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2012]

WHO BEARS THE COST OF EXCESSIVE EXECUTIVE
COMPENSATION (AND OTHER CORPORATE AGENCY COSTS)?

DAVID I. WALKER*

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I. INTRODUCTION

MANAGERIAL agency costs are ubiquitous in the modern public corporation. Agency costs arise from the separation of ownership and control and reflect the divergence between share-value-maximizing actions of managers and managers' actual actions, plus the monitoring and bonding expenditures (including contracting costs) undertaken to reduce that divergence.¹ Agency costs vary firm by firm, but regulatory actions and even business practices can have a systematic impact on agency costs. For example, increased or decreased enforcement of insider trading rules can affect agency costs across a wide spectrum of companies.

Who bears the burden of corporate agency costs? Who gains or suffers when agency costs rise or fall systematically? To the extent that corporate governance experts have considered this question, they have assumed, explicitly or implicitly, that shareholders bear these costs as the recipients of residual corporate returns.²

* Professor of Law and Maurice Poch Faculty Research Scholar, Boston University School of Law. For their valuable comments on this Article and related work, I thank Victor Fleischer, Louis Kaplow, Andrew Lund, Mike Meurer, Gregg Polsky, Fred Tung, David Webber, Chuck Whitehead, and participants in the Villanova Law Review Norman J. Shachoy Symposium on taxation. I thank William Becker and David Skinner for excellent research assistance.

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

2. See, e.g., Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 785 (2002).

This Article suggests that, from an incidence perspective, managerial agency costs can be analogized to the corporate income tax. Both can be thought of as differential taxes on investment in corporate equity. Fifty years of research on the incidence of corporate income taxes suggests that the view that shareholders bear the entire cost or enjoy the entire benefit of changes in agency costs is too simplistic.³ Both theoretical and empirical work on incidence indicate that corporate taxes, and, if the analogy holds, agency costs, may be borne over the long run by suppliers of capital and labor to the general economy to a significant degree. Exactly how much of the burden is borne by investors and how much by workers is a hotly contested question, but the evidence suggests that shareholders are unlikely to bear the full burden.

In keeping with the theme of this section of the symposium, this Article focuses on the incidence of one particular manifestation of managerial agency costs—excessive executive pay—while recognizing that the implications of the analysis are much broader. Although the point is contested, many commentators and analysts believe that executive pay at U.S. public companies reflects systematic market failure, and, as a result, executives receive more compensation than they would in a well-functioning market.⁴ For the purposes of this Article, I accept the premise of systematic market failure and ask at whose expense this excess pay is extracted.⁵ The answer, I believe, is that some fraction of the cost of systematically excessive executive pay is likely to be shifted from shareholders to other investors, labor, or both.

Of course, the extraction of excessive executive pay is likely to have other adverse consequences beyond the transfer of funds from shareholders, other investors, and workers to executives. The managerial power view of the executive compensation setting process implies that the design of executive pay packages will be distorted from the most efficient design

3. See *infra* notes 45–68 and accompanying text.

4. See, e.g., GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES (1991); Bebchuk et al., *supra* note 2, at 751; Lucian A. Bebchuk & Robert J. Jackson, Jr., *Executive Pensions*, 30 J. CORP. L. 823 (2005); Lucian A. Bebchuk, Yaniv Grinstein & Urs Peyer, *Lucky CEOs and Lucky Directors*, 65 J. FIN. 2363 (2010); Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283 (2005); Marianne Bertrand & Sendhil Mullainathan, *Agents with and Without Principals*, 90 AM. ECON. REV. 203 (2000); Marianne Bertrand & Sendhil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are*, 116 Q. J. ECON. 901 (2001).

5. Although I accept this premise for the purposes of this Article, I recognize that the premise is by no means universally accepted. See, e.g., Stephen M. Bainbridge, *Is "Say on Pay" Justified?*, 32 REG. 42, 42–44 (2009) (questioning premise of "say on pay"); John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1144 (2005) (arguing that case for systematic market failure has not been made with respect to executive pay); Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?*, 123 Q. J. ECON. 49, 50 (2008) (developing model involving competitive matching of CEO talent and firms that can explain most observed patterns in CEO pay).

in order to camouflage executive pay and deflect outrage.⁶ To the extent that it is transparent, excessive executive pay may adversely affect worker morale at lower levels in the organization.⁷ Excessive pay in the public company sector may result in increased executive compensation in the private company context and even in the non-profit sphere.⁸

This Article will touch on these ancillary costs of excessive executive pay, but its primary focus is on detailing the likely transfer of value to executives from capital and labor and the assumptions underlying the analysis.⁹ This Article also will consider the policy implications of the idea that shareholders may not bear the full economic “tax” imposed by excessive executive pay. For example, continuing the tax analogy, a transfer of value from shareholders to executives would be modestly regressive, but a transfer from labor to executives would be much more so. Recognizing the likely incidence of excessive executive pay and the fact that suppliers of non-corporate capital and labor do not even have a representative at the executive pay bargaining table may provide a rationale for additional executive pay regulation or a different type of regulation.¹⁰

The remainder of this Article is organized as follows. Part I provides data on executive compensation and describes why pay levels may be excessive systematically. The incidence analysis is developed in Part II. Part III briefly considers other costs of systematically excessive executive pay, while Part IV discusses the implications of a conclusion that shareholders are unlikely to bear the full cost of excessive executive pay. The conclusion to this Article briefly considers the application of the incidence analysis developed herein to managerial agency costs generally.

II. THE EXECUTIVE PAY PROBLEM

A. *Description of the Problem*

The traditional view of the executive pay-setting process is an efficient or “optimal” contracting view first propounded by Jensen and Meckling.¹¹ Under this model, a board of directors that cannot perfectly observe the effort, focus, and effectiveness of its agent (the CEO) negotiates a contract that minimizes such agency costs as (1) monitoring the executive, (2)

6. See Bebchuk et al., *supra* note 2, at 754.

7. See *infra* notes 77–78 and accompanying text.

8. See *infra* note 76 and accompanying text.

9. This is not to suggest that these other costs are small. It is certainly possible that costs resulting from distorted pay design exceed the inefficiencies resulting from the transfer of value to executives from other stakeholders. See Bebchuk et al., *supra* note 2, at 785.

