Tax Cuts and Jobs Act did little to affect executive pay, counter to what Congress intended

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Through the Tax Cuts and Jobs Act of 2017, Congress attempted to curb CEO pay by repealing a long-standing exemption that allowed companies to deduct large amounts of qualified performance-based pay. New research finds the change has had little effect, with CEO pay either staying the same or growing after the law made it more costly to award executives with high levels of compensation.

The intention of the legislation was to move top-executive compensation away from stock-based compensation and performance pay that can lead to a myopic emphasis on short-term results and toward cash-based fixed compensation.

Professors at Indiana University, the University of Texas and the Chicago Booth School of Business examined CEO pay packages before and after the tax policy change and found no evidence that companies affected by the law changed total compensation, compensation mix or pay-performance sensitivity.

"It's very politically amenable right now to say they're going to tax these corporations and these executives and it's going to reduce income inequality, but our research—and that of others—suggests that taxes are just not a big enough stick to change the structure or the magnitude of executive compensation," said Bridget Stomberg, associate professor of accounting and a Weimer Faculty Fellow at the IU Kelley School of Business. "We found no statistical effects, which is counter to what Congress intended. We looked very hard and see no evidence of a reduction in CEO pay."

The article, "Examining the Effects of the Tax Cuts and Jobs Act on Executive Compensation," has been published online by the journal *Contemporary Accounting Research*. The other authors are Lisa De Simone, an associate professor of accounting at the University of Texas' McCombs School of Business; and Charles McClure, an assistant professor of accounting at Booth. Stomberg and De Simone are co-hosts of the podcast "Taxes for the Masses."

Since 1994, publicly traded companies were generally subject to a $1 million-a-year cap on the amount of top-executive compensation that they could deduct from corporate taxable income. But there was an exemption, allowing them to deduct more if the pay was linked to the company's performance. In 2017, Congress reduced the corporate tax rate to 21 percent from 35 percent and eliminated the exemption, limiting the deductibility of certain highly compensated employees to only $1 million.

In the paper, Stomberg and her colleagues used a battery of over 40 tests to examine changes in executive compensation from fiscal years 2017 to 2018, when the tax rules took effect. They used a control sample of companies operating under fiscal years, which were affected later than companies operating under calendar years. They then looked at compensation in 2019 and 2020.

"Even three full years after the law took effect, we didn't see any evidence of a reduction in CEO pay," she said.

The results broadly suggest that taxes are not a first-order determinant of executive pay and that tax regulation could be relatively ineffective at curbing executive compensation in response to growing income inequality. This finding has policy implications as some in Congress propose a federal corporate tax surcharge linked to the CEO pay ratio. The cities of Portland, Oregon, and San Francisco have implemented business taxes tied to CEO pay ratios, which also has been proposed by at least eight states.

"If Congress' fundamental assumption about the relative importance of taxes in the design of executive compensation is overstated, its ability to shift current compensation practices through changes in tax policy is also likely overstated," the authors said. "Our results and those from prior studies suggest increases in firms' cost of executive compensation do little to reduce its amount.

"As a consequence, policymakers should reconsider whether changes to the taxation of executive compensation are a viable path towards addressing the perceived issues of excessive executive pay and inequality. Although our results speak only to the effects of the TCJA, we believe our results can inform the broader debate on the efficacy of tax regulation to influence executive compensation."

More information: Lisa De Simone et al, Examining the Effects of the Tax Cuts and Jobs Act on Executive Compensation†, *Contemporary Accounting Research* (2022). DOI: 10.1111/1911-3846.12801

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