensible idea was that employers and executives should select compensation instruments that minimize the combined tax burden and share the tax savings. However, they also recognized that compensation decisions entail non-tax costs and benefits, such as the creation of desirable incentives, that must be taken into account in compensation planning.

This subsection applies this global tax perspective in considering whether the impact of a surtax could be avoided in full or in part by issuing incentive stock options

¹¹⁷ See David G. Harris & Jane R. Livingstone, *Federal Tax Legislation as an Implicit Contracting Cost Benchmark: The Definition of Excessive Executive Compensation*, 77 ACCT. REV. 997 (2002).

¹¹⁸ MYRON S. SCHOLES ET AL., *TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH* (3d ed. 2005).

(ISOs) in lieu of nonqualified stock options (NQSOs), by increasing the use of equity compensation or deferred compensation generally, or by channeling compensation into non-taxed perks. The short answers are no, no, and perhaps yes, but only to a limited extent.¹¹⁹

i. ISOs versus NQSOs

From a global contracting perspective, the most obvious compensation adjustment to consider in response to the imposition of a surtax on ordinary compensation income would be a switch from non-qualified stock options to incentive stock options.¹²⁰ ISOs become increasingly tax advantaged as the rate of tax on executive ordinary income increases, and the incentive properties of the two types of options are essentially identical. Under current tax laws, however, the scope to shift from NQSOs to ISOs would be very limited. If limits on the size of ISO awards were raised, avoidance could be curtailed by applying the compensation surtax to ISO gains at exercise.

To unpack this, we must begin with a brief summary of the tax treatment of ISOs and NQSOs. The difference between the market price of the underlying stock and an NQSO's exercise price is included in the ordinary income of the optionee at exercise, and the employer that granted the option is entitled to a deduction in the same amount and in the same period for compensation paid. Going forward, the employee holds the underlying stock as a capital asset with basis equal to the market value of the stock at exercise.

If holding period and other requirements are satisfied, ISOs are not taxed until the underlying stock is sold, and the optionee is taxed at capital gains rates on the entire gain on the option.¹²¹ For the optionee, ISO treatment converts ordinary income into capital gain and permits deferral of tax beyond the point of exercise.¹²² However, the issuing firm pays a price in that no compensation deduction is allowed with respect to options taxed as ISOs. As these descriptions suggest, the relative tax advantage of ISOs versus NQSOs depends on the rate of tax on employee ordinary income, employee capital gains, and corporate income. All else being equal, ISOs become

¹¹⁹ Readers who have a limited appetite for detailed analyses of the tax treatment of equity pay may wish to take my word with respect to the first two propositions and skip ahead to subsection (4)(a)(iii), which considers increased use of non-taxed perks.

¹²⁰ I use the term "ordinary compensation income" to reflect the idea that a surtax would apply to an executive's compensation income reported on Form W-2 that is today taxed as ordinary income. The surtax would not apply to other sources of ordinary income such as interest income. In addition, the surtax would not apply to all income from services, such as gains on founders' stock (*see* Victor Fleischer, *Taxing Founders' Stock*, UCLA L. REV. (forthcoming 2011)) or (at least as a first pass) gains on ISOs taxed as capital gain.

¹²¹ I.R.C §§ 421(a), 422(a) (2006). In order to qualify for ISO tax treatment, shares underlying ISO must be held for at least two years following the grant of the option and at least one year following option exercise.

¹²² Deferral is only advantageous in this situation if option expiration is approaching and the employee has a non-tax reason for holding the underlying shares beyond exercise.

more attractive as the rate of tax applied to employee ordinary compensation income increases.

At current top marginal tax rates for executives and corporations, non-qualified options are preferred over ISOs from a global contracting perspective.¹²³ However, if a 10% surtax were to be applied to executive compensation income, including gains from the exercise of non-qualified options, high marginal rate firms and executives would be roughly indifferent between the two types of options.¹²⁴ At a 15% surtax, ISOs would clearly be tax preferred.¹²⁵

Given the ability to carryover losses from previous years,¹²⁶ many corporations face effective tax rates that are less than the 35% nominal effective rate, and another way to look at the ISO/NQSO tradeoff is in terms of the breakeven corporate tax rate. At current top marginal individual rates, non-qualified options remain tax preferred until the effective corporate rate falls below 24%.¹²⁷ With a 10% surtax, ISOs would be taxed preferred at any firm facing an effective marginal rate of 35% or less.¹²⁸ In sum, the imposition of a surtax on executive compensation income would make ISOs relatively more attractive and, in fact, tax preferred at many firms. Put another way, to the extent that executives and firms could shift from the use of non-qualified options to ISOs, they would be able to partially avoid the impact of the surtax in many situations.

Of course, if one thought there was a significant risk that the economic impact of a compensation surtax could be avoided by shifting pay into ISOs, one solution would be to apply the surtax to all options – ISO or NQSO – at the time of exercise. Doing so would not be administratively burdensome as the paper gains on ISOs at exercise are already treated as an adjustment in computing the Alternative Minimum Tax.¹²⁹

¹²³ SCHOLLES ET AL., *supra* note X, at 230. Non-qualified options are preferred from a global tax perspective when the corporate tax rate is greater than the ratio of the tax rate on the optionee's ordinary compensation income minus the effective tax rate on the optionee's capital gains over one minus the effective capital gains rate. The effective capital gains rate reflects the deferral beyond exercise of taxation on ISO gains. In the calculations that follow, I have assumed a nominal executive capital gains rate of 15% and deferral for one year at an after-tax rate of 5%, yielding an effective capital gains rate of 14.3%. At a 35% marginal rate on ordinary compensation income, the breakeven corporate tax rate is 24%. Thus, NQSOs are jointly preferred for firms facing effective marginal rates equal to the 35% top stated rate.

¹²⁴ Increasing the marginal rate on ordinary compensation income from 35% to 45% increases the breakeven corporate marginal rate to 36%, slightly higher than the stated rate. If one assumes that ISOs provide no deferral benefit, such that the effective capital gains rate is equal to the nominal rate, the breakeven corporate rate in this scenario is 35%.

¹²⁵ At a 50% marginal rate on ordinary compensation income, the breakeven corporate marginal rate is 42%.

¹²⁶ See I.R.C. § 172 (2006) (permitting losses to be carried back two years and forward twenty years).

¹²⁷ See *supra* note x.

¹²⁸ See *supra* note x.

¹²⁹ Applying the surtax to ISO gains at exercise might be thought to be particularly unfair or burdensome in that executives are required to retain shares underlying ISOs for at least one year following exercise in order to qualify for preferential tax rates, I.R.C. § 422(a) (2006), but observers

It is not clear, however, that we would need to apply the surtax to ISO exercise because the capacity of firms to issue ISOs to senior executives is extremely limited. The ISO provision of the Code includes a non-inflation adjusted annual limit on ISO grants of \$100,000 per recipient.¹³⁰ The limit applies to the aggregate fair market value of stock subject to ISOs that first becomes exercisable in a given year, and the dollar limit is based on the market value of the stock subject to the option on the date of grant. Purported ISO shares in excess of this limit are treated as NQSO shares.

Compensatory options are almost always granted at the money, that is, with an exercise price equal to the fair market value of the underlying stock on the date of grant.¹³¹ Under a reasonable range of assumptions, the per share value of an at-the-money option on the stock of a large public company would be somewhere between 30% and 50% of the share price.¹³² As a result, the value of an option on shares worth \$100,000 would be around \$30,000 to \$50,000. For a senior corporate executive subject to a surtax on pay, the difference between ISO and NQSO tax treatment on a chunk of compensation this small would be negligible.

If an executive pay surtax were to be adopted, executives and firms might lobby for an increase in the limitation on ISOs. In such a case, it might make sense to reconsider applying the surtax to ISOs at exercise. Absent an increase in the ISO limitation, the scope for avoidance via ISO issuance seems trivial.

ii. Other Equity Based Pay and Deferred Compensation

may not be seriously concerned about cash flow issues faced by the population of executives who would be subjected to the surtax.

More generally, the application of the AMT to ISO gains at exercise has long been problematic. In cases in which ISO exercise produces a paper gain at exercise, but in which share prices drop before the ISO holding period requirements are satisfied, it often turns out that the former holder has little or no net gain on the ISO, but paid substantial AMT at exercise. Former ISO holders were entitled to a credit for AMT paid on ISO exercise, but that credit could well exceed the tax due on the sale of the underlying shares, creating what is known as the “ISO AMT Trap.” Young, relatively low paid tech workers who received a substantial chunk of their compensation in ISOs and fell into the AMT trap provided a fairly compelling case for relief, and Congress provided that relief in 2006. Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432 § 402, 120 Stat. 2922, 2953 (2006) (codified at I.R.C. § 53(e) (2006)) (allowing a refundable tax credit through 2012). However, the same degree of sympathy may not extend to highly compensated executives who would be subject to a surtax.

¹³⁰ I.R.C. § 422(d) (2006).

¹³¹ Today, at-the-money option design is ubiquitous because I.R.C. § 409A effectively bars grants of in-the-money options and employees excessively discount out-of-the-money options. David I. Walker, *The Non-Option: Understanding the Dearth of Discounted Employee Stock Options*, 89 B.U. L. REV. 1505, 1508, 1549-50 (2009).

¹³² The value of an at-the-money option is primarily a function of the time to exercise and the volatility of the stock. The figures provided in the text are based on a six year period to option exercise, stock price volatility ranging from 25% to 50%, no dividends, and a 3% risk free rate.

A surtax on executive pay would have little or no impact on the attractiveness from a global contracting perspective of non-qualified deferred compensation or of equity based compensation relative to non-equity pay. Thus, equity pay and deferred compensation would not present a significant avoidance opportunity.

