

IRET Byline

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Limiting Deductions for Executive Compensation: Another Exercise in the Politics of Envy

To finance an additional 20 or 26 weeks of unemployment compensation benefits, the House Ways and Means Committee proposes a couple of stiff tax increases on upper-income individuals and on corporations with highly-paid executives. The first of the proposed revenue raisers would extend for two years the present-law personal exemption phaseout for individuals with adjusted gross incomes above specified amounts. The other revenue gainer would disallow the deduction of executive compensation in excess of \$1 million. The only conceivable justification for these revenue raisers is that the people stuck with the additional taxes have no effective way of opposing them.

Neither of the proposed tax hikes meets any test of efficiency or fairness. By no stretch of the imagination can the taxpayers who would be called upon to pony up the additional taxes be held accountable for the unemployment for which the additional benefits are to be paid, nor will any of them benefit from the payment of the additional unemployment compensation. These taxpayers are the designated goats only because they are politically impotent.

The proposed tax hikes invoke the worst of all of the recent trends in tax policy. They combine the soak-the-rich politics of envy with the anti-big

business bias that has infected nearly all tax legislation beginning with the Tax Reform Act of 1986.

The phase-out of the personal exemption was enacted as one of the revenue raisers in the infamous Omnibus Budget Reconciliation Act of 1990. As has so often been the case in recent years, the only conceivable rationale for the phase-out is that it produces a significant amount of additional revenue from people who can't organize as a pressure group to protest such outrageously discriminatory tax provisions. Extending the phase-out for two years beyond its scheduled termination in taxable year 1995 relies on the same sort of unprincipled soak-the-rich mind set.

That mind set also produced the second revenue raiser in the unemployment compensation extension bill. A majority of the Ways and Means Committee members obviously feels that any executive's compensation in excess of \$1 million is not a legitimate business expense and should not therefore be entitled to the same tax treatment as other employees' compensation or other expenses of doing business. The legislation does not affect the deductibility of salaries paid to other employees who may earn over \$1 million annually, such as professional athletes, television news anchors, and movie stars. The implication is that Ways and Means Committee members know better than the stock holders and boards of directors of American companies what business executives are worth. How the figure of \$1 million was arrived at is not explained and why it might be OK for a business to pay non-executive employees more than a million but not executives is also not explained. No matter what rationale the Ways and Means Committee staff comes up with, this proposal is an attempt to place arbitrary controls on the compensation of executives. It is industrial policy at its worst.

The Congress should not even remotely contemplate any such measure unless it is convinced that the public interest is involved, but how a corporation's executive compensation policy is

invested with the public interest defies explanation. It is not for public policy makers to determine whether any given CEO or other corporate officer is worth his pay, whatever that may be. No public policy maker has any operational criteria on which to base any such judgment.

One can almost hear, even now, a member of Congress, called upon to justify this highly discriminatory proposal, maintaining that allowing the deduction of executive compensation in excess of \$1 million is a "tax expenditure," a subsidy the cost of which is paid for by all of us taxpayers who are not so favored. This notion suggests that all the income individuals receive really is the property of the government and whatever the government does not tax away is a gift to the taxpayer.

To allow business expenses to be deducted is not to subsidize the activities associated with those expenses. An income tax presumably is just that, a tax on income. Compensation paid to an employee, no matter what position the employee holds in the company or what salary he or she receives, is not income to the company, it is an expense that is incurred in order to generate income. There is no legitimate excuse for including any of these expenses in a company's taxable income base. If the proposal becomes law, the non-deductible portion of the executive's salary will be double taxed, once under the corporate tax paid by the affected business and then again under the personal income tax paid by the executive. Clearly, this double taxation has to raise the cost to corporations of using highly skilled and productive executives.

It may be that what the Ways and Means majority has in mind is putting tax pressure on corporations to cut back the compensation of their top executives. The country has had enough sad experience with government-imposed price and wage controls to know that this is very bad business, indeed. Contrary to the views of the House Ways and Means Committee, boards of directors have a far better sense of how much corporate management is worth to their company

than do members of Congress. The fact that many large corporations are willing to pay their top executives salaries that exceed \$1 million annually reflects their conviction that the contributions of those executives to the value of the company is worth the cost and therefore are efficient expenditures. Executive salaries, no matter how high, are not gifts from the company or its shareholders.

This tax change would penalize those corporations that depend on highly compensated executives for their efficient operation. There is no reason, in a market where competition for executive talent prevails, to expect that executive compensation, regardless of the level, represents an inefficient use of the corporation's resources. If any corporation mistakes an executive's worth and overpays him or her, there are powerful market forces, reflected in shareholders' pocketbooks, that lead pretty quickly to corrective action by the company. And certainly, there is every reason to believe that second guesses made by members of Congress about how any corporation's resources should be allocated would exacerbate, not improve, any inefficiencies that might exist. Such decisions made in Washington are nothing but pretentious governmental micro-management of business decision making. We have had examples galore, provided by the failed command economies of Eastern Europe, of the ruinous consequences of this "government-knows-all" sort of public policy.

The proposed limitation on the deductibility of executive compensation would serve no socially useful purpose. It would, instead, lead to inefficiencies in corporations' uses of their resources and it would formalize tax discrimination against certain categories of corporate employees simply because of their title and job description. The sole purpose of this tax change is to enhance the revenue flow to the Treasury. Once again, the politics of envy are being used to accomplish an end that can't be justified in terms of economic efficiency or ethics.

Norman B. Ture
President

Roy E. Cordato
Senior Economist