10. Shareholders are represented by a corporation’s directors. Of course, affiliated or “inside” directors are conflicted as to the determination of their compensation, but the unaffiliated, or “outside,” directors are charged with representing shareholder interests in negotiating executive pay. The extent to which outside directors serve as faithful shareholder representatives is taken up in the next Part.

11. See Jensen & Meckling, *supra* note 1.

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.¹² According to this view, executive compensation is a tool that is used by directors to minimize agency costs.

The competing managerial power view of the executive pay-setting process posits that the outside directors who are charged with negotiating executive pay lack the proper incentives and tools to bargain effectively and that their independence is undermined by executive influence over the board and by small group dynamics.¹³ This does not mean that there are no constraints on executive pay. The managerial power view posits that outrage among investors and financial analysts will limit the amount of executive pay and shape its composition. Under this view, executive compensation is a manifestation of agency costs, rather than or in addition to being a tool to minimize those costs.

Of course, the managerial power view and the optimal contracting view of the pay-setting process may coexist, providing relatively more or less explanatory power at particular firms.¹⁴ 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, external market forces are thought to permit considerable slack, leaving one to question the extent to which such forces actually limit executive rent extraction.¹⁵

This Article assumes that the managerial power view accurately describes the pay-setting process at a significant number of U.S. public companies. That view suggests two major sources of inefficiency. The focus of much of the literature is on the distortions in compensation design that follow from an outrage constraint.¹⁶ 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 and the financial press, channels would be irrelevant under this model. Outrage simply would be a function of total appropriation and, although total pay

12. *See id.*

13. *See* Bebchuk et al., *supra* note 2.

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

15. *See* Bebchuk et al., *supra* note 2.

16. *See, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 64–66 (2004); Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71, 75–76 (2003); Bebchuk & Grinstein, *supra* note 4, at 300–01; Bebchuk et al., *supra* note 2, at 786–88; Core et al., *supra* note 5.

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would remain excessive, firms would structure pay to minimize agency costs and maximize shareholder value. But appropriation is not transparent. Managers may be able to increase their pay by camouflaging compensation and avoiding outrage. Doing so, however, results in compensation choices that are not share value maximizing.¹⁷

The second source of inefficiency relates to the transfer to executives of excessive compensation and the distortions in investment behavior that result. Executives receive more pay than they would in a well-functioning market. 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 significant number of firms, pay levels will be systematically higher.

Systematically excessive pay levels would result from the ubiquitous practice of setting compensation based on the pay practices of peer companies, i.e., “benchmarking.”¹⁸ As a result of benchmarking, lax pay practices at some firms tend to drive up executive pay levels generally. The problem is exacerbated by the Lake Wobegon effect.¹⁹ Because no board is willing to publicly admit that its executives are below average, firms generally seek to pay their executives at or above the fiftieth percentile.²⁰ This practice of benchmarking with targets above the fiftieth percentile leads to upward ratcheting in executive pay.²¹ 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

17. See Bebchuk et al., *supra* note 2, at 786–89. The corporate income tax results in an analogous distortion in financing and payout decisions. See Rosanne Altshuler et al., *Capital Income Taxation and Progressivity in a Global Economy*, 30 VA. TAX REV. 355, 361 (2010).

18. This process is driven in large part by compensation consultants whose role is to collect, organize, and report (in redacted form) comprehensive pay information. See John M. Bizjak et al., *Does the Use of Peer Groups Contribute to Higher Pay and Less Efficient Compensation?*, 90 J. FIN. ECON. 152, 154–55 (2008).

19. See *The News from Lake Wobegon*, PRAIRIE HOME COMPANION, <http://prairiehome.publicradio.org/about/podcast/> (last visited Mar. 29, 2012) (describing Lake Wobegon as fictional Minnesota town where “all the women are strong, all the men are good looking, and all the children are above average”).

20. Bizjak et al., *supra* note 18, at 153 (finding that vast majority of S&P 500 firms sampled “target[ed] pay levels at or above the 50th percentile of the peer group”). In addition, companies often select peer groups with an eye towards justifying high executive pay levels. See John Bizjak et al., *Are All CEOs Above Average? An Empirical Analysis of Compensation Peer Groups and Pay Design*, 100 J. FIN. ECON. 538 (2011); Michael Faulkender & Jun Yang, *Inside the Black Box: The Role and Composition of Compensation Peer Groups*, 96 J. FIN. ECON. 257, 259 (2010).

21. Bizjak et al., *supra* note 18, at 155.

done more to increase below average elements of pay at lagging firms than to reduce above average pay levels or elements.²²

B. *Executive Pay Levels and Growth in Executive Pay*

Reports of big executive compensation packages certainly provoke outrage, but is executive pay economically significant? Is there reason beyond mollifying an outraged public to worry about excessive pay and who bears the cost? The answer to all of these questions appears to be “yes.” Top executive pay represents a very significant fraction of corporate earnings, a fraction that has been growing over time along with executive pay levels generally and with the growing gap between executive pay and the compensation of rank and file workers. Even if only a small fraction of executive pay is in a sense “unearned,” the stakes are significant.

