

Abstract

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Why Executive Pay Matters to Innovation and Inequality

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In this paper I argue that a prime cause of the growing inequity and instability in the US economic system is the stock-based compensation of the executives who run the nation's leading industrial and financial corporations. In the 1980s and 1990s agency theorists advocated this type of compensation as an incentive for corporate executives to "maximize shareholder value" (MSV), and thereby improve the performance of the economy as a whole. First, I argue that the basic tenets of agency theory are contradicted by the theory of innovative enterprise. Then I show that in the corporate economy of the United States, the implementation of the incentives advocated by agency theory for the sake of MSV have over the past three decades resulted in an explosion of top executive pay. I go on to document the importance of stock buybacks in the United States as an instrument for MSV that, by manipulating a company's stock price, helps to boost executive pay. Finally I contend that in the United States the use of stock-based compensation, and in particular stock options, to motivate corporate executives to have a strong personal interest in the performance of their companies' stock prices has resulted in not only an inequitable distribution of income but also reduced investment in innovation and unstable economic performance.