



Promoting
Prosperity
in

Mississippi

EDITED BY

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Published by the
Institute for Market Studies at Mississippi State University



MISSISSIPPI STATE UNIVERSITY™
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Published by the
Institute for Market Studies at Mississippi State University



The Institute for Market Studies at Mississippi State University was created in 2015 to support the study of markets in order to provide a deeper understanding regarding the role of markets in creating widely shared prosperity.

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admin@ims.edu • www.ims.msstate.edu

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Book design by Finney Creative, Inc. © 2018

Printed in the United States of America

ISBN 978-1-7320353-0-0

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Preface

What creates prosperity? Why are some states rich and others poor? Why does Mississippi consistently rank as one of the poorest states in the nation? Can anything be done to move Mississippi ‘out of last place’? These questions are often raised by our students and fellow Mississippians. This book addresses each of these questions by identifying areas in which Mississippi can improve its economic conditions.

In this book, we identify key areas for Mississippi economic policy reform. Twenty-one scholars, ten of which are from or work in Mississippi, have contributed original policy research. All twenty chapters were written specifically for Mississippi with a shared goal to promote prosperity in the state. While some of the chapters contain complex policy reforms, we have made every effort to present the concepts and ideas in a way that is understandable to the average citizen, the person who can benefit the most from this information.

The first three chapters of the text summarize the basic economic principles necessary to achieve economic prosperity. These three chapters present the principles behind the reforms proposed in the subsequent seventeen chapters. Each chapter was written independently and offers unique insight into different areas of state policy reform. While the topics covered range from tax reform, education reform, healthcare, corporate welfare, occupational licensing and business regulatory reform to criminal justice reform, and natural disaster recovery efforts, there is a clear unifying framework underlying the conclusions reached in each chapter. The theme throughout is that economic growth is best achieved through free market policies, policies which are based on limited government, lower regulations, lower taxes, minimal infringement on contracting and labor markets, secure private property rights, low subsidies, and privatization. Policy based on these principles allows Mississippians to have more rights and more choices in their lives.

We hope that readers come away with a better understanding of capitalism’s true potential to generate the long-run economic growth necessary to make Mississippi more prosperous, as well as ideas for policy reforms that could accomplish it in our lifetimes. This book illustrates that if Mississippi embraces economic freedom, the state will experience more entrepreneurship, increased business and capital formation, higher labor productivity and wages, and overall economic growth. Our main goal is to provide the scholarly, academic research that can inform state policy decisions and open a much needed dialogue on growth-oriented policy reform in Mississippi.

We focus on long-run policy improvements. Thus, the analysis is not an assessment of any particular administration or political party. Instead, this book can be thought of as a blueprint of possible economic reform proposals that use scientific evidence as a guiding principle. We emphasize that our unifying framework, which shapes the conclusions drawn in each chapter, is based on economic science, not politics. All authors address their respective topics by relying on academic research. Topics and policy conclusions were not based on any particular political agenda, political party, or political expediency. Instead, the authors relied on cold, hard facts and data with references to published academic literature to develop policy reform suggestions specific for Mississippi. In fact, many reforms suggested may not be politically possible.

The inspiration for this book came from *Unleashing Capitalism*, a series of books using economic logic to improve state policy in West Virginia, South Carolina, and Tennessee. We owe thanks to more people

than we could possibly list. We are indebted to our colleagues and the Finance and Economics advisory board at Mississippi State University who helped review chapters and provide invaluable feedback. We thank Ken and Randy Kendrick, Earnest W. and Mary Ann Deavenport, and the Pure Water Foundation for the funding necessary to embark on a project of this magnitude. We also thank our friends and family for their support, and for putting up with the long working hours that went into conducting this research. Most importantly, we would like to thank the staff and supporters of the Institute for Market Studies at Mississippi State University for publishing this book. Without their support, this book would not have been possible.

Let's start promoting prosperity in Mississippi!