Compensation data for senior public company executives is readily available. For many years, U.S. public companies have been required to disclose in their annual proxy statements pay data for their “top five” executives, currently defined as the CEO, CFO, and three most highly compensated executives other than the CEO and CFO. S&P’s Execucomp database collects this data for executives at over two thousand public companies.²³ For 2008, aggregate executive compensation for roughly 10,000 Execucomp executives totaled \$25 billion, an average of about \$2.5 million per top executive.²⁴

Senior executive pay and, in particular, CEO pay, has been increasing over the last several decades. According to a recent report, the median value of 2010 CEO compensation at the 350 largest U.S. public companies was \$9.3 million, an increase of over 10% from the previous year.²⁵ CEO

22. For example, Grinstein, Weinbaum, and Yehuda find that after disclosure requirements were enhanced for perks, firms that provided a low level of perks compared with their peers increased perks in the second year after enhanced disclosure was mandated, while firms that provided a relatively high level of perks did not reduce them. The authors provide additional evidence suggesting that the increase in perks by formerly low-perk firms reflected actual ratcheting rather than simply increased disclosure. Yaniv Grinstein et al., *The Economic Consequences of Perk Disclosure* (Apr. 3, 2011) (Cornell Univ. Johnson Sch. Research Paper Series), No. 06-2011, *available at* <http://ssrn.com/abstract=1108707>.

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

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

25. See Joann S. Lublin, *CEO Pay in 2010 Jumped 10%*, WALL ST. J., May 9, 2011, at B1 (reporting data compiled by Hay Group). Average pay for this group of CEOs was \$10.6 million. *The Wall Street Journal/Hay Group Survey of CEO Compensation*, WALL ST. J. (May 8, 2011), <http://graphicsweb.wsj.com/php/CEOPAY11.html#top> (presenting study of compensation for CEOs of 350 largest U.S. public

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pay has increased in *real terms* by 500% or more over the last thirty years.²⁶ The compensation of other senior executives has also risen rapidly, although not as rapidly as CEO pay.²⁷

The fraction of corporate earnings being devoted to compensating senior executives also has been increasing over time. Bebchuk and Grinstein collected pay data for Execucomp listed executives over the 1993 to 2003 period and estimated pay for U.S. public companies with market capitalization in excess of \$50 million that were not listed on Execucomp. Over the entire period, they estimated that top executive pay constituted 6.6% of earnings. However, 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%.²⁸

The growth of executive pay can also be seen in the growing disparity between top executive pay and the compensation of rank and file workers.²⁹ In 1980, the ratio of average CEO pay to average rank and file worker pay was 42 to 1. By 1990, that ratio had increased to 100 to 1. At the peak of the dot-com bubble in 2000, the ratio exceeded 500 to 1. The ratio declined as executive pay moderated during the financial crisis, but even in 2009 it continued to exceed 250 to 1.

Analysts have struggled to explain the rapid growth in U.S. executive pay. Equity compensation, which did not become significant until the 1980s, accounts for almost all of the growth.³⁰ Operating within an optimal contracting approach, Holmstrom and Kaplan argue that the addition of this risky pay necessitated an overall increase in compensation of risk-averse executives.³¹ Frydman and (separately) Murphy and Zbojnik explain the growth in CEO pay as following from a shift in the requisite skill

companies). To be sure, pay levels in 2009 were somewhat depressed as a result of the financial crisis, but the trend remains steadily upward.

26. See Carola Frydman & Raven E. Saks, *Executive Compensation: A New View from a Long-Term Perspective, 1936–2005*, 23 REV. FIN. STUD. 2099, 2107 (2010) (presenting graph depicting increase of over 500%); Gabaix & Landier, *supra* note 5, at 51 (2008) (finding 500% increase).

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

28. Bebchuk & Grinstein, *supra* note 4, at 302.

29. See *Executive PayWatch*, AFL-CIO, <http://www.aflcio.org/corporatewatch/paywatch/pay/index.cfm> (last visited Mar. 29, 2012) (analyzing compensation data from “299 companies in the S&P 500 Index”).

30. Frydman & Jenter, *supra* note 27, at 77–80.

31. Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121 (2001); Bengt Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What’s Right and What’s Wrong?*, 15 J. APPLIED CORP. FIN. 8 (2003). This view is in line with Jensen and Murphy who had argued that improving executive incentives would necessitate paying executives more. Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It’s Not How Much You Pay, But How*, HARV. BUS. REV., May–June 1990, at 138.

set.³² Formerly, firm-specific skills dominated, limiting outside opportunities, but, increasingly, general management skills dominate, which leads to greater competition for talent and to managers capturing greater rents. Recently, Gabaix and Landier have proposed a model involving competitive matching of CEO talent and firms.³³ The model predicts that average compensation should move with firm size, and the model explains the increase in pay over time, as well as cross-industry and cross-country pay observations. The authors find very little dispersion in CEO talent at the largest firms, but given the tremendous amount of assets under management and a multiplier effect, the model can explain large pay differentials.

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.³⁴ 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.³⁵

The bottom line is that top executive pay is economically significant and increasingly so. Bebchuk and Grinstein estimate that top executive pay at non-Execucomp firms with market capitalization in excess of \$50 million is in aggregate about two-thirds of executive pay reported in Execucomp.³⁶ Using that figure, a ballpark estimate for 2008 top executive pay for U.S. public companies with market capitalization in excess of \$50 million is about \$40 billion.³⁷ Note, moreover, that these figures include

32. Carola Frydman, *Rising Through the Ranks: The Evolution of the Market for Corporate Executives, 1936–2003* (Nov. 18, 2005) (unpublished manuscript), available at <http://mitsloan.mit.edu/finance/pdf/frydman-090208.pdf>; Kevin J. Murphy & Ján Zábajník, *CEO Pay and Appointments: A Market-Based Explanation for Recent Trends*, 94 AM. ECON. REV. 192 (2004); Kevin J. Murphy & Ján Zábajník, *Managerial Capital and the Market for CEOs* (Apr. 2007) (unpublished manuscript), available at <http://ssrn.com/abstract=984376>.

33. Gabaix & Landier, *supra* note 5. The idea that small differences in talent are consistent with large differences in pay was also explored by Charles P. Himmelberg & R. Glenn Hubbard. See 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>.

34. Bebchuk & Grinstein, *supra* note 4, at 302.

35. *Id.* at 301–02. In a similar vein, Jensen, Murphy, and Wruck argue that the favorable accounting treatment of options in the 1990s led boards to systematically undervalue this form of compensation. See Michael C. Jensen et al., *Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them*, 39 (European Corporate Governance Inst., Working Paper No. 44, 2004), available at <http://ssrn.com/abstract=561305>; Kevin J. Murphy, *Stock-Based Pay in New Economy Firms*, 34 J. ACCT. & ECON. 129, 143–45 (2003).

