A TAX RESPONSE TO THE EXECUTIVE PAY PROBLEM

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INTRODUCTION

Many observers believe that the executive labor market in the United States 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]

[1] Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 754 (2002); *see also* GRAEF S. CRYSTAL, IN SEARCH OF EXCESS (1991); Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283, 302 (2005); Lucian A. Bebchuk, Yaniv Grinstein & Urs Peyer, *Lucky CEOs and Lucky Directors*, 65 J. FIN. 2363, 2365 (2010); Lucian A. Bebchuk & Robert J. Jackson, Jr., *Executive Pensions*, 30 J. CORP. L. 823, 826 (2005); Marianne Bertrand & Sendhil Mullainathan, *Agents with and Without Principals*, 90 AM. ECON. REV. (PAPERS & PROC.) 203, 206-07 (2000) [hereinafter Bertrand & Mullainathan, *Agents*]; Marianne Bertrand & Sendhil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are*, 116 Q.J. ECON. 901, 902 (2001) [hereinafter Bertrand & Mullainathan, *CEOs*].

[2] Bebchuk, Fried & Walker, *supra* note 1, at 766-74; Bebchuk, Grinstein & Peyer, *supra* note 1, at 2373-82; *see also* Bebchuk & Grinstein, *supra* note 1, at 300-02; Bertrand & Mullainathan, *Agents*, *supra* note 1, at 208.

[3] *See* Bebchuk, Fried & Walker, *supra* note 1, at 840-42.

[4] Bertrand & Mullainathan, *CEOs*, *supra* note 1, at 916; *see also* Bebchuk, Fried & Walker, *supra* note 1, at 840-42.

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 market, and excessive executive pay likely has contributed 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, since 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.

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[5] *See, e.g.*, Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 44 (2003); Ran Duchin, John G. Matsusaka & Oguzhan Ozbas, *When Are Outside Directors Effective?*, 96 J. FIN. ECON. 195, 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, 1289 n.22 (1998); Randall S. Thomas, *Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information*, 38 ARIZ. L. REV. 331, 332 (1996); Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too* 4-5 (John M. Olin Ctr. for Law, Econ., and Bus. at Harvard Law Sch., Discussion 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, Fried & Walker, *supra* note 1, at 786-91 (arguing that executive compensation is structured to camouflage pay and limit outrage); Bebchuk & Jackson, *supra* note 1, at 831.

[7] *See infra* notes 82-92 and accompanying text.

[8] *See infra* notes 73-76 and accompanying text.

[9] *See infra* notes 227-41 and accompanying text.

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. 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.[10] By these measures, an executive pay surtax would be a relatively non-distorting and thus 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.[11] 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 limited to public company executives. This Article argues, however, 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 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 two-pronged approach of this Article primarily targets symptoms of market failure – systematically excessive pay and its attendant distortions – rather than seeking to correct the underlying deficiencies in corporate

[10] *See infra* notes 111-33 and accompanying text.

[11] *See infra* notes 133-36 and accompanying text.

governance, which have thus far proved to be irremediable. The adoption of these proposals, however, would also send a powerful signal to managers and directors that could help to re-establish more reasonable norms regarding acceptable corporate behavior and pay practices. In this respect, the proposals that follow are aimed at the heart of the matter.

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

Part IV 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 the Conclusion. In addition, the Conclusion 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.

I. THE EXECUTIVE PAY PROBLEM

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

Executive compensation in the United States 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 2011 CEO compensation at 300 of the largest U.S. public companies was $10.3 million, reflecting an increase of about 14% from the temporarily reduced pay levels seen during the height of the financial crisis.[12] Public company CEO pay has increased in *real terms* by 500% or more over the last 30 years.[13]

[12] HAYGROUP, THE WALL STREET JOURNAL/HAY GROUP 2011 CEO COMPENSATION STUDY 1 (2012), *available at* http://www.haygroup.com/downloads/ww/WSJ_Hay_Group_2011_Study_Summary_Results_FINAL_5.20.12.pdf (reporting 2011 median total direct compensation of $10.3 million, a 2.8% increase over 2010); *see also* HAYGROUP, THE WALL STREET JOURNAL/HAY GROUP 2010 CEO COMPENSATION STUDY 1 (2011), *available at* http://www.haygroup.com/downloads/ww/misc/wsj_2010_ceo_compensation_study_5-17-11_web.pdf (reporting that the median total direct CEO compensation in 2010 increased by 11%

The growth of executive pay is also reflected in the increased disparity over time between top executive pay and the compensation of rank-and-file workers. In 1980 the ratio of average CEO pay to average rank-and-file worker pay was 42 to 1.[14] By the early 1990s, that ratio had increased to 100 to 1.[15] At the peak of the dot-com bubble in 2000, the ratio exceeded 400 to 1.[16] The ratio declined as executive pay moderated during the financial crisis, but even in 2009 it continued to exceed 200 to 1.[17] 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.[18]

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.[19] Standard & Poor's ExecuComp database collects this data for executives at over 2000 public companies.[20] In 2010 aggregate executive compensation for roughly 10,000 ExecuComp executives totaled $26.7 billion, an average of about $2.67 million per top executive.[21]

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from 2009 levels to $9.3 million).

[13] Carola Frydman & Raven E. Saks, *Executive Compensation: A New View from a Long-Term Perspective, 1936-2005*, 23 REV. FIN. STUD. 2099, 2107 fig.1 (2010) (finding an increase of over 500%); Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?*, 123 Q.J. ECON. 49, 51 (2008) (finding a 500% increase).

[14] *Executive Paywatch: Trends in CEO Pay*, AFL-CIO, http://www.aflcio.org/Corporate-Watch/CEO-Pay-and-the-99/Trends-in-CEO-Pay (last visited Jan. 16, 2013).

[15] *See* LAWRENCE MISHEL ET AL., ECON. POLICY INST., THE STATE OF WORKING AMERICA 290, 291 fig.4AH (2012).

[16] *Id.*

[17] *Id.* at 291 & fig.4AH.

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

[19] Executive Compensation, 17 C.F.R. § 229.402(a) (2012) (requiring "clear, concise and understandable disclosure of all plan and non-plan compensation awarded to, earned by, or paid to" "the registrant's principal executive officer," its "principal financial officer," and its "three most highly compensated executive officers other than the PEO and PFO").

[20] The ExecuComp universe includes "active, inactive, current and previous members" of the S&P 1500. *Compustat ExecuComp*, COMPUSTAT, http://www.compustat.com/products.aspx?id=2147492873 (last visited Jan. 11, 2013).

[21] *See* COMPUSTAT EXECUCOMP, http://wrds-web.wharton.upenn.edu/wrds/index.cfm (search results on file with author). All the data reported herein are based on the ExecuComp variable TDC1. The TDC1 measure of executive pay 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 2010 was $28.41

Lucian Bebchuk and Yaniv Grinstein collected similar data for ExecuComp-listed executives over the 1993-to-2003 period and also estimated pay for U.S. public companies with market capitalization in excess of $50 million that were not listed on ExecuComp.[22] For the entire period, they estimated that top executive pay constituted 6.6% of the aggregate earnings of these companies.[23] 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%.[24]

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.[25] Assuming that this relationship still holds, a ballpark estimate for 2010 top executive pay for U.S. public companies with market capitalization in excess of $50 million would be about $44.5 billion.[26] Note, moreover, that these figures include only the top five executives at each company.[27] 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.[28] Remember, also, that these figures do not reflect one-time transfers, but represent annual flows to company executives.

To be sure, executives of public companies would be very highly compensated even in a well-functioning managerial labor market. Reciting the

billion. *Id.*

[22] Bebchuk & Grinstein, *supra* note 1, at 296.

[23] *Id.* at 297.

[24] *Id*.

[25] *Id.*

[26] This figure was calculated by adding $26.7 billion aggregate compensation for ExecuComp executives to $17.5 billion (2/3 x $26.7 billion) aggregate compensation for non-ExecuComp executives. Note, however, that Bebchuk and Grinstein's data are reported in 2002 dollars, and thus the $50 million cutoff would be somewhat higher in 2010 dollars.

[27] Executive Compensation, 17 C.F.R. § 229.402 (2012).

[28] Examining tax return data, Bakija, Cole, and Heim found that executives of non-closely held businesses in the top 0.1% of earners received 1.14% of national income in 2005 (excluding capital gains). Jon Bakija, Adam Cole & Bradley T. Heim, *Jobs and Income Growth of Top Earners and the Causes of Changing Income Inequality: Evidence from U.S. Tax Return Data* 43 (Econ. at Williams Coll., Working Paper No. 2010-24, 2012), *available at* http://web.williams.edu/Economics/wp/BakijaColeHeimJobsIncomeGrowthTopEarners.pdf. In 2008 national income (excluding capital gains) amounted to $7.8 trillion. *The Database*, WORLD TOP INCOMES DATABASE, http://topincomes.g-mond.parisschoolofeconomics.eu/#Database: (last visited Jan. 11, 2013) (select "United States," from "2008" to "2008," and "Income Control" variable, and then press "retrieve"). 1% of this amount is $78 billion. Although this data excludes capital gain income, it includes ordinary income other than compensation. Nonetheless, we can derive a ballpark range for executive pay from this and the other data cited herein of about $40 to $80 billion annually.