Of course, one would have to take some care in designing a surtax to guard against avoidance through the use of tax advantaged deferred compensation. Under current tax rules, executives can enter into non-qualified deferred compensation arrangements with their employers that defer compensation, earnings on that compensation, and the tax on both until the amounts are received at retirement or other termination from employment.¹³³ From a global contracting perspective, non-qualified deferred compensation tends to be preferable when an executive's tax rate is likely to be lower at payout than when the compensation is earned, when the employer's tax rate is likely to be higher at payout than when the compensation is earned, or when the employer can invest at a higher after-tax rate than can the executive.¹³⁴

Suppose, for example, that a surtax was designed to apply to an executive's W-2 compensation in a year. Amounts deferred through a non-qualified plan would not be reported in the year earned and would not be subjected to the surtax. In this case, it would be important to ensure that the deferred compensation was subjected to the surtax when it was paid out. Otherwise, executives and firms could avoid the surtax through non-qualified deferred compensation.

One might also think at first blush that increasing an executive's effective marginal tax rate by applying a surtax to compensation would encourage deferral by lowering her after-tax investment returns, but a surtax would have no impact on the after-tax savings rates available to an executive outside of a company plan. The surtax would apply only to compensation received in the year. Outside of a company plan, an executive would be taxed on her investment gains at the regular ordinary income rates or capital gains rates that apply to all individual investors.

Assuming that employer and executive tax rates are not expected to change over time and that non-qualified deferred compensation is attractive at a particular company because the employer can obtain higher after-tax investment returns (perhaps because losses from prior years result in a low effective marginal rate), placing a surtax on executive compensation income would make deferred compensation somewhat less attractive. The reason, in a nutshell, is that the executive-level tax benefit in this scenario is equivalent to imposing tax on the amount deferred in the year earned and exempting subsequent investment gains from tax. As the rate of tax on compensation

¹³³ Ethan Yale & Gregg D. Polsky, *Reforming the Taxation of Deferred Compensation*, 85 N.C. L. REV. 571, 577 (2007).

¹³⁴ SCHOLLES ET AL., *supra* note X, at 214. Note that employer tax deductions associated with non-qualified deferred compensation are deferred as well.

income increases and the notional after-tax pool of funds diminishes, the benefit of exempting returns on that amount falls as well.¹³⁵

The imposition of a relatively flat surtax on executive pay would seem to have little impact on deferred compensation decisions. However, if a steeply graduated surtax were to be adopted, it might be advisable to apply the surtax to all compensation, deferred or non-deferred, earned by an executive within the year. In such a case, an executive might anticipate being subjected to a lower surtax at retirement and might increase deferred compensation for that reason. Note that the imposition of a surtax on amounts deferred in the year earned would not prevent an executive from enjoying the current benefits of deferral (if any) with respect to ordinary tax rates.¹³⁶ To be sure, the added tax burden might discourage deferral at the margin since an executive would have to come up with the funds to pay the surtax, but the application of a modest surtax on compensation amounts deferred by very high income individuals would not seem too burdensome.¹³⁷

As in the case of non-qualified deferred compensation, if tax rates are not expected to change over time, the global tax advantage of NQSOs and restricted stock relative to salary and bonus, for example, depends primarily on the after-tax investment rates available to firms and executives. A surtax on executive pay would not affect after-tax returns to executives on investments made with post-compensation dollars. Those returns would continue to be taxed at ordinary marginal rates or capital gains rates. On this dimension, a surtax would be irrelevant.

As in the case of deferred compensation, however, in cases in which equity compensation is tax preferred, the extent of the preference does depend on the rate of tax applied to an executive's compensation income, and, as before, placing a surtax on executive compensation income would tend to somewhat reduce the attractiveness of equity compensation.¹³⁸

Companies, however, also care about the incentive properties of various compensation instruments, and the strength of executive incentives depends on after-

¹³⁵ See, e.g., Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money"*, 95 YALE L.J. 506 (1986).

¹³⁶ At current tax rates, a global tax benefit arises primarily when employers are able to invest at a low after-tax rate because they have a low effective marginal rate due to accumulated NOLs or invest in their own stock on a tax exempt basis per I.R.C. § 1032 (2006). See Halperin, *supra* note x [Yale L.J.], at 540.

¹³⁷ Academic commentators generally conclude that under current tax rules non-qualified deferred compensation can provide tax savings to the high income individuals that participate in them and their employers. See, e.g., Halperin, *supra* note X [Yale L.J.]; Daniel Halperin, *2009 Erwin N. Griswold Lecture Before the American College of Tax Counsel: Rethinking the Advantage of Tax Deferral*, 62 TAX LAW. 535 (2009); Yale & Polsky, *supra* note X. As such, moves that marginally discourage the use of these plans would not seem unwelcome.

¹³⁸ This analysis, based on the global contracting approach of Scholes and Wolfson, ignores the impact of tax rates on the incentives generated by stock and option compensation. Incentive effects are added to the picture in subsection b below.

tax, not pre-tax outcomes. An increase in personal tax rates, or, in this case, the adoption of an executive pay surtax, reduces after-tax incentives created by stock and options (or other forms of incentive compensation). In this respect, one can draw an analogy between taxes and insurance. An increase in marginal rates reduces after tax returns on incentive pay when outcomes are positive and cushions the negative effects when outcomes are negative. As marginal rates increase, an employer would have to increase pre-tax incentives in order to maintain the desired level of after-tax incentives. Peter Katuscak has theorized that in the case of risk and effort averse executives, it would be optimal for firms to offset the effect of an increase in marginal employee tax rates to some extent by increasing pre-tax incentives.¹³⁹ Under Katuscak's model, however, after firms adjust, the net result of the imposition of an executive pay surtax would still be a modest reduction in after-tax incentives.¹⁴⁰

Finally, in discussing non-qualified deferred compensation, I suggested that, despite the lack of impact on relative after-tax investment rates, we still might want to apply the surtax in the year that deferred pay is earned. The reason is that if a graduated surtax were to be adopted, a covered executive might expect to be in a lower effective marginal rate (regular ordinary rate plus surtax) at retirement than in the year in which pay is earned. An expectation of decreasing marginal tax rates encourages deferral. Of course, restricted stock and NQSOs also result in deferral of income, but the period of deferral generally is quite short. Restricted stock typically vests and becomes taxable between one and five years following grant.¹⁴¹ Options typically are exercised within six years of grant.¹⁴² Given this relatively short timeframe, it seems perfectly reasonable (as well as being administratively convenient) to apply the surtax to NQSO gains at exercise and to restricted stock at vesting consistent with the timing of the taxation of these instruments as ordinary compensation income.

iii. Non-Taxed Perquisites

The imposition of a surtax on executive pay would increase the attractiveness of non-taxed perquisites relative to conventional taxed compensation. However, my intuition is that the scope to pay executives in perks is fairly limited and that a modest surtax would not result in very much avoidance of this type.

¹³⁹ Peter Katuscak, *The Impact of Personal Income Taxation on Executive Compensation* (May 8, 2004) (unpublished manuscript, available at <http://ssrn.com/abstract=649851>).

¹⁴⁰ *Id.*

¹⁴¹ FREDERICK W. COOK & CO., *THE 2009 TOP 250: LONG-TERM INCENTIVE GRANT PRACTICES FOR EXECUTIVES* 13 (2009), http://www.fwcook.com/alert_letters/2009_Top-250-Report.pdf.

¹⁴² See J. Carr Bettis et al., *Exercise Behavior, Valuation, and the Incentive Effects of Employee Stock Options*, 76 J. FIN. ECON. 446, 447 (2005) (finding for a sample of 140,000 option exercises by executives at almost 4000 firms between 1996 and 2002 that, on average, options were exercised a little over two years following vesting and more than four years prior to expiration); Jennifer N. Carpenter, *The Exercise and Valuation of Executive Stock Options*, 48 J. FIN. ECON. 127, 138 (1998) (finding for a sample of forty firms (mainly large manufacturers) that executive stock options granted between 1983 and 1984 were, on average, exercised after 5.8 years).

A Tax Response to the Executive Pay Problem

Suppose, for example, that, in response to the imposition of a surtax, a company purchases a house for \$10 million that it allows its CEO and her family to live in rent free. Suppose the fair market rental value of the property would be \$500,000 per year. If the rental value of this home is excludable, the surtax (as well as individual income taxes generally) could be avoided on \$500,000 per year in compensation.¹⁴³ In order for company provided housing to be excludable from income, the housing must be provided for the convenience of the employer, must be on the business premises, and must be provided and accepted as a condition of employment.¹⁴⁴ Each requirement is something of a term of art in tax law, and one can find examples of the exclusion being upheld in situations that stretch the common sense meanings of business premises and convenience of the employer.¹⁴⁵

Combined business and personal travel might provide another example. Aside from the 50% limitation on the deductibility of meals,¹⁴⁶ business travel is deductible by the employer and results in no tax consequences for the executive. Following the imposition of a surtax, one would think that “business” travel to attractive destinations would become somewhat more attractive, representing a shift in compensation to this non-taxed perk.

Nonetheless, I would not anticipate a great deal of compensation being redirected in this fashion following the imposition of a surtax. The shift into employer owned housing would seem to be the most significant threat, and even here the ability and willingness of firms and executives to redirect compensation would be limited for at least four reasons. First, there is the difficulty of qualifying for the exclusion under the tax rules and regulations.¹⁴⁷ Second, public companies must now disclose in the executive compensation discussion section of their annual proxy statements all substantial perks (taxed or untaxed) delivered to their top executives.¹⁴⁸ Public company executive compensation packages are now subject to a separate shareholder vote that is non-binding, but quite embarrassing to lose. And excessive perks appear

¹⁴³ The employer would be entitled to deduct its expenses related to the acquisition and maintenance of this business property. I.R.C. § 162.