36. Bebchuk & Grinstein, *supra* note 4, at 297.

37. \$25 billion aggregate compensation for Execucomp executives plus two-thirds times \$25 billion equals \$41.7 billion.

only the top five executives at each company. There are likely to be more than five “senior” executives at many large, public companies, and thus this figure likely understates the aggregate amount of senior executive pay. Also, bear in mind that these figures represent annual flows to company executives, not one-time transfers.

III. WHO BEARS THE COST OF EXCESSIVE EXECUTIVE PAY?

The corporate governance literature assumes, explicitly or implicitly, that excessive executive pay comes at the expense of shareholders who bear residual corporate gains and losses.³⁸ This section analogizes systematically excessive pay to a corporate-level tax and explores the implications of that analogy within the extensive literature on the incidence of the corporate tax. If this analogy holds, we must conclude that it is far from clear that shareholders bear the cost of systematically excessive executive pay and that non-corporate capital and/or labor are likely to bear a significant fraction of the burden.

A. *Systematic and Firm Specific Excess Executive Pay*

In thinking about the incidence question it is useful to conceptually divide excess executive pay between firm-specific excesses and systematic excesses. To the extent that executive pay is greater at a particular firm because of a particularly strong CEO or particularly lax outside directors, the cost is likely to be borne entirely by that firm’s shareholders. If we assume that the firm is engaged in competitive products and labor markets (below the executive level),³⁹ it would be difficult for existing shareholders to pass on such firm-specific costs to consumers or employees. If the firm collects monopoly rents, those rents will simply be reduced by the excessive compensation. Lenders to the firm—bondholders or banks—will not be affected by excessive pay that does not materially threaten solvency. New suppliers of equity—either purchasers of a new issuance of shares, or purchasers of outstanding shares—will demand a discount to reflect the reduction in equity returns caused by extraction of excessive compensation. Thus, existing shareholders, i.e., “old” equity, should bear the cost of existing excessive pay and of any firm-specific increase in executive pay.

But what about executive pay that is at a higher level, systematically, than would prevail in a well-functioning market? Systematically higher pay that results from lax governance at some firms, comparative benchmarking, and an executive labor pool that is infected by these practices would seem to be analogous to a corporate-level income tax. Like an actual tax, the economic tax created by systematically excessive pay reduces net shareholder returns across the board. If the “tax” may be avoided by shifting

38. Bebchuk et al., *supra* note 2.

39. Note that there is no inherent inconsistency in assuming market failure in the executive labor market and assuming an efficient rank and file labor market.

investment into other domestic sectors or by shifting capital abroad, those capital flows will affect the incidence of systematically excessive pay.

Of course, there are differences between actual corporate taxes and this economic tax that might affect the incidence analysis. First, the actual corporate income tax is exogenously determined, while executive pay levels are to a large extent endogenous. But the argument here is that, to some extent, excessive executive pay at any particular firm is exogenous. Second, the design of the actual corporate tax (a percentage of profits) is quite different from the design of the economic tax arising from excessive executive pay (which may provide useful incentives). Third, the corporate income tax is relatively transparent,⁴⁰ while excessive compensation is much less transparent. Nonetheless, as further discussed below, it is not obvious that any of these differences seriously weakens the analogy between the corporate tax and systematically excessive pay.

For the sake of pursuing and unpacking the analogy, let us suppose that there has been an economic shock that has loosened the outrage constraint and allowed executives to extract increased pay across the board. We can use Bebchuk and Grinstein's suggestion that the bull market of the 1990s loosened the outrage constraint and allowed for increased pay.⁴¹ The question, then, is what is the incidence of the systematic increase in executive pay?⁴²

The increase in pay comes directly from the corporate treasury, but of course the treasurer does not bear the cost. As with a corporate tax, we must look beyond the legal fiction of the corporation to determine which individuals bear the cost of the increase in executive pay.⁴³ In the first instance, shareholders bear the cost. Shareholders will be unable to shift the burden of the increase in compensation in the short term because labor and other contracts are fixed.⁴⁴ Over time, however, the incidence of increased systematic excess pay may shift as a new investment equilibrium develops. In order to consider how that equilibrium might evolve, it will be helpful to delve into the literature on the incidence of the corporate income tax.

40. The corporate tax rules are perfectly transparent. Corporate tax returns are not public documents, however, and it can be difficult to reconcile actual tax liabilities with accrued tax liabilities reported in company financial statements. See, e.g., Michelle Hanlon & Terry Shevlin, *Book-Tax Conformity for Corporate Income: An Introduction to the Issues*, 19 TAX POL'Y & ECON. 101, 106 (2005) (describing why company financial disclosures do not provide clear picture of tax liabilities).

41. Bebchuk & Grinstein, *supra* note 4, at 300–01.

42. The incidence of a baseline level of excessive pay and of a change in excessive pay may differ. Because policy choices would affect the extent of excessive pay, it seems most useful to focus on the incidence of a change in excessive compensation. See Alan J. Auerbach, *Who Bears the Corporate Tax? A Review of What We Know*, 20 TAX POL'Y & ECON. 1, 2 (2006) (noting that analysis of incidence of corporate tax changes is more meaningful than overall tax incidence analysis).

