

The Vices and Virtues of Limiting Executive Compensation

TESTIMONY

by

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He is the author of three books on how markets work. A member of the Mercatus Center's Financial Markets Working Group, he is finishing a monograph on the financial crisis. He is also the host of the weekly award-winning podcast, EconTalk. He holds a Ph. D in economics from the University of Chicago.

Chairman Towns, Ranking Member Issa, and Distinguished Members of the Committee:

Americans are angry about executive compensation.

Rightfully so.

The executives at General Motors and Chrysler don't deserve to make a lot of money. They made bad products that people didn't want to buy.

The executives on Wall Street don't deserve to make a lot of money. They were reckless with other people's money. They made bad bets that didn't pay off. And they wasted trillions of dollars of precious capital, funneling it into housing instead of health innovation or high mileage cars or a thousand investments more valuable than bigger houses.

Everyday folks who are out of work through no fault of their own want to know why people who made bad decisions not only have a job but a big salary to go with it.

No wonder they're angry at Wall Street,

But if we keep getting angry at Wall Street, we'll miss the real source of the problem. It's right here. In Washington.

We are what we do. Not what we wish to be. Not what we say we are. But what we do. And what we do here in Washington is rescue big companies and rich people from the consequences of their mistakes. When mistakes don't cost you anything, you do more of them.

When your teenager drives drunk and wrecks the car, and you keep giving him a do-over—repairing the car and handing him back the keys—he's going to keep driving drunk. Washington keeps giving the bad banks and Wall Street firms a do-over. Here are the keys. Keep driving. The story always ends with a crash.

Capitalism is a profit and loss system. The profits encourage risk-taking. The losses encourage prudence. Is it a surprise that when the government takes the losses, instead of the investors, that investing gets less prudent? If you always bail out lenders, is it surprising that firms can borrow enormous amounts of money living on the edge of insolvency?

I'm mad at Wall Street. But I'm a lot madder at the people who gave them the keys to drive our economy off the cliff. I'm mad at the people who have taken hundreds of billions of taxpayer money and given it to some of the richest people in human history. I'm mad at Bush and Obama and Paulson and Geithner and Bernanke. And I'm mad at Congress. You made sure that risk-takers continue to expect that the rules that apply to the rest of us don't apply to people with the right connections.

You have saved the system, but it's not a system worth saving. It's not capitalism but crony capitalism.

Using a Special Master for Compensation to get our money back is too little, too late.

Many people argue that because the government handed out the money, the government has a right to dictate how it is spent. It's a reasonable thought in personal relations. If I offer you money, I have a right to attach strings to my generosity. But in a constitutional democracy like ours, it is not the government that has rights. We, the people, have rights. The Constitution exists to restrain government, not to empower it.

Whether government has the right or not isn't the question. The question is whether we want government to have the power to set compensation. Despite our anger, the answer is no.

F. A. Hayek, the Nobel Laureate economist, said: "The curious task of economics is to demonstrate to men how little they really know about what they imagine they can design."

The Special Master imagines he can design compensation packages that "align incentives" while "retaining key talent."

But it is impossible for any one person—no matter how wise—to anticipate the consequences of such decisions. Certainly the Special Master does not possess that knowledge.

Nor does he have any incentive to acquire that knowledge. He has no skin in the game.

Worse, a single individual has been given enormous arbitrary power. He threatens to expand that power. This is not good for the rule of law, democracy or capitalism.

By focusing on those who owe the government TARP money, the Special Master distracts from the other firms that benefited from government rescue—Goldman Sachs and JP Morgan Chase and others.

The comfort we receive from seeing compensation reduced distracts us from the policies that created the problem in the first place—the rescue of Wall Street from its own recklessness.

It is a charade of political window dressing to make crony capitalism look respectable.

I want my country back.

Let's get the government out of the auto business, out of the banking business and out of the compensation design business. We need explicit timetables to disengage from government ownership including a plan for how the Federal Reserve will draw down its balance sheet. Most of all, we need to stop trying to imagine we can design housing markets and mortgage markets and financial markets and compensation.

I want my country back.

I want a country where responsibility still means something. Where rich and poor, Main Street and Wall Street live by the same rules. We don't need a Special Master to level the playing field. We just need to take the crony out of crony capitalism so we can get back to the real thing.