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 baseline 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 – and, in particular, a tax response – given that assumption. This Article is not intended to reopen the debate concerning the efficiency of the executive labor market,[29] but in order to evaluate potential responses, it is necessary to understand in what ways this 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.[30] 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 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.[31] According to Jensen and Meckling, 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.[32] These managerial agency costs 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.[33] Most of the theoretical and empirical literature on executive pay proceeds from the assumption that compensation arrangements are selected to minimize agency costs and maximize shareholder value.[34]

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[29] For an overview of the debate, see Symposium, *Management and Control of the Modern Business Corporation*, 69 U. CHI. L. REV. 729 (2002). *See also* John E. Core, Wayne R. Guay & Randall S. Thomas, *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1144 (2005) (reviewing LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004)).

[30] Bebchuk, Fried & Walker, *supra* note 1, at 754.

[31] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 309 (1976).

[32] *See id.* at 309-10.

[33] *Id.* at 308. Some degree of agency cost is unavoidable in the modern, widely held corporation. *Id.*

[34] Surveys of the executive compensation literature emanating from the optimal contracting perspective include John E. Core, Wayne R. Guay & David F. Larcker,

Many observed features of the executive pay landscape, however, appear to be inconsistent with the share-value-maximizing, or optimal contracting, model of the executive-pay process.[35] An alternative, managerial power view of the 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.[36] Under this view, executive pay is not simply a tool to combat agency costs; it is a product of the agency problem.[37] 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.[38]

The managerial power view and the optimal contracting view of the pay-setting process are not mutually exclusive. At any given firm, one approach or the other may provide relatively more explanatory power.[39] 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, 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.[40]

The managerial power view of the executive-pay-setting process suggests two major sources of inefficiency. Much of the literature focuses on the distortions in compensation design that follow from an outrage constraint and

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Executive Equity Compensation and Incentives: A Survey, FED. RES. BANK N.Y. ECON. POL'Y REV., Apr. 2003, at 27, and Frydman & Jenter, *supra* note 18.

[35] BEBCHUK & FRIED, *supra* note 29, at 3-4; *see also* Bebchuk, Fried & Walker, *supra* note 1, at 755; Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP., Summer 2003, at 71, 72; Bebchuk & Grinstein, *supra* note 1, at 302; Frydman & Jenter, *supra* note 18, at 89-94.

[36] Bebchuk, Fried & Walker, *supra* note 1, at 754.

[37] *Id.* at 784.

[38] *Id.* at 786.

[39] *Id.* at 755. 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. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 254 (1999). This theory predicts that compensation arrangements would not be designed to maximize shareholder value, but to balance the interests of the stakeholders. *Id.* at 280-81.

[40] *See* Bebchuk, Fried & Walker, *supra* note 1, at 786-93. For example, it seems quite clear that given the defensive mechanisms available to target management, the hostile-takeover market provides little disciplinary force on senior executive pay. *See* Henry G. Manne, *Bring Back the Hostile Takeover*, WALL ST. J., June 26, 2002, at A18.

the attendant costs.[41] 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.[42] Doing so, however, results in compensation choices that do not maximize shareholder value.[43]

This Article focuses 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 resulting distortions in investment behavior. 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.[44]

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."[45] 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.[46] 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 the 50th percentile of peer executive compensation.[47] This practice of benchmarking with targets at

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[41] BEBCHUK & FRIED, *supra* note 29, at 64-66; Bebchuk & Fried, *supra* note 35, at 75-76; Bebchuk, Fried & Walker, *supra* note 1, at 786-88; Bebchuk & Grinstein, *supra* note 1, at 300-01; Core, Guay & Thomas, *supra* note 29, at 1143.

[42] Bebchuk, Fried & Walker, *supra* note 1, at 789.

[43] *See id.*

[44] *See id.* at 842 (observing that pay levels will be systematically higher because compensation committees at well-governed firms must increase compensation in order to attract CEOs away from the poorly governed firms from which they presently extract rents).

[45] John M. Bizjak, Michael L. Lemmon & Lalitha Naveen, *Does the Use of Peer Groups Contribute to Higher Pay and Less Efficient Compensation?*, 90 J. FIN. ECON. 152, 153 (2008).

[46] Lake Wobegon, of course, is radio personality Garrison Keillor's mythical Minnesota community where "all the children are above average." *See* A PRAIRIE HOME COMPANION WITH GARRISON KEILLOR, http://prairiehome.publicradio.org/about/podcast/ (last visited Jan. 11, 2013).

[47] Bizjak, Lemmon & Naveen, *supra* note 45, at 153 (finding that the vast majority of

or above the 50th percentile leads to upward ratcheting in executive pay.[48] 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.[49]

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.[50]

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

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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 toward justifying high executive pay levels. *See* John Bizjak, Michael Lemmon & Thanh Nguyen, *Are All CEOs Above Average? An Empirical Analysis of Compensation Peer Groups and Pay Design*, 100 J. FIN. ECON. 538, 550 (2011); Michael Faulkender & Jun Yang, *Inside the Black Box: The Role and Composition of Compensation Peer Groups*, 96 J. FIN. ECON. 257, 259 (2010).

[48] Bizjak, Lemmon & Naveen, *supra* note 45, at 155.

[49] For example, Yaniv Grinstein, David Weinbaum, and Nir Yehuda found that after disclosure requirements for perks were enhanced, 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. Yaniv Grinstein, David Weinbaum & Nir Yehuda, *The Economic Consequences of Perk Disclosure* 2 (Johnson Sch. Research Paper Series, No. 06-2011, 2011), *available at* http://ssrn.com/abstract=1108707. The authors provide additional evidence suggesting that the increase in perks by formerly low-perk firms reflected actual ratcheting rather than simply increased disclosure. *Id*.

[50] Outliers exist at both the high and low ends of the executive pay spectrum. *See, e.g.*, 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); Gretchen Morgenson, *The Best and the Worst in Executive Pay*, N.Y. TIMES, Sep. 17, 2006, § 3, at 1; Sophia J.W. Hamm, Michael J. Jung & Clare Wang, Making Sense of One Dollar CEO Salaries 27 (Aug. 15, 2012) (unpublished manuscript available at http://ssrn.com/abstract=1796403) (examining CEOs who receive salaries of one dollar per year, finding that a subset are not compensated through other means, and finding positive market reaction in this subset of cases).

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 considering who bears the cost of this transfer. It continues 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 United States.

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.[51] 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 have discussed at greater length elsewhere,[52] 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 tax. Like an actual tax, the economic tax created by systematically excessive pay reduces investor returns in a particular sector, which may have an effect on the allocation of capital.[53] 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.[54] Nonetheless, this literature suggests, 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

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[51] *See, e.g.*, Bebchuk, Fried & Walker, *supra* note 1, at 785.

[52] *See* David I. Walker, *Who Bears the Cost of Excessive Executive Compensation (and Other Corporate Agency Costs)?*, 57 VILL. L. REV. 653, 662 (2012).

[53] *Id.* at 669.

[54] *See id.* at 663.

sectors (corporate and non-corporate) and two factors of production (labor and capital).[55] 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 holders of capital in the economy.[56] Joel Slemrod and Jon Bakija explain the model by drawing an analogy to the imposition of a toll on one of two parallel highways.[57] When the toll is first imposed, those who drive on the road with the new toll bear the entire cost. Over time, however, some drivers switch from the toll road to the non-toll road, which increases congestion and the cost of using the non-toll road and reduces the congestion and cost of using the toll road. In equilibrium, the total cost, including tolls and time, 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.[58]

This model of corporate tax incidence is quite elegant but its assumption of a closed economy and fixed factors of production is unrealistic. Much of the theoretical work in recent years has focused on exploring the incidence question under more realistic, open-economy assumptions.[59] 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 the incidence of a systematic increase in excessive executive pay, falls primarily on the immobile factor of production: domestic labor.[60] 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.

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

[56] *Id.* at 219.

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

[58] 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 55, at 218.

[59] *See, e.g.*, Alan J. Auerbach, *Who Bears the Corporate Tax? A Review of What We Know*, *in* 20 TAX POLICY AND THE ECONOMY 1, 2-3 (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?*, 6 ADVANCES ECON. ANALYSIS & POL'Y, no. 1, 2006, at 1, 3; William C. Randolph, *International Burdens of the Corporate Income Tax* 6-9 (Cong. Budget Off., Working Paper No. 2006-09, 2006), *available at* http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/75xx/doc7503/2006-09.pdf.

[60] *See* Randolph, *supra* note 59, at 26.

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.[61]

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.[62] For example, to the extent that the 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.[63] As Rosanne Altshuler, Benjamin Harris, and Eric 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.[64]

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.[65] Unfortunately, empirical work in this area is also subject to criticism, and, to my knowledge, no economist 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. Let's begin with the closed-economy model. An important assumption in maintaining the analogy between the corporate income tax and systematically excessive executive pay under this model is that executive pay excesses do not infect the entire economy. It is an important assumption, in other words, that investors would be able to avoid an increase in executive pay by shifting capital to other sectors. This seems to be a reasonable assumption. There are a number of domestic investment sectors, such as real estate, that would not be tainted by excessive executive pay.[66]

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[61] Gravelle & Smetters, *supra* note 59, at 10-12.

[62] *See* Auerbach, *supra* note 59, at 1.

[63] *Id.* at 25-28.

[64] Rosanne Altshuler, Benjamin H. Harris & Eric Toder, *Capital Income Taxation and Progressivity in a Global Economy*, 30 VA. TAX REV. 355, 361 (2010).

[65] *See, e.g.*, Mihir A. Desai, C. Fritz Foley & James R. Hines Jr., *Dividend Policy Inside the Multinational Firm*, FIN. MGMT., Spring 2007, at 5, 25; Kevin A. Hassett & Aparna Mathur, *Taxes and Wages* 25 (Am. Enter. Inst. for Pub. Policy Research, Working Paper No. 128, 2006), *available at* http://www.aei.org/files/2006/03/06/20060315_TaxesandWages.pdf.