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

44. Cf. Auerbach, *supra* note 42.

B. *A Brief Review of the Theory and Evidence on the Incidence of Corporate Taxes*

The corporate income tax incidence literature goes back fifty years to the seminal work of Arnold Harberger.⁴⁵ For many years, incidence analysis was mainly theoretical. Unfortunately, theoretical approaches have failed to resolve the question of who bears the burden of corporate taxation, as results are highly dependent on assumptions. Recent years have seen an increase in empirical analyses of corporate tax incidence, but these studies are also open to various criticisms that limit their persuasiveness. Nonetheless, we do know more about corporate tax incidence than we once did, and it is fair to say that the consensus among economists is that it is unlikely that shareholders bear the entire burden of an increase in corporate taxes in an open economy and that it is likely that non-corporate capital and labor bear a significant fraction of the burden.⁴⁶

In the early 1960s, Harberger analyzed corporate tax incidence employing a general equilibrium model that included two sectors (corporate and non-corporate) and two factors of production (labor and capital).⁴⁷ Harberger assumed a closed economy and a fixed supply of labor and capital. In Harberger's model, a tax on the corporate sector was borne not by corporate shareholders alone but by all holders of capital in the economy. Joel Slemrod and Jon Bakija explain the Harberger model by analogizing to the imposition of a toll on one of two parallel highways.⁴⁸ At first, those who drive on the road with the new toll bear the entire cost. However, over time, drivers abandon the toll road for the non-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 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.⁴⁹

The Harberger model of corporate tax incidence is quite elegant, but its assumptions of a closed economy and fixed factors of production are unrealistic. Much of the theoretical work since Harberger has been focused on exploring the incidence question under more realistic, open

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

46. See Altshuler et al., *supra* note 17, at 360-70 (summarizing theoretical and empirical work on corporate tax incidence).

47. Harberger, *supra* note 45.

48. SLEMROD & BAKIJA, *supra* note 43.

49. One may ask why workers bear none of the burden under the Harberger model. The answer, in a nutshell, is that Harberger 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 his model, the total amount of capital invested in the economy is fixed, labor can move between the corporate and non-corporate sectors, and thus total returns to labor are fixed.

economy assumptions. Recent theoretical work typically assumes that capital is more or less mobile internationally, but that labor is not.

Randolph, for example, shows that in an open economy setting, an increase in the domestic corporate tax rate causes capital to shift abroad.⁵⁰ Total returns to capital are maintained on a world-wide basis, but foreign labor benefits because increased foreign capital improves productivity and wages, while domestic labor suffers for the opposite reason. Randolph's base estimate is that domestic labor bears about 70% of the cost of an increase in the corporate tax, while domestic capital bears about 30%.⁵¹ The burden borne by capital increases, however, as the size of the domestic economy increases relative to the world economy and as the size of the domestic corporate sector increases relative to the overall domestic economy.⁵² This analysis assumes, of course, that a change in the corporate tax rate in one country is not matched in other countries. If corporate income tax rates rise and fall in unison around the world, open economy models collapse into closed economy models, and Harberger's results return to the fore.⁵³

The incidence determined by open economy models is very sensitive to other underlying assumptions. Gravelle and Smetters show that Randolph's results are highly sensitive to assumptions concerning the degree to which domestic and foreign traded goods substitute for one another and the degree to which investors substitute between domestic and foreign investments.⁵⁴ They replicate Randolph's results when they assume perfect substitutability along both dimensions. But when they employ more reasonable (in their view) assumptions about these factors, their model indicates that domestic capital bears 70% to 90% of the burden of the corporate income tax.⁵⁵

Alan Auerbach introduces further complications into the theoretical analysis of corporate tax incidence, many of which suggest that shareholders may in fact bear a considerable portion of the burden of additional corporate-level taxes.⁵⁶ For example, Auerbach stresses the importance of timing. He explains that an increase in corporate taxes reduces asset val-

50. William C. Randolph, *International Burdens of the Corporate Income Tax* 43 (Cong. Budget Office, Working Paper No. 9, 2006), available at <http://www.cbo.gov/ftpdocs/75xx/doc7503/2006-09.pdf>.

51. *Id.* at 44.

52. *Id.* at 36–38.

53. See Matthew H. Jensen & Aparna Mathur, *Corporate Tax Burden on Labor: Theory and Empirical Evidence*, 131 TAX NOTES 1083, 1085 (2011) (citing Arnold C. Harberger, *Corporate Tax Incidence: Reflections on What is Known, Unknown, and Unknowable*, in FUNDAMENTAL TAX REFORM: ISSUES, CHOICES, AND IMPLICATIONS 283 (John W. Diamond & George R. Zodrow eds., 2008)).

54. Jane G. Gravelle & Kent A. Smetters, *Does the Open Economy Assumption Really Mean that Labor Bears the Burden of a Capital Income Tax?*, 6 B.E. J. ECON. ANALYSIS & POL'Y, 1 (2006).

55. *Id.* at 25 tbl.2.

56. Auerbach, *supra* note 42.

ues and future rates of return. The cost of the former is borne by existing shareholders. The cost of the latter is borne by new shareholders, other providers of capital, labor, or all three constituencies, depending on the considerations modeled by Harberger, Randolph, Gravelle and Smetters, and others. The degree to which the tax is borne by existing shareholders depends on the responsiveness of capital to the imposition of a tax.⁵⁷ Auerbach also suggests several reasons that shareholders may not be able to shift the burden of taxes even over the long run. 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.⁵⁸ As Altshuler, Harris, and Toder suggest, given Auerbach's insights, it is possible that shareholders bear most (or even all) of the long-run costs associated with an increase in the corporate income tax.⁵⁹

Given the indeterminacy of the theoretical literature on 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 to a significant extent. For example, using cross-country differences in corporate income tax rates and wage rates, Hassett and Mathur found that a one percent increase in corporate income tax rates was associated with a one percent reduction in wage rates.⁶⁰ Desai, Foley, and Hines utilized data from American multinational firms in estimating that between 45% and 75% of the burden of corporate taxes is borne by labor, with the balance borne by capital.⁶¹

Unfortunately, empirical work in this area is also subject to criticism. Gravelle and Hungerford have criticized the methodology employed in these studies,⁶² and they and others have raised broader concerns.⁶³ For example, burden shifting should be a long-term phenomenon, but these studies capture relatively short-run effects. Moreover, some recent empirical studies provide implausibly large burdens on labor.⁶⁴ It is not clear how much weight should be placed on these empirical studies.⁶⁵

57. *Id.*

58. *Id.*

59. Altshuler et al., *supra* note 17, at 361.

60. Kevin A. Hassett & Aparna Mathur, Taxes and Wages (Mar. 6, 2006) (unpublished manuscript), available at <http://www.aei.org/paper/24063>.