¹⁴⁴ I.R.C. § 119(a) (2006).

¹⁴⁵ See, e.g., *Adams v. United States*, 585 F.2d 1060 (Ct. Cl. 1978) (holding that housing located in a prestigious Tokyo location and provided to the president of a Japanese subsidiary of a U.S. company was on the business premises because the house was associated with the company and was used regularly for business entertaining).

¹⁴⁶ I.R.C. § 274(n) (2006).

¹⁴⁷ I.R.C. § 119(a); Treas. Reg. § 1.119-1(b).

¹⁴⁸ SEC Release No. 33-8732A (2006). The SEC now requires proxy statement identification and valuation of any perk that is valued at the greater of \$25,000 or ten percent of total perk value. The SEC has declined to define “perquisite” for disclosure purposes, but has noted that an item need not be disclosed if it is “integrally and directly related to the performance of the executive’s duties.” Otherwise, any item conferring a personal benefit constitutes a perk for these purposes. Moreover, the SEC has stressed that the fact that an item might be provided for the convenience of the employer and non-taxable for the executive is not relevant in determining whether an item must be disclosed. Finally, executive housing is specifically listed in the SEC release as an example of an item that must be disclosed as a perk. *Id.*

to be a huge red flag for proxy advisory firms making recommendations on shareholder “say on pay” votes. Third, aside from a (relatively) modest base salary, most executive compensation is incentive pay of one form or another, and redirecting that compensation into perks would diminish the incentives the board is attempting to create. Fourth, a modest surtax would not result in excessively high marginal rates, and would not increase the driving force to shift compensation into non-taxed perks to a very significant extent.¹⁴⁹

In addition, of course, the imposition of a surtax on executive pay would increase the attractiveness of other “working condition” fringe benefits,¹⁵⁰ such as fancy office chairs, but this is trivial. A surtax would also provide a stronger incentive for firms to provide executives with non-taxed health¹⁵¹ or life insurance¹⁵² coverage, but the statutory exclusion for fringe benefits of this type is extremely limited, and so called “split dollar” life insurance arrangements that formerly provided an end-run around the statutory limitation on that benefit have been sharply curtailed.¹⁵³

b. Organizational Form

At the margin, imposing a surtax on executive pay could impact choices regarding organizational form, such as the public/private decision or the decision to organize as a subchapter C corporation or as a pass-through entity. The result is a series of line drawing problems. For example, should the surtax be limited to public company executives, or be extended to cover executives of private firms?

Obviously, limiting a surtax to the compensation received by public company executives would increase the incentive for public companies to go private and for private companies to shun public offerings. One might think that a modest surtax placed on the compensation received by a handful of senior executives would not affect the public/private calculus in any meaningful way, but a surtax limited to public

¹⁴⁹ Contrast the imposition of a hard cap on executive pay. If a cap did not apply to corporate owned executive housing or to personal travel disguised as business travel, one would expect significant increases in these activities following the imposition of a cap. *See infra* note X and accompanying text.

¹⁵⁰ I.R.C. § 132(a)(3)&(d) (2006).

¹⁵¹ I.R.C. § 106 (2006) (exclusion of health or accident insurance provided by employer).

¹⁵² I.R.C. § 79 (2006) (exclusion of \$50,000 of group-term life insurance provided by employer).

¹⁵³ In a split dollar life insurance arrangement, an employer and an executive joined in the purchase of a “whole life” life insurance policy covering the executive. (A “whole life” policy includes an investment element in addition to “term” insurance coverage.) Typically, the employer paid some or all of the premiums and was entitled to recover the premiums paid from policy proceeds. The executive received current life insurance coverage and was entitled to policy proceeds in excess of employer contributions. The tax issue was how to value the benefits conferred on executives through the employer contributions. Prior to 2002, the IRS took the position that an executive was required to pay or recognize as income only the “term cost” of the life insurance, which was typically well below the actual value transferred from employer to employee. The additional value transferred was not deductible by the employer, but to the extent that the executive’s marginal rate exceeded the firm’s marginal rate, this arrangement was attractive from a global contracting perspective. In 2001 and 2002, the IRS issued notices that eliminated the tax advantage of split dollar insurance arrangements. *See* Stewart Reifier, *New IRS Rules for Split-Dollar Life Insurance Arrangements*, CORP. BUS. TAX’N MONTHLY, May 2003, at 20, 21-27.

company executives would add to a growing list of burdens of being a public company, including the increased compliance costs associated with the Sarbanes-Oxley Act,¹⁵⁴ and for some firms could represent the proverbial straw that breaks the camel's back. There are still good reasons for going public, such as providing liquidity to employee stockholders,¹⁵⁵ but it is becoming more clear over time that diversified public shareholders are not necessarily needed as the ultimate enterprise risk bearers.¹⁵⁶

The cleanest way to eliminate the incentive to go or stay private would be to extend the surtax to include private company executives, and, to the extent that the private company executive labor market is "infected" by excesses in the public company market, such an extension could well be justified. But doing so would not eliminate the line drawing problem, it would simply shift it.

Private company executives represent a significant fraction of very high income taxpayers. Bakija, Cole, and Heim estimated that in 2005 there were more private company executives earning more than \$1 million per year than public company executives.¹⁵⁷ Bakija, Cole, and Heim did not have information on organizational form, but private companies would have consisted primarily of closely held businesses organized as C corporations, S corporations, or LLCs. Some of these businesses would have been portfolio companies held by private equity funds; others would have been independent stand alone business ventures.

Given a lack of dispersed ownership, executive pay arrangements at these private companies are more likely to be at arm's length than are public company pay arrangements. In cases in which there is a close identity of ownership and management, pay levels are essentially irrelevant.¹⁵⁸ At portfolio companies and similar firms where managers and owners are not identical, we would expect private equity owners or their counterparts to bargain vigorously over executive pay. As

¹⁵⁴ See Ellen Engel et al., *The Sarbanes-Oxley Act and Firms' Going Private Decisions*, 44 J. ACCT. & ECON. 116 (2007) (finding an increased frequency of going private transactions in the wake of the passage of Sarbanes-Oxley).

¹⁵⁵ Even this benefit of going public is being eroded as markets develop in shares of closely held firms. The SEC is currently examining the proper role and the proper regulation of these markets. See, e.g., Peter Lattman, *Stock Trading in Private Companies Draws S.E.C. Scrutiny*, DEALBOOK, Dec. 27, 2010, <http://dealbook.nytimes.com/2010/12/27/stock-trading-in-private-companies-draws-scrutiny>; Julianne Pepitone, *SEC Casts Wide Net in Private Stock Trading Probe*, CNNMONEY, Feb. 28, 2011, http://money.cnn.com/2011/02/27/technology/secondary_market/index.htm; Julianne Pepitone, *SEC May Ease Private Stock Sale Rules*, CNNMONEY, Apr. 8, 2011, http://money.cnn.com/2011/04/08/technology/SEC_shareholder_limit/index.htm.

¹⁵⁶ Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231 (2008)

¹⁵⁷ Bakija et al, *supra* note X, at 51 tbl.3.

¹⁵⁸ At the extreme, consider a situation in which a firm has a sole shareholder who is also the company's CEO. Taxes aside, whether the owner takes her profits in the form of compensation or dividends is irrelevant. There is no agency problem in this case because there is no separation of ownership and control.

noted above, however, to the extent that private companies compete with public companies for executive talent, private company pay negotiators would have to recognize and compensate for rent that could be extracted by executives at public firms. In other words, despite the existence of arm's length bargaining, executives of private companies may benefit from the lack of effective bargaining at public companies. If so, this phenomenon would provide a justification for expanding the reach of an executive pay surtax to encompass private company executives.¹⁵⁹

But placing a surtax on private company executives would likely create distortions. Public companies can go private, but they are unlikely to remain public and become pass-through entities. Some private companies that are currently organized (or as a startup potentially would organize) as C corporations and compensate their executives with salary, bonus, and equity compensation might respond to a surtax on executive pay by adopting a pass-through structure that provides compensation in the form of partnership profits.¹⁶⁰ Theoretically, a surtax could be designed to reach compensation in this form, but then the designer would have to struggle with distinguishing labor income from investment income.¹⁶¹ That, perhaps, would be a bridge too far.

So there is a tension. On the one hand, extending the reach of a surtax to include private company executive pay would respond to the inflation of pay levels in this market that results from excess pay in the public company market and would avoid creating a new incentive for public companies to go private. On the other hand, extending the surtax to private companies would encourage those companies to restructure so as to avoid the surtax on compensation. Perhaps a compromise that would balance these competing concerns would be in order. The surtax might be extended to cover private firm executive pay, but at lower rates – perhaps 50% of the rate that applies to public company executive pay.

c. Career Decisions

Although economists generally agree that short and medium-term labor supply elasticity for high income primary earners is quite low,¹⁶² a surtax applied to executive

¹⁵⁹ At first blush, one might think that applying a surtax to public company executive pay could be costly for private companies to the extent that public company executives are able to negotiate higher pay levels to compensate for the tax. But this is not necessarily the case. If we assume that private companies negotiate effectively at arm's length but are essentially price takers, they would only need to keep executive candidates whole on an after-tax basis.

¹⁶⁰ See Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89, 93-96 (2008) (describing Blackstone's issuance of common units in a publicly traded partnership that enabled Blackstone's founders to continue to receive their returns in the form of carried interest taxed at capital gains rates). Placing a surtax on private company executive pay would also exacerbate the problem identified by Fleischer in *Taxing Founders' Stock*, *supra* note X, by encouraging founders to take their labor earnings in the form of share price appreciation.

¹⁶¹ Cf. Fleischer, *supra* note X [Founders' Stock].