[66] Although some U.S. domestic real-estate investment is carried out under corporate

Another important and apparently valid assumption in a closed-economy setting 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.[67]

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 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.[68]

An open-economy model would collapse into a closed-economy model if changes in systematically excessive U.S. executive pay were matched abroad,[69] 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 single, 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.[70] These differences do not

form, most, including, most obviously, owner-occupied housing, is not.

[67] 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. Bebchuk, Fried & Walker, *supra* note 1, at 774-75; Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 553-57 (1984).

[68] *See supra* notes 60-61 and accompanying text.

[69] 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*, 131 TAX NOTES 1083, 1085 (2011).

[70] *See* Brian J. Hall, INCENTIVE STRATEGY II: EXECUTIVE COMPENSATION AND OWNERSHIP STRUCTURE 6-7 (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., *Are US CEOs Paid More? New International Evidence* 27-28 (European Corporate Governance Inst., Working Paper No. 255/2009, 2012), *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 as well as 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. 08-26, 2008), *available at* http://ssrn.com/abstr

in themselves confirm that U.S. executive pay is excessive. Some commentators have suggested that because of differences in ownership structure or culture, executive talent may be more important to the success or failure of firms in the United States than abroad.[71] Nonetheless, increases or decreases in systematically excessive executive pay in the United States 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.[72] 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.

2. Effect of Excessive Executive Pay on Corporate Investment

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

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 reallocate 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 presumably are inefficient.[73]

act=1265122 (demonstrating that non-U.S. executives receive less total compensation and less performance-oriented pay, but also providing evidence of a shift toward U.S. pay practices).

[71] Bebchuk, Fried & Walker, *supra* note 1, at 842-43; *see also* 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)).

[72] *See supra* notes 51-68 and accompanying text.

[73] As with any distortion in a complex economic system, it is possible that the economic

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,[74] 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.[75] 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.[76]

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.[77] In recent work examining executive compensation at portfolio

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tax imposed by excessive executive pay offsets some other distortion and actually moves us closer to overall efficiency. This is the well-known problem of the second best. R.G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11, 11-12 (1956).

[74] For example, Lucian Bebchuk and Yaniv Grinstein posit that the bull market of the 1990s loosened the outrage constraint which permitted executives to increase their compensation. Bebchuk & Grinstein, *supra* note 1, at 300-01.

[75] 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, Assem Safieddine & Gopala K. Vasudevan, *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) (describing the adverse selection problem as a feedback loop in which management's disinclination to issue secondary offerings increases investors' unwillingness to participate in them).

[76] 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, 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.

[77] It is also possible that the managerial power view describes the pay-setting process at

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.[78] Pay negotiations in the private equity setting should reflect arm's length bargaining,[79] 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.[80] 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.[81]

4. Impact on Growing Inequality of Wealth

Inequality of wealth in the United States has increased markedly in the last several decades, particularly at the very high end of the distribution. Recent data suggest that growth in executive pay may be a significant contributing factor.

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many nonprofit organizations, which would seem to suffer from agency problems that are similar to those encountered in the public company context. If so, this phenomenon might independently justify extension of an executive pay surtax into the nonprofit sector.

[78] Robert J. Jackson, Jr., *Private Equity and Executive Compensation*, 60 UCLA L. REV. (forthcoming 2013) (manuscript at 22-23).

[79] 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 Strömberg, *Leveraged Buyouts and Private Equity*, J. ECON. PERSP., Winter 2009, at 121, 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.

[80] 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 78, at 4. Absent deal bounties, average portfolio company CEO pay might be lower than public company pay by a statistically significant amount. Walker, *supra*, at 1217.

[81] The "infection" of the private company executive labor market by excesses in the public company market may somewhat mitigate the distortions in the public equity market. If capital fleeing one sector faces the same economic tax in alternative sectors, there would be no distortion. The significance of this effect would depend on the relative size of the public company, private company, and other investment sectors.

The share of total U.S. pre-tax income, excluding capital gains, received by the top 1% of earners increased from about 8% in 1980 to about 18% in 2008.[82] The increased concentration of income at the very top has been even more dramatic with the top 0.1% of earners receiving about 2% of national income in 1980 and about 8% in 2008.[83] During the early 1980s, pre-tax income inequality was only modestly greater in the United States than it was in Europe.[84] Today that difference is dramatic.[85] Although income inequality is to some extent a desirable result of a thriving, capitalist economy, at some level inequality may become a serious policy concern.[86]

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 at the very top of the income distribution. 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 United States in 2005.[87] Non-financial sector, or "main street," executives alone accounted for about 30% of the top 0.1%.[88] These authors also found that the larger group of executives, managers, supervisors, and financial professionals accounted for about 70% of the

[82] *The Database*, *supra* note 28 (select "United States," then select from "1980" to "1980," next select "Top 1% Income Share"; repeat for year 2008); *see also* Thomas Piketty & Emmanuel Saez, *Income and Wage Inequality in the United States, 1913-2002*, *in* TOP INCOMES OVER THE TWENTIETH CENTURY: A CONTRAST BETWEEN EUROPEAN AND ENGLISH-SPEAKING COUNTRIES 141, 147 (A.B. Atkinson & Thomas Piketty eds., 2007). Excluding capital gains, 2008 national income was about $7.8 trillion. *The Database*, *supra* note 28.

[83] *The Database*, *supra* note 28 (select "United States," then select from "1980" to "1980," next select "Top 0.1% Income Share"; repeat for year 2008).

[84] Bakija, Cole & Heim, *supra* note 28, at 53 fig.1.

[85] *Id.*

[86] Although the protests largely remained peaceful, the recent Occupy Wall Street and related Occupy movements highlight growing frustration with income inequality in the United States. *See, e.g.*, Andrew Ross Sorkin, *Occupy Wall Street: A Frenzy That Fizzled*, N.Y. TIMES, Sept. 18, 2012, at B1.

[87] Bakija, Cole & Heim, *supra* note 28, at 37 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.

[88] This figure includes executives of closely held businesses. *Id.* at 37 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, 1043 (2010). However, Kaplan and Rauh were only able to identify the occupations of 17.4% of the top 0.1% of income earners. *Id.* at 1041 tbl.14. Bakija, Cole, and Heim identify the occupations of 98-99% of these individuals. Bakija, Cole & Heim, *supra* note 28, at 1, 37.

increase in the share of national income going to the top 0.1% of the income distribution between 1979 and 2005.[89]

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,[90] but for the purposes of this Article, I am assuming that at least a part of the growth in executive pay reflects market failure. Moreover, as suggested previously,[91] 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.[92]

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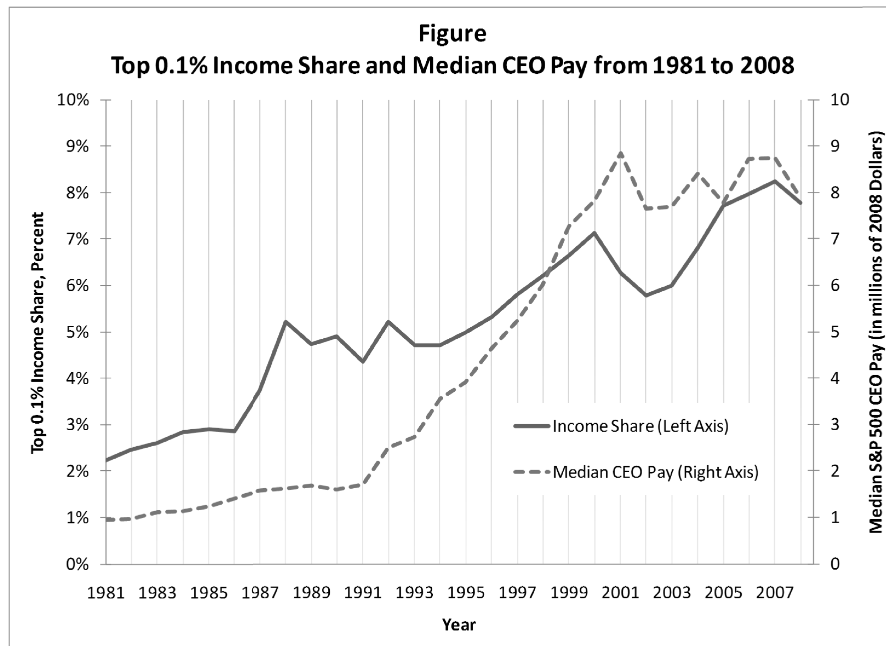
[89] Bakija, Cole & Heim, *supra* note 28, at 2.

[90] Xavier Gabaix and Augustin Landier have proposed a model involving competitive matching of CEO talent and firms. Gabaix & Landier, *supra* note 13, at 50. 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. *Id.* The authors find very little dispersion in CEO talent at the largest firms, but given the tremendous amount of assets under management and a multiplier effect, the model can explain large pay differentials. *Id.* The idea that small differences in talent are consistent with large differences in pay was also explored by Charles Himmelberg and Glenn Hubbard. 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. Bebchuk & Grinstein, *supra* note 1, at 283-84. 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. *Id.* at 284, 300-02. In a similar vein, a number of scholars argue that the favorable accounting treatment of options in the 1990s led boards to systematically undervalue this form of compensation. *E.g.*, Kevin J. Murphy, *Stock-Based Pay in New Economy Firms*, 34 J. ACCT. & ECON. 129, 143-45 (2003); Michael C. Jensen & Kevin J. Murphy, *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. Research Paper Series, No. 04-28, 2004), *available at* http://ssrn.com/abstract=561305.