61. Mihir A. Desai et al., *Dividend Policy Inside the Multinational Firm*, FIN. MGMT., Spring 2007, at 5.

62. JANE G. GRAVELLE & THOMAS L. HUNGERFORD, CORPORATE TAX REFORM: ISSUES FOR CONGRESS 16 (2007).

63. WILLIAM M. GENTRY, DEP'T OF THE TREASURY, OTA PAPER 101, A REVIEW OF THE EVIDENCE ON THE INCIDENCE OF THE CORPORATE INCOME TAX 101 (2007).

64. Altshuler et al., *supra* note 17, at 368 (citing work by Gentry and by Gravelle and Hungerford).

65. Altshuler, Harris, and Toder take a dim view: "empirical studies to date contribute little, if anything, to resolving the question of who actually bears the burden of the corporate income tax. We are left to rely on theoretical models" *Id.* at 369.

In sum, setting aside the special considerations discussed by Auerbach, the consensus among economists is that the burden of a corporate income tax in an open economy is shifted to a significant degree to non-corporate capital and to labor. But at that point the consensus ends. The lack of agreement is seen in the various approaches taken by government agencies in estimating the distribution of the overall burden of taxes. In its analyses, the Treasury Department assumes that the burden of the corporate income tax is borne by all holders of capital.⁶⁶ The Congressional Budget Office utilizes various assumptions ranging from 100% of the burden borne by capital to 100% borne by labor.⁶⁷ The Joint Committee on Taxation ignores the incidence of the corporate tax altogether in determining the overall incidence of U.S. taxes,⁶⁸ an approach that is clearly wrong, but somewhat understandable under the circumstances.

C. *The Incidence of Systematically Excessive Executive Pay*

This section explores the implications of the admittedly indeterminate corporate tax incidence literature for systematically excessive executive pay. If systematically excessive executive pay is analogous to a tax on the corporate sector, the primary implication is that shareholders may bear a portion of the cost for the reasons suggested by Auerbach, but that otherwise the burden is shared by non-corporate capital, labor, or both. This section considers various reasons that the analogy might or might not be sound, but concludes that the analogy is reasonably persuasive.

If the analogy is sound, the implication of the Harberger model would be that the cost of systematically excessive executive pay would at first be borne by shareholders, but that over time capital would shift to sectors that do not suffer from excess executive pay. In equilibrium, Harberger's model predicts that corporate shareholders would bear the incidence of excess executive pay pro rata with other suppliers of capital in the economy.⁶⁹

An important assumption in maintaining the analogy between the corporate income tax and systematically excessive executive pay under the Harberger model is that the executive pay excesses do not infect the entire economy. In other words, it is important that investors be able to avoid an increase in executive pay by shifting their capital to other sectors. This seems to be a reasonable assumption. It seems likely that excesses in the public company executive pay market would infect pay levels at some private companies and perhaps at non-profits. But non-profits, of course, are not an investment target. More importantly, there would seem to be a

66. SLEMROD & BAKIJA, *supra* note 43.

67. *Id.*; Jensen & Mathur, *supra* note 53, at 1083.

68. Jensen & Mathur, *supra* note 53, at 1083.

69. This is not to suggest that these are necessarily different individuals. Many shareholders will also hold non-corporate investments.

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large amount of investment capital that would not be tainted, such as owner occupied housing.

Another important assumption is that markets other than the executive labor market are reasonably efficient. There is little reason to think that market failure in the executive pay-setting process results in inefficiencies in the products, capital, or (non-executive) labor markets. It may be true that executives with power are able to pay their underlings at an above market rate, but executives with power should have the same interest as shareholders in optimizing compensation below the executive suite.

The analogy between the corporate tax and excessive 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.

Of course, one might think a reduction in domestic labor productivity and wages associated with a flight of capital abroad would negatively impact executive compensation, and this would be true in a competitive executive labor market in which executives received compensation equal to the marginal product of their labor. If so, capital flight would act as a self-correcting brake on excessive executive pay. But the assumption here is that this particular market is not efficient and that an outrage constraint rather than marginal productivity caps compensation.

The open economy model would collapse into a closed economy model if changes in systematically excessive U.S. executive pay were matched abroad, but despite the fact that executives are more mobile internationally than rank and file workers, cross-country differences in executive compensation suggest that there is not a global executive labor market. Cross country comparisons of executive 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 in

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 G. Fernandes et al., *The Pay Divide: (Why) Are U.S. Top Executives Paid More?* 1 (European Corporate Governance Inst., Working Paper No. 255, 2009), 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 differences are largely explained by firm, ownership, and board characteristics and by riskiness of equity-based compensation); Randall S. Thomas, *International Executive Pay: Current Practices and Future Trends* 8 (Vanderbilt Law Sch., Research Paper No. 08-26, 2008), available at <http://ssrn.com/abstract=1265>

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

What about the other differences between the economic “tax” of systematically excessive executive pay and our actual corporate tax? As noted above, the apparent difference in exogeneity does not survive close scrutiny. Once one understands how excessive pay levels at poorly governed firms infect other firms through the benchmarking process, excessive pay appears to be no less exogenous than the corporate tax. To be sure, corporate directors could adopt another approach. They could screen potential benchmark firms based on the quality of their corporate governance. But given current practices, systematically excessive pay is, to a large degree, exogenous.

Even if boards are price takers in terms of the overall level of executive pay, they have some flexibility to design compensation to optimize incentives. In this respect, the economic tax of excessive pay differs from the corporate tax. But the difference seems unimportant from an incidence perspective for two reasons. First, given the interest of executives and boards in camouflaging excessive pay, design discretion may be limited. Second, efficient design can only mitigate the cost of excessive pay; it cannot totally eliminate it.