¹⁶² See *supra* notes X(87-99) and accompanying text.

pay could affect the career decisions of talented individuals. Directionally, imposing a surtax on executive pay should discourage entry into the executive labor market.

However, this distortion in the executive labor market should be seen as offsetting a distortion that currently exists and thus as a positive, efficiency-enhancing aspect of a surtax approach. One implication of this Article's premise that executive compensation is inflated systematically as a result of deficiencies in the compensation-setting process is that the number of candidates seeking these positions would be inflated as well. To this extent, an executive pay surtax can be seen as a corrective tax that seeks to reduce distortions that follow from market failure.

IV. A TAX RESPONSE TO THE EXECUTIVE PAY PROBLEM: INVESTOR TAX RELIEF

The second element of the proposal is investor tax relief, which is designed to mitigate the inefficient distortion of investment that follows from the extraction by executives of excessive compensation. This Part expands on the rationale for investor tax relief and discusses factors that should be considered in designing such relief.

A. Why Investor Tax Relief?

As discussed in Part I, the extraction of excessive compensation by U.S. executives reduces shareholder returns and discourages investment in the corporate sector. The primary idea behind channeling the proceeds of an executive pay surtax into investor tax relief is to offset the distortionary effects of excessive compensation on investment. If we think of excessive executive pay as being an economic tax on investment, reducing actual investment taxes should mitigate the adverse effect.

Investor tax relief need not necessarily be tied to the imposition of a surtax. Either project could be pursued independently.¹⁶³ However, two considerations suggest that

¹⁶³ Generally, it is a mistake to think of revenues from Pigovian taxes as being "free" money that is available to be directed to noble causes. For example, environmental taxes may cause actors to internalize external costs, which is move in the direction of efficiency, but these taxes do make participants worse off. *See, e.g.*, James A. Mirrlees, *Global Public Economics*, in *NEW SOURCES OF DEVELOPMENT FINANCE 200* (A.B. Atkinson ed., 2004). As a result, their revenues should not necessarily be directed towards "green" initiatives, if those initiatives would not have been pursued absent the environmental tax. However, the present case is somewhat different. To the extent that an executive pay surtax simply extracts a portion of the rents received by executives, no one else is made worse off by the imposition of the tax.

Of course, this does not mean that the revenue should be frittered away. Any potential use of the revenue must compete with a reduction in other taxes that distort behavior, such as existing income taxes. There is already a great deal of support for the idea of reducing corporate income tax rates in order to reduce distortions and enhance competitiveness, and one could view the imposition of an executive pay surtax as an offset to a general corporate tax rate reduction. *See, e.g.*, THE PRESIDENT'S ECONOMIC RECOVERY ADVISORY BOARD, THE REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE, AND CORPORATE TAXATION 65 (Aug. 2010),

linking the two might be advantageous. First, as discussed in Part III, surtaxes might be partially offset by increases in executive pay. To the extent that this occurs, the surtax would actually increase the drag on domestic corporate investment. Refunding the surtax to investors would ensure that distortions in investment were not worsened by the imposition of a surtax. If a surtax were to be fully refunded to investors, investors could be no worse off, in aggregate, as a result of the imposition of the surtax. In all likelihood, a surtax would be at most partially passed on to employers, and investor tax relief would both cover the greater compensation expense arising from the surtax gross up and mitigate the effect of excessive executive compensation as it currently exists.

Second, a revenue neutral combination of a surtax and investor tax relief might be more politically palatable than either element alone. Adding investor tax relief to the imposition of a surtax would defuse arguments that the surtax proposal is anti-business and might overcome the resistance of those opposed to tax increases generally. Adding the surtax to investor tax relief would provide a funding mechanism and deflate the opposition of deficit hawks.¹⁶⁴

One might object that returning surtax proceeds to investors, a wealthy class on average, is taking money from the super rich and giving it to the merely rich, which is an odd way of combating the effect of excessive executive pay on income inequality. But the greatest growth in income inequality in the U.S. has been at the very highest end. It lies in the top 0.1% of earners increasing their share of national income from 2% to 8% over the last thirty years, and executives are more concentrated in that class than investors generally.¹⁶⁵ Moreover, to the extent that excessive executive pay burdens labor through a shift away from public company investment, mitigating that investment distortion through investor tax relief would benefit labor indirectly.

B. Investor Tax Relief Design Issues

Investor tax relief could take one of several forms. Relief could be granted in the form of a reduction in the corporate income tax rate, or relief could be provided at the investor level, through a reduction in taxes on dividends or capital gains. Relief could be general or firm-specific, ranging from a refundable corporate tax credit equal to the surtax collected from the executives at a particular company to a general reduction in the tax rate on qualified dividends. This section discusses the factors that one would consider in designing investor tax relief to respond to the problems created by

http://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report.pdf (noting that reduction in effective corporate tax rates would result in significant revenue losses absent efforts to broaden the tax base).

¹⁶⁴ Cf., Thomas Merrill & David M. Schizer, *Energy Policy for an Economic Downturn: A Proposed Petroleum Fuel Price Stabilization Plan*, 27 YALE J. REG. 1 (2010) (suggesting that a stabilizing surcharge on the price of oil be refunded to consumers in order to, inter alia, reduce political opposition).

¹⁶⁵ See *supra* note x and accompanying text.

excessive executive pay. On balance, I conclude that corporate tax relief is the more promising approach, but that the arguments for firm-specific versus general corporate tax relief are about even.

1. Matching the Effect and Incidence of Pay Excesses

While shareholders bear the cost of excessive executive pay in the first instance, as discussed in Part II, the long-run incidence is less clear. It also seems obvious that extraction of excess compensation discourages investment in the corporate sector, but the degree to which this occurs and where the capital flows instead is not fully clear. Ideally, investor tax relief would be matching in incidence and would reverse the distortions created by excessive executive pay.

Part II suggested that from an incidence perspective, the effect of excessive executive pay may be similar to that of a corporate level income tax. If that is right, it would make sense to provide investor relief in the form of corporate income tax relief. We may not know exactly what fractions of incremental corporate taxes and excessive executive pay are borne by shareholders, non-corporate capital, and labor, but the fractions should be the same in the two cases. Thus, if it is true that domestic labor ultimately bears the lion's share of the burden of incremental taxes and excess executive pay, corporate tax relief should flow through to labor, as well. However capital allocations are distorted by the economic tax of excessive pay, those distortions should be mitigated by a reduction in corporate income taxes.

Of course, a general reduction in corporate tax rates would not mitigate the effects of excessive executive pay at companies that are effectively tax exempt because of large accumulated losses.¹⁶⁶ And there is no reason to think that these firms would be immune from the effects of failure in the executive labor market. Thus, to the extent that shareholders of a firm with a large loss position bear the cost of excessive executive pay, a general corporate tax rate reduction would provide little benefit. Firm-specific tax relief, e.g., a refundable corporate tax credit, would benefit shareholders in this instance. For two reasons, however, this factor may not weigh greatly in favor of firm-specific relief. First, for diversified shareholders the difference between firm-specific and general corporate tax relief would be minimal. Second, to the extent that the cost of excessive executive pay is passed on to non-corporate capital or labor through a shift in equilibrium investing, again general corporate tax relief should suffice.

The effect of shareholder level tax relief, i.e., dividend tax relief, may also flow through to the factors of production that bear the cost of excessive executive pay, but

¹⁶⁶ Under U.S. tax laws, companies that generate losses are not entitled to receive money back from the government, but these companies are permitted to carry these losses – termed net operating losses or NOLs – backward and/or forward in time to offset taxable profits. I.R.C § 172 (2006). A company that has a large accumulated NOL position may have a low likelihood of paying taxes for a considerable number of years and thus a very low effective tax rate.

this is somewhat less clear. Of course, even in the first instance, dividend tax relief would respond to the investment inhibiting effect of excess executive pay in only a very rough fashion. Assuming that dividend tax relief had no impact on dividend practice, the relief would only benefit taxable individuals or entities investing in dividend paying companies. Diversified taxable investors would see the benefit even if some of their holdings failed to generate dividends, but diversification would not help non-taxable investors in this respect.

2. Protection against Surtax Gross Ups

As discussed above, investor tax relief would be required to ensure that investment distortions resulting from excessive executive pay were not exacerbated by compensation gross ups in response to a surtax. Gross up protection also has implications for the optimal design of investor tax relief. Firm-specific relief, e.g., providing a refundable corporate tax credit equal to the surtax collected from the executives at a particular company, would be the safest way to ensure that investors did not suffer from the imposition of a surtax. However, providing firm-specific relief might encourage surtax gross ups if executives, boards, and investors more closely identify refunded amounts with the surtax collected from the executives.

Consider the suggestion in Part III that surtax rates could be increased to account for the likelihood of partial gross ups. It was noted that any desired reduction in after-tax executive pay generally could be achieved by increasing the surtax rate and that refunding surtax proceeds to investors generally would ensure that distortions in investment decisions resulting from extraction of excessive pay would be mitigated, not worsened.¹⁶⁷ However, ramping up the surtax rate in the face of gross ups would increase pre-tax executive pay and this difference in nominal compensation would matter if investor tax relief were to be provided through a general reduction in marginal corporate income tax rates or general dividend tax relief. The association between the corporate cost of gross ups and investor tax relief would be quite loose, and gross ups could result in winners and losers among investors. Reducing the corporate tax rate would not benefit investors in effectively tax exempt firms, but these investors would bear the cost of grossed up executive pay. Dividend tax relief would not benefit non-taxable investors, whereas gross ups would come at the expense of both taxable and non-taxable investors. As a result, increasing surtax levels to mitigate shifting incidence of the surtax might be effective in aggregate, but might disadvantage some investors relative to others.