[91] *See supra* Part I.C.3.

[92] In the figure that follows, income share data was retrieved from The World Top Incomes Database. *The Database*, *supra* note 28. 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. COMPUSTAT EXECUCOMP, *supra* note 21. Data from prior years is taken from Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653, 662 (1998) (reporting 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) (reporting 1992 data for S&P 500 industrial



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 United States by reducing the denominator of the fraction. 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.[93] To some degree, individuals considering a career as a doctor, engineer, lawyer, investment banker, or

companies). All pay data is inflated to 2008 dollars based on the CPI index.

[93] *See* Emmanuel Saez, *Direct or Indirect Tax Instruments for Redistribution: Short-Run Versus Long-Run*, 88 J. PUB. ECON. 503, 505 (2004); *cf. Carried Interest: Hearings Before the S. Comm. on Fin.*, 110th Cong. 59 (2007) (statement of Joseph Bankman, Ralph M. Parsons Professor of Law and Business, Stanford Law School) (arguing that the carried-interest subsidy distorts career choice).

corporate executive would be influenced in their choices by the rents available to those who succeed in the competition to become senior executives.[94]

II. 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 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. A person could support one and not the other.[95] Accordingly, this Part makes the case for the surtax, and the argument for providing investor tax relief is deferred until Part III. However, that Part will argue that there are strong economic and political reasons to link these two elements.

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,

[94] 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, 2609 (2008) (demonstrating a relationship between MBA placement in the investment banking sector and the two-year return on the S&P 500 as of graduation).

Of course, this distortion may or may not move us further away from social optimality. Professional labor markets may be distorted in other ways, which presents another problem of the second best. Lipsey & Lancaster, *supra* note 73, at 11. Moreover, judgments will vary with respect to the social value of various careers.

[95] *See infra* note 199 and accompanying text.

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.

The surtax could be set at a fixed percentage of all compensation in excess of a threshold, for example, 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.[96] 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 and risk.[97] 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.[98]

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[96] 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. For a description of ExecuComp coverage, see *supra* note 21 and accompanying text. The data reported in this footnote 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 of these elements aligns with taxable compensation except for the last. Restricted stock is taxed upon 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. Executive Compensation, 17 C.F.R. § 229.402(a) (2012). 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. *See* COMPUSTAT EXECUCOMP, *supra* note 21. 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, Cole & Heim, *supra* note 28, at 37 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.

[97] Despite firm-specific and systematic excesses, executive-pay levels are a function of certain well-understood determinants that could be used to provide a nuanced threshold for the imposition of a surtax. For a survey of the evidence, see Frydman & Jenter, *supra* note 18, at 89-94.

[98] *See supra* note 187-194 and accompanying text. The existence of multinational firms

Within a firm, the surtax would be applied to the compensation of the most senior executives, who presumably have the greatest influence over setting their own pay. The definition of "officer" for purposes of Securities Exchange Act section 16(a) might usefully be employed to determine surtax applicability.[99]

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 Section 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 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 reduce pre-tax executive pay, but that is irrelevant. The real concern is the fairness and equality of *after-tax* income and wealth, not of pre-tax income per se. Thus, from this perspective, the imposition of a surtax would be equivalent to a reduction in pre-tax pay.[100]

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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.

[99] General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.16a-1(f) (2012). Obviously, only public company officers are required to report transactions under section 16(a). Nonetheless, the caselaw interpreting the definition of "officer" could be used to identify appropriate private company executives if a surtax were to be extended to this population. ROBERT CHARLES CLARK, CORPORATE LAW 113-14 (1986).

[100] Although we cannot measure the degree to which U.S. executive pay is systematically excessive, in my view, the 10% surtax rate used as an example throughout this Article is at the low end of the likely range; for a highly paid CEO, a 10% surtax on compensation in excess of $1 million would approximate a 10% surtax on total pay. I reach this conclusion simply by observing the lengths to which executives have gone to conceal compensation. *See, e.g.*, David I. Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561, 564 (2007) (describing the impact of backdating on the value and size of stock option grants and suggesting that obfuscation of pay may have motivated some backdating occurrences). It seems highly unlikely that executives would engage in such machinations to gain an advantage of only a few percent.

Although a surtax would mitigate the effect of systematically excessive executive pay on after-tax income inequality, the impact on the overall level of inequality in our society would be minimal. Thus, one might conclude that a surtax would be more effective in addressing the unfairness of executives receiving excessive pay levels than in mitigating income inequality.

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 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.[101]

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.[102] Use of those funds is discussed in Part III.

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.[103] 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,[104] and § 280G disallows deductions for golden-parachute payments that are subject to the § 4999 excise tax.[105] Commentators generally agree that these tax incentives have not been successful,[106] and some have argued for

[101] *See supra* note 94.

[102] *Cf.* 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). Don Fullerton and Gilbert 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).

[103] I.R.C. § 4999(a) (2006).

[104] *Id.* § 162(m)(1).

[105] *Id.* § 280G(a). Section 280G is discussed at greater length *infra* notes 133-36 and accompanying text.

[106] Brian J. Hall & Jeffrey B. Liebman, *The Taxation of Executive Compensation*, 14 TAX POL'Y & ECON. 1, 1-2 (2000); Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 881 (2007).

their repeal.[107] Stand-alone repeal of these provisions, however, 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.[108]

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.[109] 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 quite small relative to the distortions created by coercive regulation

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[107] *See, e.g.*, Bruce A. Wolk, *The Golden Parachute Provisions: Time for Repeal?*, 21 VA. TAX REV. 125, 142 (2001).

[108] 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 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, 493 (2009).

[109] 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. Hall & Liebman, *supra* note 106, at 32. As previously noted, § 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. *Id.* 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. *See* Polsky, *supra* note 106, at 884. 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. *See* Hall & Liebman, *supra* note 106, at 33. 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 2008 crisis. Hall & Liebman, *supra* note 106, at 36 (finding that salary reductions post-1993 were more than offset by additional stock option grants); Polsky, *supra* note 106, 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).

of executive pay, an alternative considered in Part IV. Putting this in terms of public-finance theory, minimal expected distortion suggests that a surtax on executive pay might be a "good" tax, bearing low efficiency costs.[110] 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 III.

1. Executive Labor Supply and Income Elasticity[111]

A surtax on executive pay would increase the effective marginal tax rate faced by covered executives. Given the recent expiration of the Bush-era tax cuts, the imposition of a flat 10% surtax would increase the marginal federal rate to almost 50%, and increase marginal combined federal and state rates to 55% or more.[112] 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,[113] and this finding appears to hold even for high-income taxpayers. For example, Robert Moffitt and Mark 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.[114]

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

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[110] *See* HARVEY S. ROSEN, PUBLIC FINANCE 292-93 (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).

[111] 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).

[112] American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 2313. One must also include the 1.45% Medicare portion of payroll taxes that does not phase out with income. I.R.C. § 3101(b) (2006).

[113] Emmanuel Saez, Joel Slemrod & Seth H. Giertz, *The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review*, 50 J. ECON. LITERATURE 3, 3 (2012); 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. *See* Saez, *supra*, at 3-4; Slemrod, *supra*, at 774-75. I would not expect any substantial difference in labor supply or taxable-income elasticities between male and female executives.

[114] Robert A. Moffitt & Mark O. 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 ages twenty-five and fifty-four in 1983. *Id.* at 204-05. The mean adjusted gross income for their high marginal tax rate (MTR), or "rich," subsample was $168,899 in 1983 and $287,115 in 1989, the second panel period. *Id.* at 206 tbl.7.1.

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.[115] Recent studies embrace this view and investigate the effect of taxes on the elasticity of taxable income (ETI).[116]

High-income taxpayers exhibit greater ETI than low- or moderate-income taxpayers, probably because high-income taxpayers have more flexibility to shift the timing and composition of their income.[117] However, studies of executive responsiveness to tax rates have failed to find significant non-transitory ETI.[118]

Austan Goolsbee examined the responsiveness of corporate executives to the increase in marginal tax rates that came into effect in 1993.[119] 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.[120] Once he eliminated stock option compensation from his analysis, Goolsbee concluded that corporate executives essentially failed to respond to the Clinton-era tax hikes.[121]

Hall and Liebman replicated Goolsbee's analysis, extended it back through the 1980s, and concluded that the timing of option exercise was not explained

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[115] 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, Slemrod & Giertz, *supra* note 113, at 4 ("[U]nder some assumptions *all* responses to taxation are symptomatic of deadweight loss.").

[116] Nada O. Eissa & Seth H. Giertz, *Trends in High Incomes and Behavioral Responses to Taxation: Evidence from Executive Compensation and Statistics of Income Data* 1 (Cong. Budget Office, Working Paper No. 2006-14, 2006), *available at* http://www.cbo.gov/ftpdocs/77xx/doc7711/2006-14.pdf.

[117] *Id.* at 2. 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. *Id.* at 22, 55 tbl.4.4. Bradley Heim estimates gross taxable income elasticities in excess of 1.0 for taxpayers with incomes in excess of $500,000. 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). 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. *Id.* at 158.

[118] Eissa & Giertz, *supra* note 116, at 33.

[119] Austan Goolsbee, *What Happens When You Tax the Rich? Evidence from Executive Compensation*, 108 J. POL. ECON. 352, 375 (2000). The marginal tax rate (federal only) on income in excess of $250,000 increased from 31% to 39.6% in 1993. *Id.* at 357.