Finally, there is the difference in certainty and transparency. The corporate tax is relatively certain and transparent; excessive pay is less so. But, once again, this difference does not seem to undermine the incidence analogy. Investors cannot exactly calculate excessive compensation, but, at the margin, excessive pay will reduce returns in the corporate sector, and investors will respond to those returns. Presumably, the effect would be similar to the impact of insider trading on equity markets. Commentators generally agree that equity investors would respond to increased insider trading by reallocating their capital away from the infected market.⁷²

In sum, the analogy between the corporate income tax and systematically excessive executive pay seems reasonably sound, which suggests that the incidence of systematically excessive pay is similar to that of the corpo-

122 (demonstrating that non-U.S. executives receive less total compensation and less performance-oriented pay, but also providing evidence of shift towards U.S. pay practices).

71. See Bebchuk et al., *supra* note 2, at 842–43; 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 ROBERT C. CLARK, CORPORATE LAW 274 (1986); Kenneth E. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 808 (1980).

rate income tax. The corporate tax incidence question has not been resolved and may never be resolved,⁷³ but assuming that the analogy is a good one, the latest thinking on incidence suggests that it would be inappropriate to assume that shareholders necessarily bear the entire cost of excessive executive pay.

IV. OTHER COSTS OF SYSTEMATICALLY EXCESSIVE EXECUTIVE PAY

The primary thrust of this Article concerns the incidence of systematically excessive executive pay. But incidence analysis only tells us who is at the other end of the transfer to executives. There are also social costs of systematically excessive executive pay, which arise from inefficiencies that are created as a result of this transfer.

Whatever its incidence, systematically excessive executive pay dampens incentives to invest in the U.S. corporate sector. As Auerbach explains, the corporate income tax and, by analogy, systematically excessive executive pay distort the allocation of capital between either the corporate sector and the domestic non-corporate sector (under the Harberger model) or between domestic and foreign investments (under open economy models).⁷⁴ Unless the shift is offsetting some other distortion, a tax on one sector of production introduces unnecessary deadweight loss.⁷⁵

As noted above, there are other costs and distortions associated with excessive executive pay at large, public companies. First, there may be externalities. Systematically excessive pay at large public companies may infect pay levels at private companies and even in the non-profit sector, if these organizations compete with public companies for the same pool of executives. The extent to which the executive labor pool is common to these organizations is unclear. Closely held, family-owned companies may not compete for the same pool. On the other hand, one would think that portfolio companies owned by private equity, venture capital, and hedge funds often would compete for the same pool of executives, as would some large non-profits, such as hospitals, that are in the same product market as for-profit organizations.⁷⁶

Excessive executive pay in these sectors represents a transfer and may distort capital allocation, as well. To some extent, however, the infection of these other markets may mitigate the distortions created in the public company sector. If capital fleeing one market faces the same economic "tax" in an alternative market, there would be no distortion. Ultimately, whether infection of other markets magnifies or mitigates capital alloca-

73. Auerbach, *supra* note 42.

74. *Id.*

75. *See id.* at 9 (explaining that more general tax on capital income would not create this distortion).

76. *See* David I. Walker, *Executive Pay Lessons from Private Equity*, 91 B.U. L. REV. 1209, 1218 (2011) (discussing competition for executives and criticizing prior studies conducted on executive pay).

tion distortion is an empirical question that turns on international capital mobility and similar factors.

A more direct ancillary cost of excessive executive pay in the public company sector arises from diminished morale of workers below the senior executive suite.⁷⁷ Evidence suggests that vertical pay inequity leads to increased employee turnover and reduced product quality, and systematically excessive pay exacerbates pay inequity.⁷⁸

Finally, to the extent that executive pay is limited by an outrage constraint, firms and executives are motivated to adopt compensation design practices that obscure the amount of compensation delivered. Because salience plays no role in efficient compensation design, this distortion tends to reduce share value. Commentators have pointed to heavy reliance on stock options, which are difficult to value, and on pension benefits, which formerly were poorly disclosed, as examples of this distortion. Of course, this effect is not a result of excessive pay. Systematically excessive pay and distortions in pay design both flow from defects in the executive pay bargaining process. Hence, further elaboration of this point lies beyond the scope of this Article.

V. IMPLICATIONS

The main message of this Article is that we should not assume that excessive executive pay necessarily comes at the expense of shareholders. The burden may be shifted in part to other investors and to labor. If one accepts this conclusion, how would one think differently about corporate governance and corporate governance regulation?

First, for some, the possibility that labor bears a significant fraction of the cost of excessive pay will make regulation more attractive because the stakes are greater, or at least different. One way to think of this is that, distortions aside, a transfer from shareholders to executives represents a transfer from the rich to the super rich. Even accounting for shares held by mutual funds, pension funds, and other institutions, share ownership is heavily skewed towards the wealthiest U.S. households.⁷⁹ Continuing the

77. See 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, 146 (2002) (arguing that increases in CEO pay, particularly during economic downturns, are likely to decimate employee morale).

78. Douglas M. Cowherd & David I. Levine, *Product Quality and Pay Equity Between Lower-Level Employees and Top Management: An Investigation of Distributive Justice Theory*, 37 ADMIN. SCI. Q. 302, 316 (1992) (showing “substantial positive relationship” between product quality and pay equity between executives and hourly workers); James B. Wade et al., *Overpaid CEOs and Underpaid Managers: Fairness and Executive Compensation*, 17 ORG. SCIENCE 527, 539 (2006) (finding that pay inequity leads to higher levels of employee turnover).

79. Edward N. Wolff, *Recent Trends in Household Wealth in the United States: Rising Debt and the Middle-Class Squeeze—an Update to 2007* 58 tbl.15a (Levy Econ. Inst. of Bard Coll., Working Paper No. 589, 2010), available at http://www.levyinstitute.org/pubs/wp_589.pdf.

tax analogy, a transfer from shareholders to executives is modestly regressive. On the other hand, a transfer from labor to executives would be highly regressive. A transfer from all holders of capital in the economy, including holders of owner-occupied housing, would likely fall somewhere in between.