Inconsistency between investors could be minimized by closely linking the surtax to firm-specific tax relief. For example, firms could be given a *refundable* corporate

¹⁶⁷ The second statement is strictly true as long as a firm's corporate marginal tax rate equals or exceeds the executive's marginal tax rate (excluding the surtax). *See supra* note X and accompanying text.

tax credit equal to the surtax collected from executives at that firm. This approach would best ensure that investors were not harmed by the imposition of a surtax.¹⁶⁸

Providing firm-specific relief, however, might have the unintended consequence of encouraging implicit gross ups if executives, boards, and perhaps even investors closely identify the corporate tax relief with the surtax collected. For example, the following two investor tax relief strategies might have different effects on executive, board, and investor psychology, and thus on the outrage constraint. First, suppose that the top corporate income tax rate for 2013 applicable to Acme Co. and all other U.S. corporations is reduced from 35% to 34.8% as a result of aggregate surtax collections in 2012. Suppose Acme's tax bill is reduced by \$5 million. Second, imagine that Acme is entitled to a \$5 million refundable tax credit for 2013 based on the collection of \$5 million in surtaxes from Acme executives in 2012. One can imagine that Acme's executives, directors, and investors might be more likely to view the firm-specific refundable credit as being the "executives' money," and thus would be more amenable to compensating the executives up for the surtax in this scenario than they would be in the face of an across the board corporate tax rate cut.

If so, this factor might offset the investor protective feature of firm-specific relief to some degree. Whether general or specific, corporate income tax relief appears to be superior to dividend tax relief when it comes to gross up protection. As discussed in the previous subsection, dividend policies are heterogeneous, and many shareholders might suffer the consequences of a surtax gross up but enjoy no relief from a reduced rate of tax on their nonexistent dividends.

3. Salience and Persistence

If investor tax relief were to be provided through a general reduction in corporate or shareholder level taxes, one might be concerned about whether the magnitude of a surtax-commensurate rate cut would be salient and/or whether the "refund" would disappear over time in the course of further negotiations over tax rates. This is partially a question of the relative magnitude of excess executive pay, dividends, and corporate income and partially a question of design.

Public company executive pay in excess of \$1 million per executive is at least \$20 billion annually.¹⁶⁹ Let us take this as a low end estimate of the tax base for a surtax.

¹⁶⁸ To be sure, this approach would not fully protect investors in firms with very low effective tax rates if executives achieved complete surtax gross ups. Although the company would be entitled to a refund of the surtax paid, the gross up would also reimburse the executive for tax at ordinary income rates on the gross up amount. A firm with a low effective tax rate would see little tax benefit from making this payment, so there would be a net after-tax cost. Nonetheless, investors in a firm with a low effective tax rate would fare much better in a regime of firm-specific refundable credits for surtaxes paid than in a regime in which corporate tax rates were cut generally to offset surtax receipts. Matching a corporate tax credit with individual firm surtax proceeds would be somewhat analogous to the current matching of corporate deductions for compensation paid with employee inclusions. *See* I.R.C. § 83(a)&(h) (2006).

By comparison, qualified dividends reported on taxable returns in 2008 totaled \$141 billion,¹⁷⁰ and taxable corporate income is about \$1 trillion per year.¹⁷¹

Assuming no change in behavior and simply to provide a ballpark estimate of orders of magnitude, a 10% surtax applied to executive pay in excess of \$1 million per executive per year would generate about \$2 billion. This amount is roughly comparable to a one percentage point reduction in the tax rate on qualified dividends, which would cost the Treasury about \$1.4 billion. But \$2 billion in surtax receipts would fund only about a 0.2% point reduction in the corporate tax rate, reducing the current top rate from 35% to 34.8%, for example. A surtax on executive pay could fund a meaningful and salient reduction in the taxation of investment returns but only a very modest reduction in the general corporate income tax that one might fear would be lost in the rounding.

Of course, a firm-specific corporate income tax credit tied to the surtax would not be hampered by the mis-match in magnitude between excess executive pay and corporate income. Even without reverting to firm-specific relief, this difference in scale could be addressed by explicitly tying the general corporate income tax relief in any year to the amount of surtax collected in the prior year. In this way, the general corporate tax relief would not be lost in negotiations over the rate.

In sum, from a salience and persistence perspective, general dividend relief is probably superior to general corporate tax relief. However, it is possible to mitigate the corporate tax relief disadvantage through creative design.

4. Other Issues

Several other issues might be considered in designing investor tax relief to mitigate the adverse effect of excessive executive pay.

- Although the effect might be modest, dividend tax relief would encourage investment in dividend paying firms, larger payouts at dividend paying firms, and dividend payouts at more companies, at the margin. To this extent, both taxable and tax exempt investors might benefit as healthy dividend payouts may provide corporate governance benefits.¹⁷²

¹⁶⁹ See *supra* note X.

¹⁷⁰ STATISTICS OF INCOME DIVISION, INTERNAL REVENUE SERV., STATISTICS OF INCOME 2008 INDIVIDUAL INCOME TAX RETURNS 42 tbl.1.4 (2008). \$141 billion of aggregate qualified dividends were reported on 21 million taxable returns. Total aggregate qualified dividends of \$159 billion were reported on 26 million taxable and non-taxable returns.

¹⁷¹ STATISTICS OF INCOME DIVISION, INTERNAL REVENUE SERV., STATISTICS OF INCOME 2008 CORPORATION INCOME TAX RETURNS 2 fig. A (2008) (estimating aggregate corporate income subject to tax of \$1.25 trillion for 2007 and \$0.98 trillion for 2008).

¹⁷² Amy Dittmar & Jan Mahrt-Smith, *Corporate Governance and the Value of Cash Holdings*, 83 J. FIN. ECON. 599 (2007) (finding the market significantly discounts the value of cash-on-hand in poorly

A Tax Response to the Executive Pay Problem

- Firm-specific relief might be viewed as suggesting a level of precision in assessment of excessive compensation that executive pay critics would not claim. It is impossible to determine how much executive pay is excessive at any given company and should be refunded to that company's investors. It is unlikely, of course, that any board would acknowledge that a portion of executive pay is excessive and that any surtax should be applied.
- General investor tax relief, taking the form of a reduction in corporate tax rates or dividends, generally, seems more in keeping with the idea that executive pay is systematically higher across firms because managers with power over their own pay at a significant number of companies drive up the entire executive pay market. As a result, investors in the corporate sector, non-corporate capital, and labor bear this cost, irrespective of the quality of corporate governance at any particular company. Arguably, then, tax relief should be directed at corporate sector investors generally.
- Providing general investor tax relief would be less administratively burdensome and less expensive than providing firm-specific relief, and the relatively modest sums at stake tend to make a low cost approach more desirable.

In sum, investor tax relief could take one of several forms. There are pros and cons to general and firm-specific approaches and to approaches that are based on corporate income and dividends. In my view, corporate income seems the more promising basis for investor tax relief and the case for general versus firm-specific corporate income tax relief seems about balanced. Ultimately, political considerations would likely play as important a role as economic considerations in designing investor tax relief.

V. REGULATORY ALTERNATIVES

governed firms); Jarrad Harford et al., *Corporate Governance and Firm Cash Holdings in the US*, 87 J. FIN. ECON. 535 (2008) (finding firms with weaker governance more likely to repurchase shares than issue dividends in order to avoid future payout commitments); Pornsit Jiraporn, et al., *Dividend Payouts and Corporate Governance Quality: An Empirical Investigation*, 46 FIN. REV. 251 (2011) (finding firms with strong governance have a higher propensity to pay dividends). *But see* Wayne H. Mikkelson & M. Megan Partch, *Do Persistent Large Cash Reserves Hinder Performance*, 38 J. FIN. & QUANTITATIVE ANALYSIS 275 (2003) (finding that the holding of large cash reserves promotes investment without hindering performance); Micah S. Officer, *Dividend Policy, Dividend Initiations, and Governance* (Oct. 5, 2006) (unpublished manuscript, available at <http://www.terry.uga.edu/finance/docs/officer.pdf>) (finding predicted dividend payers with weak governance are more likely to pay dividends than predicted dividend payers with strong governance).

This Part considers several alternative means of regulating executive compensation including direct, coercive regulation, enhanced disclosure, and a different form of tax incentive. This Part concludes that the two pronged tax approach that has been the focus of this Article is superior to coercive regulation, which might be more effective in limiting pay but could be highly inefficient, and to disclosure-based reforms or expansion of I.R.C. § 162(m), which are unlikely to be effective without being counterproductive.

A. Coercive Regulation

Some commentators troubled by perceived excesses in executive compensation have proposed placing limits on executive pay that would be backed by coercive sanctions. A “hard” cap would be the most effective way to limit executive pay, but caps would also create significant distortions. Even if executive pay levels are too high systematically, we do not know the exact degree of excess pay and there is likely to be substantial heterogeneity in the amount of excess pay from firm to firm. Thus, coercive regulation is likely to be highly inefficient relative to tax-based regulation.

1. What Coercive Regulation Might Look Like

In general terms, caps on executive pay could be designed as fixed limitations or caps could be based on a formula, such as a multiple of median employee pay or company revenues. The Obama administration proposed to limit the non-incentive compensation of TARP covered executives to \$500,000 per year,¹⁷³ but I am not aware of any serious proposal to place a fixed dollar limit on *total* executive compensation.¹⁷⁴ The most empirically robust determinant of executive pay is firm size,¹⁷⁵ and given the huge differences in public company size and scope of managerial responsibility, it is readily apparent that a one-size-fits-all fixed limitation on total executive pay would not be a sensible regulatory option.

A formula-based limitation on executive pay would be more plausible. Outraged by the growing disparity between CEO pay and average worker pay, a number of commentators and legislators have proposed to limit CEO pay to a multiple of some measure of employee pay.¹⁷⁶ However, these proposals still do not get at the scale

¹⁷³ See Press Release, U.S. Dept. of Treasury, Treasury Announces New Restrictions on Executive Comp. (Feb. 4, 2009).