[120] *Id.* at 365-66.

[121] *Id.* at 375. Excluding options, the elasticity was 0.14. *Id.* at 372.

by changes in marginal tax rates, but by stock market movements.[122] 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."[123]

Nada Eissa and Seth Giertz generated elasticity results that were similar to Goolsbee's for the Clinton-era tax hike.[124] However, their analysis of the Bush-era tax cuts generated negative long-run elasticities,[125] and they concluded that their results, and Hall and 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.[126] 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 incomes generally.[127]

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.[128] Although Goolsbee's findings and interpretation were contested by Hall and Liebman,[129] 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

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[122] Hall & Liebman, *supra* note 106, at 2.

[123] *Id.* at 41 n.19. As Goolsbee notes, "permanent" is a misnomer in this context. *See* Goolsbee, *supra* note 119, at 365-66. These analyses capture changes in income occurring over a few years. *Id.* at 366 n.15. They do not capture changes in choice of occupation, the decision to retire early, or similar very long-term effects of taxes. *Id.*

[124] 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 116, 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. Slemrod, *supra* note 113, at 775. 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. *Id.*

[125] Eissa & Giertz, *supra* note 116, at 52 tbl.4.1, 59 tbl.4.8.

[126] *Id.* at 2-4.

[127] Professor Victor Fleischer of the University of Colorado Law School 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. For a presentation of a tournament model of the executive labor market, see Edward P. Lazear & Sherwin Rosen, *Rank-Order Tournaments as Optimum Labor Contracts*, 89 J. POL. ECON. 841 (1981).

[128] Goolsbee, *supra* note 119, at 359.

[129] Hall & Liebman, *supra* note 105, at 3.

seem particularly problematic as long as the surtax that is enacted is permanent.[130] 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.[131]

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.

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.[132] And, of course,

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[130] Of course, no tax rule is actually permanent, but the idea here is of a nominally permanent measure rather than a surtax analog of, for example, a one-time tax holiday for repatriation of profits held outside the United States. *See, e.g.*, Kristina Peterson, *Tax-Repatriation Holiday Gathers Some Steam*, WALL ST. J. (June 23, 2011), http://online.wsj.com/article/SB10001424052702303339904576404183763158882.html.

[131] As stock options move into the money, that is, 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, STEWART C. MYERS & FRANKLIN ALLEN, 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.

[132] 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 27-29 (Aug. 2012) (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.

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.

Our experience with I.R.C. §§ 280G and 4999, however, suggests that the issue is more complicated.[133] 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.[134] 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.[135] 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.[136]

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.[137] 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.

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 more likely that a specific provision, for example, 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

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

[134] I.R.C. § 280G (2006). The surtax on "excess parachute payments" is 20%. *Id.* § 4999(a).

[135] Walker, *supra* note 133, at 855.

[136] *Id.* at 855-56. 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. *Id.* at 855.

[137] Wolk, *supra* note 107, at 181.

compensation.[138] As a result, the board might conclude that a gross up that preserves the five-to-one ratio would be worth the cost.[139] 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.[140]

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 statements and in executive-pay tables published annually by the *New York Times* and the *Wall Street Journal*.[141] These pre-tax levels of pay are

[138] 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, Note, *Golden Parachutes: Untangling the Ripcords*, 39 STAN. L. REV. 955, 957-59 (1987).

[139] 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. *See* David Yermack, *Flights of Fancy: Corporate Jets, CEO Perquisites, and Inferior Shareholder Returns*, 80 J. FIN. ECON. 211, 224 (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. *See* Bress, *supra* note 138, at 958 n.15. Thus, executives of potential takeover targets might push even harder for gross ups given the multiplier effect of I.R.C. §§ 280G and 4999.

[140] 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. Prior to 2006, however, firms were not required to disclose the terms of gross-up agreements in the executive compensation discussion and analysis section of their proxy statements. Executive Compensation and Related Person Disclosure, Exchange Act Release No. 33-8732A, 71 Fed. Reg. 53,158, 53,188-89 (Sept. 8, 2006) (to be codified at 17 C.F.R. pts. 228-29, 232, 239, 240, 245, 249, 274) (discussing past failure of the rules to capture material disclosures related to termination provisions and compensation). 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. *See id.* at 53,189 (requiring detailed disclosure of the terms of change of control agreements).

[141] To be sure, tax gross ups covering personal use of corporate aircraft and other perks

highly salient to investors and the financial press, and presumably the outrage constraint works, to the extent it works at all, primarily 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.[142]

To put this formulation slightly differently, the imposition of a surtax would reduce executive after-tax compensation, which is opaque, but would have no direct impact on pre-tax compensation, which is relatively transparent and salient to investors. If pre-tax compensation is limited by an outrage constraint, the imposition of a surtax would not result in additional pre-tax pay unless it served to loosen that constraint. Taken in isolation, the simple fact that a surtax would reduce the take-home pay of executives would be of no consequence under the managerial power view.[143]

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 might support a gross up. Thus, it would be important for proponents 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.[144] In other words, investors and the financial press would need to be reminded that even if pay practices at a particular firm are beyond reproach,

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* 17 C.F.R. § 229.402(c)(2)(ix)(B) (2012) (requiring disclosure of tax gross ups in the "other compensation" category); Executive Compensation and Related Person Disclosure, Exchange Act Release No. 33-8732A, 71 Fed. Reg. at 53,188-89 (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.

[142] 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.

[143] The idea that the capacity to gross up a surtax would depend on a loosening of the outrage constraint is specific to the managerial power view of the compensation-setting process. *See* Polsky, *supra* note 106, at 905 (emphasizing public outrage as the primary constraint on executive compensation under the managerial power view). This is the one place in the analysis in which the particular model of market failure matters most.

[144] *See supra* notes 46-50.

the firm's executives remain the beneficiaries of a failed labor market and the directors must not be allowed to engage in 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.[145] A bar would 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.

Before concluding this Section, it is worth considering whether executives are able to shift the incidence of general tax rate increases onto their employers, that is, whether executives are grossed up for general personal income tax rate increases. An executive-pay surtax would seem to fall somewhere in between a general rate increase and an excise tax on a specific compensation element. Eissa and Giertz suggest that one reason that executive-income elasticities might be lower than those of other high-income taxpayers might be that executives are able to pass tax rate hikes on to their employers.[146] 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. Yet 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,[147] 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. A properly designed surtax should not loosen the outrage constraint on pre-tax executive pay or provide scope for pay increases that would compensate for the surtax.

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

[146] *See* Eissa & Giertz, *supra* note 116, at 27.

[147] 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 106, at 39-41. Eissa and Giertz examined the 2001 rate reductions and found negative elasticity. Eissa & Giertz, *supra* note 116, at 3.

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.[148] 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.

b. *The Economic Impact of Surtax Gross Ups*

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 exacerbate investment distortions to a greater extent.[149] 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.[150] 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 III. It should be apparent from the discussion in this Section, 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.[151] This pay increment would cover the $118,000

[148] BEBCHUK & FRIED, *supra* note 29, at 15-17, 67-70.

[149] *See supra* note 137 and accompanying text.

[150] *See supra* Part III.B.2.

[151] The formula for determining the gross up amount (GUA) is as follows: GUA = (surtax rate * pay in excess of surtax threshold) / (1 – surtax rate – executive MTR on ordinary income). *See* Jamie Dietrich Hankinson, Comment, *Golden Parachute Tax*

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.[152] Observe 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.[153] Moreover, 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.[154]

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.[155]

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.[156] To be clear, in the case of partial gross ups, the desired reduction

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Provisions Fall Flat: Tax Gross-Ups Soften Their Impact to Executives and Square D *Overinflates Their Coverage*, 34 STETSON L. REV. 767, 785 (2005).

[152] 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 § 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 § 162(m). *See* Treas. Reg. § 1.162-27(e)(2)(vi) (as amended in 1996) (describing circumstances under which stock option compensation satisfies the performance-based pay exception to the limit on deductible senior-executive compensation).

[153] To be more precise, 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.

[154] 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 an 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.

[155] 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.

[156] 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

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.[157] 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 III.

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.[158] This is a drawback, but a fairly minor one. As we will see in Part IV, 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.

As previously observed, § 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.[159] In 1992, when § 162(m) was enacted, $1 million per year was at the high end of the CEO salary range.[160] 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.[161] 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

$222,000) 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.

[157] *See supra* notes 151-56 and accompanying text.

[158] 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, 998 (2002).

[159] *See* I.R.C. § 162(m)(4)(C) (2006) (excepting performance-based compensation from the limitation on deductible senior executive pay).

[160] In 1993, the first year for which ExecuComp provides complete data, the median salary of 1157 CEOs reported was $500,000. Only sixty-three received a salary of $1 million or more and only four received a salary in excess of $2 million.

[161] Harris & Livingstone, *supra* note 158, at 998.

to receive the largest pay increases.[162] It appears that companies read § 162(m) as an endorsement of CEO salaries up to $1 million per year.[163]

Part IV will argue 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

Part II.B.2 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.[164] This Section considers possible avoidance strategies ranging from changes in compensation design to shifts in organizational form. It also briefly considers the potential impact of a surtax on ex ante employment decisions.

a. *Compensation Design*

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. Because a surtax would apply to all forms of compensation taxed as ordinary income, there would be little scope to avoid the surtax through shifts in the use of "conventional" compensation instruments, such as stock and options.