If labor or some mix of labor and capital bear the burden, systematically excessive executive pay contributes in two ways to the growing inequality of wealth in this country. Of course, the executive class is wealthier as a result of the transfer. But wages and returns on all sorts of investments may be lower following the shift in equilibrium investing in an open economy. Recognition of this two-sided impact on inequality may increase the impetus for a regulatory response to excessive executive pay. We might be more eager to attempt to rein in pay, given a better understanding of the distributional consequences, despite the difficulty and potential unintended consequences of doing so.⁸⁰

Second, recognizing that labor and non-corporate capital may bear a large chunk of the burden of excessive compensation may affect our approach to pay regulation. To the extent that the cost of excessive pay is borne solely by shareholders, regulatory responses aimed at increasing shareholder power vis-à-vis management, such as mandating shareholder “say on pay,” may be reasonable and effective. But shareholder-centric approaches to improving pay processes may be less compelling to the extent that shareholders are able to pass on the costs. To be sure, shareholders would still have a strong incentive to rein in firm-specific excess pay, the cost of which is not passed on, and as a result, shareholders may still be in the best position to address executive pay generally. However, viewing the impact on labor and non-corporate capital as an externality suggests that shareholders may be inadequately motivated to address executive pay excesses and that different or additional regulatory responses may be dictated.⁸¹

80. Regulation of executive pay is perilous, and is not to be undertaken lightly. As discussed above, even the apparently innocuous act of requiring enhanced disclosure of executive pay may have contributed to upward ratcheting in pay levels. See *supra* note 22 and accompanying text. More intrusive regulation, such as the adoption of I.R.C. § 162(m), which limited the deductibility of senior executive pay that is not performance based, often results in unintended consequences. I.R.C. § 162(m) (2011). In the specific case of § 162(m), the intervention is thought to have contributed substantially to the widespread adoption of stock option compensation, which led to excessive levels of pay during the 1990s stock market boom and which may have encouraged excessive risk taking, contributing to the financial crisis of 2008/2009. Elsewhere, I argue that despite these cautionary tales, a tax based approach to regulating executive pay may be warranted. See David I. Walker, *A Tax Response to the Executive Pay Problem* (Boston Univ. Sch. of Law, Working Paper No. 11-50, 2011) available at <http://ssrn.com/abstract=1944115>.

81. A similar issue has been identified in the context of regulating executive pay in the financial industry. In that context, the idea is that bank shareholders have a socially suboptimal incentive to manage risk-taking incentives because taxpayers, as a result of explicit or implicit guarantees, bear a portion of losses but not

VI. CONCLUSION

Let me conclude by briefly considering the broader implications of the incidence analysis that is the heart of this Article. According to the managerial power view of the compensation setting process, excessive executive pay is just one manifestation of the agency costs that arise from the separation of ownership and control in the modern U.S. public company. Is there any reason to think that the incidence of other agency cost manifestations, such as insider trading or self-dealing, in general, would differ? I think the answer is “no.” Changes in legal rules, enforcement efforts, and perhaps even in business practices that increase managerial agency costs will be borne by shareholders in the first instance. Assuming, however, that these costs are perceived by investors and that they are unique to or are of significantly greater consequence in the corporate sphere, over time investors will respond by reallocating capital away from the more heavily “taxed” corporate sector. When that happens, returns to capital, corporate and non-corporate, domestic and international, will be affected, as will the productivity of labor and returns to labor. The incidence of corporate agency costs should mirror that of the corporate tax.

This is not an entirely new observation. Many commentators, including Clark and Scott, have argued that shareholders would respond to more prevalent insider trading by demanding a greater rate of return and that capital allocation would be impacted.⁸² What is new, I think, is the suggestion that the impact would not be limited to company founders, managers, and shareholders, but might be felt by other suppliers of capital to the economy and by labor.

Consider the following examples. Sticking first with insider trading, recent, high profile prosecutions in the U.K. apparently have led to a reduction in insider trading in that country.⁸³ We have also witnessed a number of high profile insider trading prosecutions within the last year on this side of the pond, including the conviction of Galleon head Raj Rajaratnam, which resulted in a record eleven year prison term.⁸⁴ In all likelihood, these prosecutions have led to reduced insider trading in this country, as well. If so, the benefit may extend beyond shareholders to other investors and labor. Second, enhanced SEC disclosure regulations

of gains associated with risky bets. See, e.g., Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 NW. U. L. REV. 1205, 1214 (2011). The issues are similar, but not identical. An asymmetry in the context of general oversight of executive pay would arise as a result of shareholders bearing a larger fraction of monitoring costs (through personal time and effort) than of residual losses resulting from suboptimal monitoring.

82. CLARK, *supra* note 72, at 274; SCOTT, *supra* note 72, at 808.

83. See Brooke Masters, *Suspicious Pre-Deal Trades Fall Sharply*, FIN. TIMES (London), June 14, 2011, at 1-1 (reporting on drop in suspicious trading activity before U.K. mergers and acquisitions after high-profile Financial Services Authority prosecutions).

84. Susan Pulliam & Chad Bray, *Trader Draws Record Sentence*, WALL ST. J., Oct. 14, 2011, at A1.

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have placed greater pressure on executive perks. Although the dollar amounts are relatively small, the benefit likely flows beyond shareholders. Third, suppose that the Delaware legislature were to amend “rules of the road” provisions, such as those dealing with midstream charter amendments or staggered boards, which would affect agency costs generally. Again, there is little reason to think that the costs or benefits would be limited to founders, managers, and shareholders.

Extending the tax incidence analogy to corporate agency costs generally does not change the underlying message; it simply amplifies it. Individuals outside the founder-manager-shareholder circle have a stake in minimizing corporate agency costs; shareholders may be inadequately motivated to minimize these costs; and agency costs likely contribute more to inequality of wealth in the United States than we previously realized.

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