¹⁷⁴ The Obama administration proposal can be viewed as being analogous to I.R.C. § 162(m), which was designed to encourage the use of performance-based pay, rather than as an attempt to limit overall compensation.

¹⁷⁵ See *supra* note X and accompanying text [cross reference to Murphy (1999) on same point].

¹⁷⁶ For example, Sen. Richard Durbin (D-IL) introduced legislation in 2009 that would have required a 60 percent shareholder vote to authorize executive compensation in excess of 100 times average employee compensation. See S. 1006, 111th Cong. (2009). For many years, Rep. Martin Sabo (D-MN) introduced legislation that would have limited the deduction for employee compensation to an amount equal to 25 times the pay of the lowest paid employee. Sabo has retired, but his legislation continues to be introduced in the House. See, H.R. 382, 112th Cong. (2011).

problem. Under a scheme such as this, the CEO of a small tech company populated with highly skilled and highly compensated engineers could be paid more than the CEO of a massive company with a large population of relatively low paid workers, such as Exxon.¹⁷⁷

More plausible still would be a formula tied to some measure of firm size such as assets, revenue, or market capitalization.¹⁷⁸ It is also possible that a formula would provide for adjustments based on company performance.¹⁷⁹

Dietl, Duschl, and Lang stress the importance of maintaining performance incentives within a salary cap system. Absent performance incentives, executives would be motivated to perform well only by the prospect of losing their (salary capped) positions. One would also expect that without performance incentives executives would tend to act in a much more risk averse fashion than their typically well-diversified shareholders would prefer.¹⁸⁰

Maintaining performance incentives within a “salary cap” system is not conceptually difficult. The key would be to limit the ex ante value of executive pay, but to allow and encourage firms to provide performance-based pay. Suppose, for example, that three companies each issued stock options to their CEOs with ex ante expected value of \$5 million, the limit set by their pay cap formulas.¹⁸¹ The CEO whose firm most outperformed market expectations (as incorporated in the firm’s share price at the time of option grant) would receive the largest ex post payoff.

Once one moves beyond salary, however, limitations on ex ante pay become more difficult to enforce, and this enforcement concern suggests one advantage of tax-based regulation over pay caps. The realized value of compensation is relatively easy to determine with precision (and to tax). The ex ante value of some forms of pay – stock

¹⁷⁷ Susan J. Stabile, *One for A, Two for B and Four Hundred for C: The Widening Gap in Pay Between Executives and Rank and File Employees*, 36 U. MICH. J.L. REFORM 115, 161 (2002) (rejecting a pay ratio cap because of the one-size-fits-all problem and other limitations).

¹⁷⁸ English, French, and German heads of state have discussed the imposition of CEO salary caps and the possibility of linking caps to company performance. See, e.g., Jeffrey Stinson, *As CEO Pay in Europe Rises, So Does Talk of Curbing It*, USA TODAY, June 30, 2008, http://www.usatoday.com/money/companies/management/2008-06-29-europe-ceo-pay_N.htm.

¹⁷⁹ Helmut M. Dietl et al., *Executive Pay Regulation: What Regulators, Shareholders, and Managers Can Learn from Major Sports Leagues*, 13 BUS. & POL., Issue 2, art.6 at 18-19 (2011), <http://www.bepress.com/bap/vol13/iss2/art6/>.

¹⁸⁰ In addition to their human capital, corporate executives tend to have a disproportionate fraction of their financial capital invested in their firms. Shareholders, on the other hand, tend to be diversified. Absent incentives for risk-taking, executives would tend to be more conservative in their choices regarding project selection and similar matters than their shareholders would prefer. This mis-match in risk preferences was the rationale for the introduction of stock option compensation as well as the adoption of I.R.C. § 162(m). See John E. Core et al., *Executive Equity Compensation and Incentives: A Survey*, FRBNY ECON. POL’Y REV., Apr. 2003, at 27, 33 (discussing the use of stock options to overcome managerial risk aversion); Polsky, *supra* note X, at 889-90 (same).

¹⁸¹ Valuation could be determined utilizing the Black-Scholes option pricing model.

options and SARs, in particular – requires calculations which involve manipulable inputs.¹⁸²

A hard cap on executive pay, whether formula based or not, presumably would be backed by significant sanctions for failure to comply. As it recently did in the case of several provisions of the Dodd-Frank Act,¹⁸³ Congress might direct the SEC to require the stock exchanges to delist firms that failed to comply with executive pay caps. Alternatively, Congress could impose such sufficiently severe financial penalties that it would be virtually impossible for firms to exceed the pay caps.

2. Pros and Cons of Coercive Regulation (Relative to Tax)

A significant advantage to coercive regulation in a context in which executives exert substantial influence over their own pay is that a hard cap precludes any possibility of a gross up. As long as all avenues of compensation can be identified and reasonably valued,¹⁸⁴ a hard cap would effectively limit executive pay and thus would most effectively address the impact of excessive pay on the distortion of investment decisions, the growing inequality of wealth, and the distortion in entry into the executive labor market.

Although a hard cap on executive pay would not be susceptible to being grossed up through conventional compensation, firms and executives would undoubtedly seek out ways of transferring value to executives that would not be subject to the cap. Despite investor sensitivity to executive perks, one would imagine that we would observe much greater use of corporate supplied housing, cars, and vacations disguised as business travel if these benefits were not appropriately valued and included in income subject to the cap. A hard cap would result in much greater pressure on avoidance of this type than would a surtax that allows compensation above a threshold, but extracts a portion thereof.

3. The Inefficiency of Coercive Regulation More Generally (Relative to Tax)

¹⁸² See David I. Walker & Victor Fleischer, *Book/Tax Conformity and Equity Compensation*, 62 TAX L. REV. 399, 431-32 (2009).

Another difficulty with this approach is that executives demand to be compensated for taking on risk. Unless salary caps were risk adjusted, the imposition of caps would actually encourage firms to move in the direction of “safe” pay, e.g., salary and easily achievable bonuses, in order to maximize the subjective value of pay packages to executives within the constraints of the caps. See Hall & Murphy, *supra* note X, at 5 (explaining that non-diversified executives value stock options below their cost to shareholders).

¹⁸³ See, e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act § 952(a), 15 U.S.C.A. § 78j-3(a)(1) (West 2010) (setting forth independence requirements for members of public company compensation committees and requiring the SEC to direct the exchanges to prohibit the listing of any equity security of a company that fails to comply with these independence requirements).

¹⁸⁴ As noted above, a cap based on the grant date value of pay would leave some room for manipulation and gaming, but there can be no doubt that a cap on pay would be more effective than a surtax in limiting executive value extraction through excessive compensation.

A hard cap on executive pay (whether a fixed amount or a formula based approach that would reflect differences in firm size and incorporate performance incentives) backed by severe financial penalties is an example of what economist Robert Cooter refers to as a sanction.¹⁸⁵ A surtax on executive pay above a certain threshold is a price in his terminology. The fundamental difference between the two and the primary reason that caps are likely to be an inferior approach to regulating executive pay is that sanctions are more distorting of behavior. As Cooter suggests, most actors comply with a standard that takes the form of a sanction. If firms that paid executives in excess of \$5 million per year faced certain and severe financial penalties, few would pay in excess of \$5 million per year. Taxes, or more generally, prices allow actors to optimize over the cost of paying the tax or adjusting their behavior.¹⁸⁶ Prices result in greater freedom of behavior and less distortion.

The problem for coercive regulation is one of information.¹⁸⁷ If a regulator could easily determine the optimal level of activity or precaution, a sanction might be the best regulatory response. In such a case, we want to distort behavior. However, in cases in which the regulator observes market failure but in which it is difficult to determine the efficient level of activity or precaution that is being regulated, the distortion created by a sanction can be very inefficient.¹⁸⁸ If we believe executive pay is excessive, but we do not know the optimal level of pay, a price or tax is likely to be the superior regulatory response.

It would be extraordinarily difficult for a regulator to determine the optimal level of executive pay or to produce a formula for determining that level at any particular firm. As commentators have noted, it is almost impossible for external observers to evaluate pay levels at particular firms even *ex post*,¹⁸⁹ which is, perhaps, the primary reason that the courts have been so hesitant to find that litigated pay levels are excessive.¹⁹⁰ Coming up with an *ex ante* formula to limit executive pay across the board would be even more difficult. There is undoubtedly substantial heterogeneity in the optimal level of pay at U.S. companies even after controlling for firm size, industry, etc. To be sure, a tax response to excessive pay also requires a threshold or thresholds, which could also be formula based. The difference is that, for the reasons

¹⁸⁵ Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523, 1524-25 (1984).

¹⁸⁶ Alberto Alesina & Francesco Passarelli, *Regulation versus Taxation 2* (Nat'l Bureau of Econ. Research, Working Paper No. 16413, 2010).

¹⁸⁷ Cf. Louis Kaplow & Steven Shavell, *On the Superiority of Corrective Taxes to Quantity Regulation*, 4 AM. L. & ECON. REV. 1 (2002) (demonstrating that corrective taxes are superior to direct regulation of externality generating activities when the regulator's information regarding the costs of mitigating those externalities is incomplete).

¹⁸⁸ Cooter, *supra* note X, at 1531.

¹⁸⁹ Stabile, *supra* note X, at 97.

¹⁹⁰ Kenneth J. Martin & Randall S. Thomas, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 605 (2001) (concluding that courts are reluctant "to enter into the business of determining what constitute reasonable levels of compensation").

Cooter described, the cost of getting the threshold wrong is very much lower in the case of a tax.