Let us begin with perks. Suppose 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 an individual income taxes generally, could be avoided on $500,000 per year in compensation.[165] 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.[166] Each requirement is something of a term of art in tax law, and one can find examples

[162] *Id.* at 1014.

[163] *Id.* at 1001.

[164] *See* MYRON S. SCHOLES ET AL., TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH 164-66 (3d ed. 2005) (describing a "global" contracting approach to executive-compensation tax planning in which firms and executives select instruments to minimize the combined tax burden).

[165] The employer would be entitled to deduct its expenses related to the acquisition and maintenance of this business property. I.R.C. § 162(a)(3) (2006).

[166] *Id.* § 119(a).

of the exclusion being upheld in situations that stretch the common-sense meanings of "business premises" and "convenience of the employer."[167]

Combined business and personal travel might provide another example. Aside from the 50% limitation on the deductibility of meals,[168] business travel is deductible by the employer and results in no tax consequences for the executive.[169] 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.[170]

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 might seem to be a significant threat, but 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.[171] 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.[172] Public company executive-compensation packages are now subject to a separate shareholder vote that is non-binding, but quite embarrassing to lose.[173] And excessive perks appear to be a red flag

[167] *See, e.g.*, Adams v. United States, 585 F.2d 1060, 1066-67 (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).

[168] I.R.C. § 274(n).

[169] *Id.* §§ 132(a)(3), 132(d), 162(a)(2).

[170] One might also anticipate that the imposition of a surtax would lead to greater use of company-owned properties, such as hunting or ski lodges, to entertain clients and provide untaxed consumption to corporate executives. However, the deductibility of expenses for facilities of this type is severely limited under the tax code, reducing the attractiveness of this perk. *Id.* § 274(a)(1)(B).

[171] *Id.* § 119(a); Treas. Reg. § 1.119-1(b) (as amended in 1985).

[172] Executive Compensation and Related Person Disclosure, Exchange Act Release No. 33-8732A, 71 Fed. Reg. 53,158, 53,161-93 (Sept. 8, 2006) (to be codified at 17 C.F.R. pts. 228-29, 232, 239, 240, 245, 249, 274). The SEC now requires proxy-statement identification and valuation of any perk that is valued at the greater of $25,000 or 10% of total perk value. *Id.* at 53,176. 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." *Id.* Otherwise, any item conferring a personal benefit constitutes a perk for these purposes. *Id.* Moreover, the SEC has stressed that the fact that an item is provided for the convenience of the employer and is non-taxable for the executive is not relevant in determining whether an item must be disclosed. *See id.* at 53,177. Finally, executive housing is specifically listed in the SEC release as an example of an item that must be disclosed as a perk. *Id.*

[173] 15 U.S.C.A. § 78n-1(a) (West Supp. 2012) (requiring proxies to include a non-binding shareholder vote on executive pay no less frequently than once every three years).

for proxy advisory firms making recommendations on shareholder "say-on-pay" votes.[174] 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.[175] 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.[176]

In addition, of course, the imposition of a surtax on executive pay would increase the attractiveness of other "working condition" fringe benefits,[177] such as fancy office chairs, but this is inconsequential. A surtax would also provide a stronger incentive for firms to provide executives with non-taxed health[178] or life insurance[179] 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.[180]

Moving beyond perks, the imposition of a surtax generally would make the use of incentive stock options (ISOs) more attractive relative to non-qualified stock options (NQSOs). The reason for this is that gains on ISOs are not taxed as ordinary income and would not be subject to a surtax that simply

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[174] EQUILAR, 2011 CEO BENEFITS & PERQUISITES REPORT 4 (2011) (documenting a dramatic reduction in perks as a result of increased scrutiny on executive pay).

[175] *See, e.g.*, Hall & Liebman, *supra* note 92, at 654.

[176] 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.

[177] I.R.C. § 132(a)(3), (d) (2006).

[178] *Id.* § 106(a) (excluding health or accident insurance provided by employer).

[179] *Id.* § 79(a) (excluding $50,000 of group-term life insurance provided by employer).

[180] In a split-dollar life insurance arrangement, an employer and an executive joined in the purchase of a "whole-life" life insurance policy (a policy that includes an investment element in addition to "term" insurance coverage) covering the executive. *See* Treas. Reg. § 1.61-22(b) (2003). Typically, the employer paid some or all of the premiums and was entitled to recover the premiums paid from policy proceeds. *See id.* The executive received current life insurance coverage and was entitled to policy proceeds in excess of employer contributions. *Id.* § 1.61-22(d)(3). It was difficult, however, to value the benefits conferred on executives through the employer contributions for tax purposes. 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. *See* Stewart Reifler, *New IRS Rules for Split-Dollar Life Insurance Arrangements*, 4 CORP. BUS. TAX'N MONTHLY 20, 24 (2003). 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 id.* at 26-27.

piggybacks on ordinary compensation income.[181] ISOs generally become more attractive with increasing individual tax rates, and the addition of a surtax would have the same result.[182] Avoidance through option redesign, however, should not be a significant threat to a surtax regime. First, the use of ISOs is severely limited under the tax code.[183] In fact, the number of ISOs that can be issued to a senior executive of a public company is trivial.[184] Moreover, even if this limitation were to be lifted in a post-surtax world, Congress could always expand the reach of a surtax to include gains on ISOs.[185]

Aside from the economically trivial case of ISOs, the imposition of a surtax should have no significant impact on the relative attractiveness of equity versus non-equity pay, various forms of equity pay, or deferred compensation. In each case, the imposition of a surtax is equivalent to an increase in ordinary marginal rates, and the attractiveness of these choices is not terribly sensitive to those rates.[186]

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?

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[181] 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. I.R.C. §§ 421(a), 422(a)-(b).

[182] 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. SCHOLES ET AL., *supra* note 164, at 230-31 (illustrating mathematically when NQSOs would be preferred to ISOs).

[183] The ISO provision of the tax code includes a non-inflation-adjusted annual limit on ISO grants of $100,000 per recipient. I.R.C. § 422(d)(1).

[184] *See id.*

[185] There is precedent for this approach. Unrealized gains on ISOs at exercise are included in income for purposes of the alternative minimum tax even though they are not included in an employee's ordinary income. *Id.* § 56(b)(3).

[186] As Myron Scholes and his colleagues note, the relative attractiveness of deferred compensation versus salary depends on two key factors: the expected *changes* in employee and employer tax rates over time and the after-tax rate of returns available to the employer and employee on investments. The absolute rate of tax on employee ordinary income is not a key factor. SCHOLES ET AL., *supra* note 164, at 183. Similarly, assuming consistent tax rates, the attractiveness of nonqualified equity compensation relative to cash compensation is primarily a function of the employer's after-tax return on investment. David I. Walker, *Is Equity Compensation Tax Advantaged?*, 84 B.U. L. REV. 695, 739 (2004).

In some cases, limiting a surtax to the compensation received by public company executives would increase the incentive for companies to go private and for private companies to shun public offerings. Private company executives already represent a significant fraction of very-high income taxpayers.[187] Bakija, Cole, and Heim estimated that in 2005 there were more private company executives earning more than $1 million per year than there were public company executives earning the same amount.[188] 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 investment funds; others would have been independent stand-alone business ventures.

First, consider investment-fund portfolio companies. I have argued elsewhere that executive-compensation arrangements in this realm are generally negotiated at arms' length, but that the fund managers may be price takers when it comes to executive pay, that is, that they are forced to keep pace with inflated pay levels at public companies.[189] If that is correct, there would be no need to expand the surtax to cover these companies. If a surtax reduces the after-tax wage for public company executives, portfolio company pay will fall accordingly. These executives will face an implicit tax.

By contrast, consider a stand-alone private company with close alignment of ownership and control that suffers very low agency costs. If an executive-pay surtax is limited to public companies, such a firm would have an increased incentive to stay private. If it goes public, it faces a surtax that would just be an unnecessary added burden.

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 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,[190] 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,[191] but it is becoming clear that diversified public

[187] *See* Bakija, Cole & Heim, *supra* note 28, at 16.

[188] *See id.* at 37 tbl.3.

[189] *See supra* notes 80-81and accompanying text.

[190] *See* Ellen Engel, Rachel M. Hayes & Xue Wang, *The Sarbanes-Oxley Act and Firms' Going-Private Decisions*, 44 J. ACCT. & ECON. 116, 143 (2007) (finding an increased frequency of going-private transactions in the wake of the passage of the Sarbanes-Oxley Act).

[191] 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*, N.Y. TIMES DEALBOOK (Dec. 27, 2010, 10:06 PM), http://dealbook.nytimes

shareholders are not necessarily needed as the ultimate enterprise risk bearers.[192]

One way to eliminate the added incentive to go or stay private would be to extend the surtax to include private company executives. But doing so would not eliminate the line drawing problem, it would simply shift it. Placing a surtax on private company executives would create a different set of 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.[193] 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.[194] 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 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,[195] a surtax applied to executive pay could affect the career decisions of talented individuals. Directionally, imposing a surtax on executive pay should discourage entry into the executive labor market.

.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, 7:57 AM), http://money.cnn.com/2011/02/27/technology/secondary_market/index.htm; Julianne Pepitone, *SEC May Ease Private Stock Rules*, CNNMONEY (Apr. 8, 2011, 3:48 PM), http://money.cnn.com/2011/04/08/technology/SEC_shareholder_limit/index.htm.

[192] Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 263 (2008).

[193] *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 its founders to continue to receive their returns in the form of carried interest taxed at capital-gains rates).

[194] *Id.* at 93.

