"The Spirit of Capitalism: The Role of Executive Compensation in the Financial Crisis"

Abstract

When economic disasters occur it is common to look to the managers of the economy and question the decisions they made and the incentives that drove their decisions. In the financial crisis of 2007-2009 compensation was singled out as one of the most important and deeply flawed elements of the incentive system that induced firms to accumulate enormous amounts of risk on their balance sheets. In Clementi, Cooley, Richardson, and Walter (2009) we describe many of the flawed practices in financial firms. But, executive compensation more broadly has long been a sensitive issue and financial crises have a tendency to focus increased attention on it. In 1929 for example much attention was focused on the compensation of Eugene Grace, the president of Bethlehem Steel, who faced a huge uproar when it was revealed that he received a base salary of $12,000 and a bonus of more than $1.6 million. Throughout the 1930's there was much hue and cry about executive compensation and many proposals to cap it. In the current environment the same issues have emerged. In the past two decades there has been much discussion of executive compensation, many public examples of lavish pay, but no real consensus on the extent of the problem if indeed there is one. In part, this is because there is a lack of clarity about what the facts are. In this lecture I will describe recent research on executive compensation in the United States in the period 1993– 2006 looking at both the cross-sectional and time series variation. Most importantly I will describe the extent to which compensation practices achieve the goals of providing the right incentives to managers.