A cap on executive pay that had any real teeth would have several pernicious effects. First, a cap would tend to drive talented individuals out of the sector, leaving less talented individuals with fewer outside opportunities behind to manage our largest companies.¹⁹¹ Second, pay-capped executives who remained would tend to work less and consume more leisure.¹⁹² This effect might be mitigated by utilizing caps on ex ante pay that permit the use of performance-based compensation, but as noted above, enforcement costs would increase in this scenario. Third, pay caps – even sophisticated performance and size-based caps – would lead to an inefficient allocation of talent. Dietl, Duschl, and Lang analogize to professional sports. From an efficiency standpoint, we want the most talented players to play for the teams with highest marginal returns on talent.¹⁹³ These are not necessarily the highest revenue teams, although there is probably a strong correlation. Fourth, while size- and performance-based caps seem superior to fixed dollar caps, adopting more sophisticated caps would have unintended consequences. I have already noted the potential option value manipulation problem, but caps like these could have more serious real world effects. For example, if pay caps are based on firm size, executives would have a greater incentive than today to engage in empire building, even at the expense of shareholder value.¹⁹⁴ Fifth, the imposition of pay caps with real bite might cause some U.S. companies and/or U.S. executives to repatriate overseas, if so doing would allow the executives to avoid the regulation and would result in a superior mix of compensation, taxes, services, and amenities.¹⁹⁵

¹⁹¹ Rafael D'Oliveira et al., *Should the Government Regulate CEO Pay At Top TARP Firms?* (Univ. Chi. Booth Sch. of Bus. Econ. Analysis of Major Policy Issues No. 33111, 2010) available at http://works.bepress.com/karl_muth/18.

¹⁹² *Id.*

¹⁹³ Dietl et al., *supra* note X, at 20-21.

¹⁹⁴ Executives' personal incentives to grow their businesses are already substantial. As noted, compensation is clearly correlated with firm size. See *supra* note X and accompanying text. Executive roles at larger firms are more prestigious. In addition, larger firms may be less vulnerable to takeover threats. Brent W. Ambrose & William L. Megginson, *The Role of Asset Structure, Ownership Structure, and Takeover Defenses in Determining Acquisition Likelihood*, 27 J. FIN. & QUANTITATIVE ANALYSIS 575, 581-82 (1992) (finding the probability of receiving a takeover bid is negatively related to firm size); Mary M. Bange & Michael A. Mazzeo, *Board Composition, Board Effectiveness, and the Observed Form of Takeover Bids*, 17 REV. FIN. STUD. 1185, 1190 (2004) (finding that takeover offer premiums are negatively related to firm size); Paul Barnes, *Predicting UK Takeover Targets: Some Methodological Issues and an Empirical Study*, 12 REV. QUANTITATIVE FIN. & ACCT. 283, 291 (1999) (finding the likelihood of acquisition decreases with size); Randall Morck et al., *Alternative Mechanisms for Corporate Control*, 79 AMER. ECON. REV. 842, 848 (1989) (same); David Offenberger, *Firm Size and the Effectiveness of the Market for Corporate Control*, 15 J. CORP. FIN. 66, 67 (2009) (same); Krishna G. Palepu, *Predicting Takeover Targets A Methodological and Empirical Analysis*, 8 J. ACCT. & ECON. 3, 23 tbl.3 (1986) (finding empirical support, significant at the 0.05 level, for same). But see Gerald F. Davis & Suzanne K. Stout, *Organization Theory and the Market for Corporate Control: A Dynamic Analysis of the Characteristics of Large Takeover Targets 1980-1990*, 37 Admin. Sci. Q. 605, 605 (1992); (finding large corporations more likely to be taken over).

¹⁹⁵ Some companies claim that high U.S. taxes have contributed to their decisions to reincorporate abroad. Mihir A. Desai & James R. Hines, Jr., *Expectations and Expatriations: Tracing the Causes and*

These are serious concerns, and it seems likely that if Congress were to adopt executive pay caps it would set the caps at a fairly high level so as to minimize these distortions. That result could well be worse than doing nothing. Any cap that is placed on executive pay – whether formula based or a fixed dollar amount – is likely to become a target as did the \$1 million “cap” imposed by § 162(m).¹⁹⁶ If a cap were to be enacted at the high range of current pay so as to limit the inefficiency associated with one-size-fits-all compulsory regulation, the cap would serve as an invitation to raise pay for executives at the majority of firms, at which existing pay levels would be below the cap, as well as serving as a constraint on pay for the minority of firms, where current pay levels would equal or exceed the cap.

To be sure, a surtax on executive pay would also require a threshold that would serve as a target, and a surtax could also produce pernicious effects. But both concerns would be much reduced in the case of a surtax. Ideally, most firms would not adjust compensation following the imposition of a surtax, and the surtax would simply pull back a portion of the rents that are extracted by executives, but firms would have latitude to make individualized choices regarding executive pay levels that would be precluded by a cap. Moreover, because a surtax would be just that – a tax – rather than a limitation, there would be less risk in adopting a low threshold for the tax, such as \$1 million per year. Few senior executives of the large public companies in which the pay setting process is suspect earn less than \$1 million per year. As a result, the potential cost of creating a compensation focal point through the imposition of this surtax should be modest.

Consequences of Corporate Inversions, 55 NAT'L TAX J. 409 (2002) (finding some large American corporations with extensive foreign assets try to avoid U.S. income taxes on their foreign income by “inverting” their corporate structure so as to make the former U.S. parent company a subsidiary of one of its former foreign subsidiaries); Johannes Voget, *Relocation of Headquarters and International Taxation*, 95 J. PUB. ECON. 1067 (2011) (finding foreign repatriation taxes have a significant, positive effect on the probability that a multinational firm “relocates”); Robert J. Herbold & Scott S. Powell, Op-Ed., *Tax Laws Chasing Companies Away*, HOUSTON CHRON., Dec. 20, 2009, at B10 (retired COO of Microsoft and an executive consultant arguing America’s high corporate tax rates and taxation on foreign source income, inter alia, are forcing many U.S. companies to reincorporate overseas); Orsolya Kun, *A Broader View of Corporate Inversions: The Interplay of Tax, Corporate and Economic Implications* (bepress Legal Series, Working Paper No. 78, 2003), available at <http://law.bepress.com/expresso/eps/78> (finding corporate inversions to minimize U.S. taxation on worldwide income substantially reduce the accountability of directors and officers and create significant impediments to the enforcement of shareholder rights). Individual executive repatriation would be more disruptive, and given generally lower levels of executive pay outside the U.S., it is not clear how much more pay U.S. executives could obtain by relocating abroad. The benefit of relocation would depend in large part on the severity of pay caps. Nonetheless, the imposition of significant pay caps would provide compelling motivation for executives to explore overseas alternatives.

¹⁹⁶ See David G. Harris & Jane R. Livingstone, *Federal Tax Legislation as an Implicit Contracting Cost Benchmark: The Definition of Excessive Executive Compensation*, 77 ACCT. REV. 997 (2002) (finding that firms that paid their CEOs less than \$1 million prior to the enactment of I.R.C. § 162(m) increased cash compensation in proportion to the gap between existing compensation and the \$1 million deduction limit).

But, one might object, doesn't the foregoing parade of horrors that I have associated with pay caps ignore this Article's premise that the executive labor market is flawed and that pay levels are systematically inflated today? Well, yes and no. Clearly, the impact of a pay cap on executive flight from the corporate sector depends on the amount of rent that is being extracted today. Just as LeBron James is unlikely to quit playing basketball if his pay is capped at 75% of current earnings, highly talented corporate executives who extract substantial rents are unlikely to move on as a result of a cap. On the other hand, the existence of substantial rents is unlikely to mitigate the enhanced empire building incentive. More fundamentally, the working premise of this Article does not imply that excessive executive pay is uniform. There is likely to be substantial heterogeneity, such that any pay cap arrangement that has teeth would implicate the concerns listed above at a sizeable number of firms.

B. Enhanced Disclosure

Over the last 20 years, the most popular regulatory response to perceived executive pay problems has been enhanced SEC disclosure requirements. The SEC has labored hard to ensure that pay disclosure for top corporate executives is comprehensive and transparent, and they have largely achieved that goal. New rules adopted in 2009 finally provide a comprehensive measure of the total grant date value of executive pay packages that is both reasonably accurate and comparable from firm to firm.¹⁹⁷

As noted above, enhanced SEC disclosure requirements may have contributed to upward ratcheting of executive pay,¹⁹⁸ but the general Brandeis-ian idea that sunlight is the best disinfectant remains sound.¹⁹⁹ The problem in this context is that disclosure can at best provide discipline with respect to compensation that is excessive on a *relative* basis. The innovation of requiring regular shareholder advisory voting on executive pay practices can potentially sharpen this discipline,²⁰⁰ but, because it is very difficult to assess executive pay levels on an absolute basis, disclosure and shareholder "say on pay" votes are unlikely to have any significant effect on systematically excessive pay levels that are the focus of this Article.

C. Amend I.R.C. § 162(m)

An alternative tax-based approach to addressing systematically excessive executive pay would be to amend or replace I.R.C. § 162(m) with an overall limitation on the amount of senior executive pay that is deductible, with no exceptions for

¹⁹⁷ David I. Walker, *The Law and Economics of Executive Compensation: Theory and Evidence*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATION LAW (Claire Hill & Brett McDonnell eds., Elgar Press, forthcoming 2011).

¹⁹⁸ See *supra* note X and accompanying text.

¹⁹⁹ LOUIS BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1914).

²⁰⁰ Dodd-Frank Wall Street Reform and Consumer Protection Act § 951, 15 U.S.C.A. § 78n-1(a) (West 2010).

performance-based pay, or anything else. For several reasons, however, this does not seem a promising approach.