[195] *See supra* Part II.B.1.

This distortion in the executive labor market should be seen, however, as offsetting a distortion that currently exists. 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.[196] To this extent, an executive-pay surtax can be seen as a corrective tax that seeks to reduce the distortion in the executive labor market that follows from market failure.

Of course, professional labor markets may be distorted from social optimality in other ways. If so, reducing one distortion would not necessarily improve efficiency.[197] Nonetheless, it is important to recognize that the imposition of a surtax would not create a new distortion in the executive labor market.

III. 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 the Introduction, 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.[198]

Investor tax relief need not necessarily be tied to the imposition of a surtax. Either project could be pursued independently.[199] However, two considerations

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[196] *See supra* Part II.B.4.c.

[197] Lipsey & Lancaster, *supra* note 73, at 11 (demonstrating that the elimination of one distortion may not improve efficiency where other distortions exist).

[198] As discussed by Lipsey and Lancaster, given the complexity of the system and the existence of other distortions, we cannot be certain that mitigating the effect of excess executive pay on investment patterns would increase efficiency, but this Article assumes that it would do so. Lipsey & Lancaster, *supra* note 73, at 11.

[199] Generally, it is a mistake to think of revenues from corrective taxes as being "free" money that is available to be directed to worthy causes. For example, environmental taxes may cause actors to internalize external costs, which is a move in the direction of efficiency, but these taxes make participants worse off. *See, e.g.*, James A. Mirrlees, *Global Public Economics*, *in* NEW SOURCES OF DEVELOPMENT FINANCE 200-04 (A.B. Atkinson ed., 2004). As a result, their revenues should not necessarily be directed toward "green" initiatives, if

suggest that linking the two might be advantageous. First, as discussed in Part II, 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.[200]

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 United States 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.[201] Moreover, to the extent that excessive executive pay burdens labor through a shift away from public company investment, mitigating that

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those initiatives would not have been pursued absent the environmental tax. *See id.* at 204. The present case, however, 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. Fullerton & Metcalf, *supra* note 102, at 227. 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 ECON. RECOVERY ADVISORY BD., THE REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE, AND CORPORATE TAXATION 65 (2010), *available at* http://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report.pdf (recognizing that reduction in effective corporate tax rates would result in significant revenue losses absent efforts to broaden the tax base).

[200] *Cf.* Thomas Merrill & David M. Schizer, *Energy Policy for an Economic Downturn: A Proposed Petroleum Fuel Price Stabilization Plan*, 27 YALE J. ON REG. 1, 8 (2010) (suggesting that a stabilizing surcharge on the price of oil be refunded to consumers in order to, inter alia, reduce political opposition).

[201] *See supra* note 83 and accompanying text.

investment distortion through investor tax relief would benefit labor indirectly. Thus, while the imposition of a surtax would lessen inequality at the high end of the income distribution, investor tax relief, to the extent that it flowed through to labor, would mitigate inequality at the low end of the distribution, although, to be sure, even the combined effect would be marginal when viewed in the context of the overall level of inequality in our society.

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 firm-specific or general, 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 excessive executive pay. On balance, this Article concludes that corporate tax relief is the more promising approach, but that the arguments for firm-specific versus general corporate tax relief are about evenly balanced.

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 I, 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 I 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.[202] And there is no reason to think that

[202] Under U.S. tax laws, companies that generate losses are not entitled to receive money

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, for example, 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, that is, dividend tax relief, may also flow through to the factors of production that bear the cost of excessive executive pay, but this is somewhat less clear.[203] 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 previously discussed, 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, for example, 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 II 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

back from the government, but these companies are permitted to carry these losses – termed net operating losses or NOLs – backward 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.

[203] Altshuler, Harris, and Toder assume that incremental taxes on dividends and capital gains are borne by the taxpayers who report these types of income on their returns. Altshuler, Harris & Toder, *supra* note 64, at 371.

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.[204] Ramping up the surtax rate in the face of gross ups, however, 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 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.[205]

Providing firm-specific relief, however, might have the unintended consequence of encouraging 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

[204] 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 153 and accompanying text.

[205] 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).

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 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 Section, 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 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.[206] Let us take this as a low-end estimate of the tax base for a surtax. By comparison, qualified dividends reported on taxable returns in 2008 totaled approximately $141 billion,[207] and taxable corporate income is about $1 trillion per year.[208]

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.[209] 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.[210] But $2 billion in surtax receipts would fund only about a 0.2-percentage-point reduction in the corporate tax rate, reducing the current top rate from 35% to

[206] *See supra* note 96.

[207] STATISTICS OF INCOME DIV., IRS, STATISTICS OF INCOME – 2008 INDIVIDUAL INCOME TAX RETURNS 42 tbl.1.4 (2008). Approximately $141 billion of aggregate qualified dividends were reported on twenty-one million taxable returns. *Id.* Total aggregate qualified dividends of about $159 billion were reported on twenty-six million taxable and non-taxable returns. *Id.*

[208] STATISTICS OF INCOME DIV., IRS, STATISTICS OF INCOME – 2008 CORPORATION INCOME TAX RETURNS 2 fig.A (2008) (estimating aggregate corporate taxable income of approximately $1.25 trillion for 2007 and approximately $0.98 trillion for 2008).

[209] *See supra* note 96 (identifying total public company executive pay to be at least $20 billion annually).

[210] *See supra* note 207 (reporting approximately $141 billion in qualified dividends).

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 mismatch 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. It is possible, however, 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.[211]

- 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.

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[211] *See* Amy Dittmar & Jan Mahrt-Smith, *Corporate Governance and the Value of Cash Holdings*, 83 J. FIN. ECON. 599, 600 (2007) (finding the market significantly discounts the value of cash on hand in poorly governed firms); Jarrad Harford, Sattar A. Mansi & William F. Maxwell, *Corporate Governance and Firm Cash Holdings in the US*, 87 J. FIN. ECON. 535, 537 (2008) (finding firms with weaker governance more likely to repurchase shares than issue dividends in order to avoid future payout commitments); Pornsit Jiraporn, Jang-Chul Kim & Young Sank Kim, *Dividend Payouts and Corporate Governance Quality: An Empirical Investigation*, 46 FIN. REV. 251, 253 (2011) (finding firms with strong governance have a higher propensity to pay dividends).

- General investor tax relief, taking the form of a reduction in corporate tax rates or dividends, 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.

IV. REGULATORY ALTERNATIVES

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.

The alternatives considered in this Part are generally addressed at relieving the symptoms of a failed labor market. Other commentators have suggested ways of reducing the agency problem and improving pay processes, such as increasing board accountability to shareholders or imposing a system of "professional" outside directors.[212] Consideration of alternatives of this sort is beyond the scope of this Article. In predicating this Article on the existence of market failure, I am assuming, in effect, that more direct means of eliminating market failure are unavailable and inadequate.

[212] *See, e.g.*, Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 909 (2005); Gilson & Kraakman, *supra* note 5, at 872-73 (proposing a cadre of professional outside directors).

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,[213] but I am not aware of any serious proposal to place a fixed dollar limit on *total* executive compensation.[214] The most empirically robust determinant of executive pay is firm size,[215] 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.[216] These proposals, however, still

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[213] *See* Press Release, U.S. Dep't of Treasury, Treasury Announces New Restrictions on Executive Compensation (Feb. 4, 2009), *available at* http://www.whitehouse.gov/the-press-office/treasury-announces-new-restrictions-executive-compensation.

[214] 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. *Compare* Press Release, U.S. Dep't of Treasury, *supra* note 213 (limiting only compensation other than restricted stock), *with* I.R.C. § 162(m) (2006) (excepting certain performance-based remuneration from the annual cap).

[215] *See* Kevin J. Murphy, *Executive Compensation*, *in* 3B HANDBOOK OF LABOR ECONOMICS 2485, 2493 (Orley Ashenfelter & David Card eds., 1999).

[216] For example, Senator Richard Durbin, a Democrat from Illinois, introduced legislation in 2009 that would have required a 60% shareholder vote to authorize executive compensation in excess of 100 times average employee compensation. *See* S. 1006, 111th Cong. § 2 (2009). For many years, Representative Martin Sabo, a Democrat from Minnesota, introduced legislation that would have limited the deduction for employee compensation to an amount equal to twenty-five 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. § 2 (2011).

do not get at the scale 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.[217]

More plausible still would be a formula tied to some measure of firm size such as assets, revenue, or market capitalization.[218] It is also possible that a formula would provide for adjustments based on company performance.[219]

Helmut Dietl, Tobias Duschl, and Markus Lang stress the importance of maintaining performance incentives within a salary cap system.[220] Absent performance incentives, executives would be motivated to perform well only by the prospect of losing their salary-capped positions.[221] 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.[222]

Maintaining performance incentives within a "salary cap" system is not difficult conceptually. 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.[223] The CEO whose firm most outperformed market expectations, as

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[217] 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).

[218] British, French, and German heads of government 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, http://www.usatoday.com/money/companies/management/2008-06-29-europe-ceo-pay_N.htm (last updated June 30, 2008, 9:29 AM).

[219] Helmut M. Dietl, Tobias Duschl & Markus Lang, *Executive Pay Regulation: What Regulators, Shareholders, and Managers Can Learn from Major Sports Leagues*, 13 BUS. & POL., no. 2, 2011, at 1, 18-19.

[220] *See generally id.*

[221] *Id.* at 3.