First, imagine an overall cap on deductible pay of \$1 million per executive per year – the current limitation on non-performance based pay. Our experience with the current § 162(m) suggests that this sort of tax penalty would likely be ignored with respect to highly paid executives at the majority of firms. Although most companies initially reacted to the enactment of § 162(m) by limiting non-performance based pay to \$1 million per executive per year, today firms routinely exceed this limitation, providing salaries and other non-performance based pay well in excess of the \$1 million threshold.²⁰¹ In their proxy statements, these firms typically state that deductibility is only one factor that the board considers in executive pay deliberations.²⁰² This is an interesting development, because it is generally considered to be relatively easy to qualify pay as deductible under § 162(m) by, for example, providing bonus opportunities with easily achievable targets.²⁰³ In a tax world in which there were no performance-based exceptions to a \$1 million cap on deductible pay, it seems likely that firms would simply dismiss the limitation as unreasonably low.

Thus, it is unlikely that the expanded reach of a \$1 million limitation on deductibility would significantly reduce executive pay. It would, however, raise revenue, reduce shareholder returns, and increase the disincentive to invest in the corporate sector. To the extent that the expanded deduction limitation did not impact pay levels, it would be equivalent to an increase in the corporate tax rate.

²⁰¹ For example, 62% of the 200 large, public company CEOs whose 2009 compensation was analyzed by Equilar, an executive compensation research firm, received base salary in excess of \$1 million. See *CEO Pay: The Tables*, N.Y. TIMES, Apr. 4, 2010, § BU, at 10-11.

²⁰² Apple Inc., Proxy Statement (Form Def. 14A), at 29 (Jan. 7, 2011) (“While the Compensation Committee considers the deductibility of awards as one factor in determining executive compensation, the Committee also looks at other factors in making its decisions”); Exxon Mobil Corp., Proxy Statement (Form Def. 14A), at 41 (Apr. 13, 2011) (“The primary drivers for determining the amount and form of executive compensation are the retention and motivation of superior executive talent rather than the Internal Revenue Code.”); Wal-Mart Stores Inc., Proxy Statement (Form Def. 14A), at 37 (Apr. 18, 2011) (“[Committee] retains the ability to pay appropriate compensation, even if our company may not be able to deduct all of that compensation under federal tax laws.”)

²⁰³ E.g., Jack S. Levin, *Code Section 162(m) - \$1 Million Deduction Limit on Executive Compensation*, 63 Tax Notes 723, 731-42 (1994) (discussing the substantial ambiguities in I.R.C. § 162(m) and in the 1.162-27 regulations, and proposing language that would ameliorate many of the statutory and regulatory problems); Scott P. Spector, *Executive Compensation Strategy, Design and Implementation*, June 15, 2006, 741 PLI/TAX 13, 59 (2006) (describing how “fairly easily attained goals” can nevertheless be structured to give rise to deductible performance based compensation). However the IRS has recently proposed regulations that would somewhat tighten the performance-based compensation requirements. Certain Employee Remuneration in Excess of \$1,000,000 Under Internal Revenue Code Section 162(m), 76 Fed. Reg. 37034 (proposed June 24, 2011) (to be codified at 26 C.F.R. 1.162-27) (requiring performance-based compensation plans to specify the maximum number of shares or options to be granted to any one employee at the time the plan is approved by shareholders, instead of allowing the compensation committee to select the maximum number of shares or options at a later date).

Of course, in broadening § 162(m) in the fashion contemplated herein, Congress might reasonably increase the threshold to reflect current pay practices. As noted above, median compensation of large firm CEOs was over \$9 million for 2010.²⁰⁴ Suppose Congress were to adopt a deductibility limit of \$10 million per executive per year. A deductibility cap of that magnitude might have some effect on curtailing executive pay. However, a one size fits all limitation of this sort would be inefficient for the reasons discussed in Part V. In addition, as we saw with the adoption of the present § 162(m) in 1993, a relatively high threshold might serve more as a target for the compensation of lower paid executives than as a limitation on pay for the very highly compensated.

VI. CONCLUSION

Given the risk of gross ups, the superiority of a tax response to the executive pay problem is not unambiguous. Nonetheless, the combination of a surtax placed on high levels of executive pay and corporate tax relief seems the most promising means of reducing executive after-tax incomes and ameliorating the distortions in investment created by excessive pay without incurring the risks and unintended consequences of direct, coercive regulation. Let me conclude, however, by suggesting a very different tack one might take with the data, analyses, and arguments that have been presented in this Article.

Given the growth in income inequality in this country, particularly at the high end of the income distribution, and what appears to be a looming fiscal crisis, several commentators have proposed increasing marginal tax rates for high income individuals generally.²⁰⁵ Several commentators have floated the idea of a “millionaires’ tax,” by which they really mean a surtax on annual incomes in excess of \$1 million per year.²⁰⁶

Taking this broader perspective, one could argue that deficiencies in the executive labor market resulting in rents for corporate executives represent an additional justification for levying a general surtax on high income individuals.²⁰⁷ This

²⁰⁴ See *supra* note X and accompanying text.

²⁰⁵ Warren Buffett, Op-Ed., *Stop Coddling the Super-Rich*, N.Y. TIMES, Aug. 15, 2011, at A21; James Surowiecki, *Soak the Very, Very Rich*, NEW YORKER, Aug. 16, 2010 at 33; Thomas Piketty, *Proposer’s Opening Remarks, Economist Debates: Resenting the Rich*, ECONOMIST.COM, Apr. 7, 2009, <http://www.economist.com/debate/days/view/293>.

²⁰⁶ Buffett, *supra* note X, at A21; Robert Frank & Laura Sanders, *The Battle Over the Millionaire’s Tax*, WALL ST. J. ONLINE, Mar. 26, 2011, <http://wsj.com> (search “Millionaire’s Tax”); Surowiecki, *supra* note X, at 33. A Quinnipiac University poll found broad support for a “millionaire’s tax,” even among Republicans. See Press Release, Quinnipiac University, New York Voters Back Millionaires Tax 4-1, Quinnipiac University Poll Finds; Most Voters Back Higher Tax on People Making \$250,000 (Feb. 18, 2009), <http://www.quinnipiac.edu/x1318.xml?ReleaseID=1265>.

²⁰⁷ Saugato Datta, *Moderator’s Rebuttal Remarks, Economist Debates: Resenting the Rich*, ECONOMIST.COM, Apr. 10, 2009, <http://www.economist.com/debate/days/view/294> (noting that, if true,

justification would extend to private company executives and even non-profit executives to the extent that these labor markets are infected by excess pay received by public company executives. Of course, this justification would apply only to a subset of high income individuals. The income of sports stars and entertainers may also include rents, but there is no reason to think that their compensation does not result from an efficient labor market. As we have seen, however, the subset of high income individuals to whom this rationale would apply is larger than we previously believed. Public and private company executives could account for one-third or more of individuals in the top 0.1% of the income distribution.²⁰⁸

More broadly based taxes generally are better (less distorting) than more narrowly based taxes,²⁰⁹ and expanding the surtax to all high income individuals would have several clear advantages over a surtax limited to excessive executive pay. Although companies could still increase executive pay to offset the effect of a general surtax on income in excess of \$1 million per year, one would think that a general increase in tax rates would be less likely to be grossed up than a surtax directed specifically at executive pay.²¹⁰ Given a lesser risk of gross ups, there would be less of an imperative to refund the surtax collected from executives to investors. In other words, if a general millionaires' tax were to be imposed, investor tax relief probably would have to stand on its own bottom.

In addition, expanding the surtax to all high income individuals might mitigate certain distortions and avoidance maneuvers, such as attempts to defer compensation to a period in which an individual would no longer be subject to an executive pay surtax. The imposition of a millionaires' surtax would also eliminate any difficulty in identifying the membership of the surtaxed group.²¹¹

Finally, one might think that an advantage to a general millionaires' tax over an executive pay surtax would be that the former would do less to distort career decisions. However, if one accepts the view put forward above that the executive labor market is

the argument "that there is a market failure in the way top compensation is decided...provides a rationale for higher taxation of the rich separate from concerns about inequality").

²⁰⁸ Bakija et al, *supra* note X, at 51 tbl.3.

²⁰⁹ This is true because a more narrowly based tax is (generally) more avoidable through substitution, and thus results in greater distortions in behavior. Distorted behavior resulting from taxation is, of course, the root source of taxation inefficiency. *See* ROSEN, *supra* note X, at 292.

²¹⁰ I base this assumption on the lack of empirical evidence that executives pass on the effect of general rate increases, *supra* note X and accompanying text, and on the idea that the imposition of a millionaires' tax would be less likely to loosen the outrage constraint than a tax directed specifically at executive pay.

²¹¹ On the other hand, if a general millionaires' surtax results in top individual rates significantly exceeding corporate tax rates, the C corporation may once again become a tax shelter allowing closely held businesses to defer and reduce effective taxes. *See* Daniel Halperin, *Mitigating the Potential Inequity of Reducing Corporate Rates* (Tax Policy Center Working Paper, July 29, 2009) (discussing the potential C corporation shelter issue and recommending fixes). The executive pay surtax proposed herein does not appear to implicate these issues.

A Tax Response to the Executive Pay Problem

already distorted by the existence of excessive compensation, a modest surtax limited to executive pay would reduce long-term labor supply distortions rather than create them. The imposition of a millionaires' tax instead would simply preserve the existing distortions in the executive labor market.

To be sure, it is somewhat unfair to compare an executive pay surtax to a general millionaires' surtax. The exercise has an apples to oranges quality. Moreover, while the proposal put forward in this Article addresses the executive pay problem from both ends, a millionaire's surtax would do nothing to ameliorate the distortion in capital allocation that results from excessive executive pay. In my view, these are both projects worth pursuing. As long as top total marginal federal rates remained in the vicinity of 50%, I could well imagine doing both.