[222] 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 mismatch 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, Wayne R. Guay & David F. Larcker, *Executive Equity Compensation and Incentives: A Survey*, FED. RES. BANK N.Y. ECON. POL'Y REV., Apr. 2003, at 27, 33 (discussing the use of stock options to overcome managerial risk aversion); Polsky, *supra* note 106, at 889-90.

[223] Valuation could be determined utilizing the Black-Scholes option pricing model.

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 thus easier to tax. The ex ante value of some forms of pay – stock options and SARs, in particular – requires calculations which involve manipulable inputs.[224]

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,[225] 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,[226] 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

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BREALEY ET AL., *supra* note 131, at 599-602.

[224] *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, like 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 92, at 5 (explaining that non-diversified executives value stock options below their cost to shareholders).

[225] *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act § 952(a), 15 U.S.C.A. § 78j-3(a) (West. 2012) (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).

[226] 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.

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 Generally (Relative to Tax)

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.[227] A surtax on executive pay above a certain threshold is a price in his terminology.[228] 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.[229] 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.[230] Prices result in greater freedom of behavior and less distortion.

The problem for coercive regulation is one of information.[231] 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.[232] 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

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

[228] *Id.* at 1525.

[229] *See id.* at 1527.

[230] Alberto Alesina & Francesco Passarelli, *Regulation Versus Taxation* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 16413, 2010), *available at* http://www.nber.org/papers/w16413.

[231] *Cf.* Louis Kaplow & Steven Shavell, *On the Superiority of Corrective Taxes to Quantity Regulation*, 4 AM. L. & ECON. REV. 1, 2 (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).

[232] *See* Cooter, *supra* note 227, at 1531-33.

particular firm. As commentators have noted, it is almost impossible for external observers to evaluate pay levels at particular firms even ex post,[233] which is, perhaps, the primary reason that courts have been so hesitant to find that litigated pay levels are excessive.[234] 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, and so forth. 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 Cooter described, the cost of getting the threshold wrong is very much lower in the case of a tax.[235]

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.[236] Second, pay-capped executives who remained would tend to work less and consume more leisure.[237] This effect might be mitigated by utilizing caps on ex ante pay that permit the use of performance-based compensation, but as previously noted, 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 the highest marginal returns on talent.[238] 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. This Article has 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 they have today to engage in empire building at the expense of shareholder value.[239] Fifth, the imposition of pay caps with real bite might cause some U.S.

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[233] Stabile, *supra* note 71, at 65-67.

[234] Randall S. Thomas & Kenneth J. Martin, *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").

[235] *See supra* notes 227-30 and accompanying text.

[236] Rafael Castello Branco Pastor d'Oliveira et al., *Should the Government Regulate CEO Pay at Top TARP Firms?*, SELECTED WORKS KARL T MUTH 19 (Jan. 2010), http://works.bepress.com/karl_muth/18.

[237] *Id.*

[238] Dietl, Duschl & Lang, *supra* note 219, at 20-21.

[239] Executives' personal incentives to grow their businesses are already substantial. As noted, compensation is clearly correlated with firm size. *See supra* note 215 and

companies or 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.[240]

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).[241] 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

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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); 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, Andrei Schleifer & Robert W. Vishny, *Alternative Mechanisms for Corporate Control*, 79 AM. ECON. REV. 842, 848 (1989); David Offenberg, *Firm Size and the Effectiveness of the Market for Corporate Control*, 15 J. CORP. FIN. 66, 67 (2009); 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).

[240] 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 Consequences of Corporate Inversions*, 55 NAT'L TAX J. 409, 410 (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); Robert J. Herbold & Scott S. Powell, Op-Ed., *Tax Laws Chasing Companies Away*, HOUSTON CHRON. (Dec. 20, 2009), http://www.chron.com/opinion/outlook/article/Tax-laws-chasing-companies-away-1741682.php (retired COO of Microsoft and an executive consultant arguing that America's high corporate tax rates and taxation on foreign source income, inter alia, are forcing many U.S. companies to reincorporate overseas). Individual executive repatriation would be more difficult, and given generally lower levels of executive pay outside the United States, 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.

[241] *See* Harris & Livingstone, *supra* note 158, at 998 (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).

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.[242] As a result, the potential cost of creating a compensation focal point through the imposition of this surtax should be modest.

But, one might object, does not the foregoing parade of horribles 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 twenty years, the most popular regulatory response to perceived executive-pay problems has been enhanced SEC disclosure requirements.[243] The SEC has labored hard to ensure that pay disclosure for top corporate executives is comprehensive and transparent, and it has largely achieved that goal. New rules adopted in 2009 finally provide a comprehensive

[242] Fewer than 5% of more than 2600 senior executives of S&P 500 companies earned less than $1 million in 2011. *See* COMPUSTAT EXECUCOMP, *supra* note 21.

[243] Jennifer S. Martin, *The House of Mouse and Beyond: Assessing the SEC's Efforts to Regulate Executive Compensation*, 32 DEL. J. CORP. L. 481, 491-92 (2007) (describing the SEC's current primary focus on disclosure, and noting the adoption of the Existing Regulations in 1992, which also "focus on disclosure and use a series of formatted tables that capture compensation data over several years").

measure of the total grant-date value of executive-pay packages that is both reasonably accurate and comparable from firm to firm.[244]

As noted above, enhanced SEC disclosure requirements may have contributed to upward ratcheting of executive pay,[245] but the general Brandeisian idea that sunlight is the best disinfectant remains sound.[246] 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,[247] 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 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.[248] Our experience with 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.[249] In their proxy statements, these firms typically state that deductibility is only one factor that the board considers in executive-pay deliberations.[250] This is an

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[244] David I. Walker, *The Law and Economics of Executive Compensation: Theory and Evidence*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATION LAW 232 (Claire A. Hill & Brett H. McDonnell eds., 2012).

[245] *See supra* note 49 and accompanying text.

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

[247] Dodd-Frank Wall Street Reform and Consumer Protection Act § 951, 15 U.S.C.A. § 78n-1(a) (West 2012).

[248] I.R.C. § 162(m) (2006).

[249] For example, 62% of the 200 large public company CEOs whose 2009 compensation was analyzed by Equilar, an executive compensation research firm, received base salaries in excess of $1 million. *See CEO Pay: The Tables*, *supra* note 242.

[250] 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 46 (Apr. 13,

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.[251] 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.

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.[252] 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 III. 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 increasing the compensation of lower-paid executives than as a limitation on pay for the very highly compensated.

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) ("[The 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.").

[251] *E.g.*, Jack S. Levin, George B. Javaras & William R. Welke, *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 section 1.162-27 of the Treasury Regulations, and proposing language that would ameliorate many of the statutory and regulatory problems); Scott P. Spector, *Executive Compensation Strategy, Design and Implementation*, *in* TAX LAW AND ESTATE PLANNING SERIES 2006, at 13, 59 (PLI Tax Law and Practice, Course Handbook Ser. No. J-741, 2006) (describing how "fairly easily attained goals" can nevertheless be structured to give rise to deductible performance-based compensation). The IRS, however, has proposed regulations that would tighten the performance-based compensation requirements. Certain Employee Remuneration in Excess of $1,000,000, 26 C.F.R. § 1.162-27(e)(4) (2012) (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).

[252] *See supra* note 12 and accompanying text.

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. Of course, one can object that the approach put forward here primarily addresses the symptoms of executive pay market failure, not the root causes. This is a valid observation, but not a serious criticism. It is perfectly reasonable to treat the symptoms of cancer while continuing to search for a cure. Moreover, to the extent that the adoption of these proposals helps to re-establish norms of acceptable corporate behavior and executive pay practices, they do address root causes.

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.[253] 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.[254]

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.[255] This justification would extend to private company executives and even nonprofit executives to the extent that these labor markets are infected by excess pay received by public company executives. Of course, this

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[253] Warren E. 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, *The Proposer's Opening Remarks*, *Economist Debates: Resenting the Rich*, ECONOMIST (Apr. 7, 2009), http://www.economist.com/debate/days/view/293.

[254] Buffett, *supra* note 253; Surowiecki, *supra* note 253, at 33; Robert Frank & Laura Sanders, *The Battle over the Millionaire's Tax*, WALL ST. J. (Mar. 26, 2011), http://online.wsj.com/article/SB10001424052748704517404576223012169093834.html. A Quinnipiac University poll found broad support for a "Millionaires Tax," even among Republicans. *See* Press Release, Quinnipiac Univ., 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), *available at* http://www.quinnipiac.edu/institutes-centers/polling-institute/new-york-state/release-detail?ReleaseID=1265.

[255] Saugato Datta, *Moderator's Rebuttal Remarks, Economist Debates: Resenting the Rich*, ECONOMIST (Apr. 10, 2009), http://www.economist.com/debate/days/view/294 (stating that, if true, the argument "that there is market failure in the way top compensation is decided . . . provides a rationale for higher taxation of the rich separate from concerns about inequality").

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 is not determined through 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.[256]

More broadly-based taxes generally are better (less distorting) than more narrowly-based taxes,[257] 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.[258] 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.[259]

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 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

[256] Bakija, Cole & Heim, *supra* note 28, at 37 tbl.3.

[257] 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 110, at 292.

[258] I base this assumption on the lack of historical evidence of general rate increase gross ups, *supra* note 140 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.

[259] 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 1-2 (Tax Policy Ctr., Working Paper, July 29, 2009), *available at* http://www.taxpolicycenter.org/Uploaded PDF/411931_mitigating_corporate_rates.pdf (discussing the potential C corporation shelter issue and recommending fixes).

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 remain in the vicinity of 50%, I could well imagine doing both.