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Incentive-Based Compensation and Economic Growth

Brandon N. Cline and Claudia R. Williamson

7

Incentive-Based Compensation and Economic Growth

Brandon N. Cline and Claudia R. Williamson

As discussed in Chapter 1, Mississippi ranks poorly across many economic categories. Despite programs to encourage business growth, and the occasional success in convincing large employers to locate or relocate in Mississippi, it is obvious that additional measures could be beneficial. This chapter highlights a potential obstacle to economic growth in Mississippi that could be relatively easy and inexpensive to overcome; one lying outside the usual suspects of administrative costs of doing business, educational system woes, or lack of suitable infrastructure to support technological innovation. Specifically, executive compensation for firms headquartered in Mississippi may not be structured in a way to encourage managers to pursue as many risky, value-enhancing opportunities as they should.

Incentive-based compensation links an employees pay to their performance. Adequately structured incentive pay rewards employees according to their performance and significantly reduces pay when performance is lacking. The basic logic is that employees get paid handsomely only when they perform. Perhaps most importantly, research shows higher sustained economic growth for states and enhanced performance for businesses offering incentive compensation.

The prevalence of incentive-based pay over the last two decades is largely attributable to efforts to minimize agency problems. The generic term “agency problem” refers to any number of scenarios where one party acts on behalf of another. Two common issues often arising from agency problems are shirking and risk-sharing. Shirking takes place when the best interests of the principal and the agent are not aligned, and the principal cannot easily or efficiently monitor the agent’s actions. Thus, the agent may take actions that are in his or her best interest but detrimental to the best interests of the principal. For example, employees may spend a little more time checking their phone when the boss is out. Risk-sharing

becomes an agency problem when the agent and principal view risk differently. These types of agency concerns are precisely what performance-based payment plans attempt to resolve.

Our purpose in this chapter is to consider how Mississippi firms rank in terms of incentive-based compensation relative to other states. We also consider whether potentially less-than-optimal incentive-compatible contracts may be a contributing factor in the Mississippi's subpar economic performance.¹

What we find, is that companies headquartered in Mississippi do not emphasize incentive-based compensation as heavily as similar firms headquartered in other states. Thus, an alternative way of enhancing prosperity in Mississippi could include educating Mississippi businesses and policymakers on the benefits of incentive-based compensation and encouraging incentive-based compensation use through state policies.²

Incentive-based executive compensation is used to reduce the agency conflicts that result when shareholders, who are the owners of the firm, hire managers to make decisions for the firm. Economic theory suggests that, in the absence of proper incentives, managers make decisions that enhance their own well-being at the expense of others, particularly if their efforts are difficult to observe or costly to monitor. Properly structured employment contracts incentivize managers to take appropriate risks in pursuit of profitable opportunities for the firm.³ Since shareholders ultimately desire the highest firm value possible, one way to achieve incentive-compatibility between managers and shareholders is by offering managers an equity stake in the firm.

When businesses plan and execute capital expenditures wisely, they in turn experience better company performance and marginal productivity increases. Increasing marginal productivity increases income levels and standards of living for all employees. Therefore, any change that can spur Mississippi businesses to improve performance is ultimately beneficial for all employees of those businesses. It is also beneficial to society in general, as these incentives ultimately lead to the efficient production of the goods and services consumers desire at lower prices resulting in higher standards of living. While the improved income levels and higher standard of living resulting from enhanced business performance are admittedly small in the short-run, even modest gains are valuable. As shown in chapter 1, a one percent increase in the rate of economic growth leads to over \$7,000 in additional average income in only one generation. As more gains are made, the common roadblocks to economic growth discussed in the previous chapters can be mitigated.

In addition to general increases in income levels and standards of living for current employees and consumers, there are at least four other reasons better company performance can lead to improved state economic performance. First, better company performance increases corporate income tax payments. Second, new jobs are created for state residents as companies expand. Third, large shareholders tend to be located geographically close to the headquarters of the firms they own.⁴ The increased income to shareholders from better firm performance (i.e. a higher stock price) would most likely result in increased income tax revenues for the state and increased consumer or corporate spending. Fourth, as a company's market value increases, it creates additional social value by engaging in corporate social responsibility. For example, Card, Hallock, and Moretti (2008) find that a \$100,000 increase in market value for a firm results in an increase of approximately \$70 in donations to non-profit organizations in the city of that

1 Executive compensation is analyzed purely from a financial research perspective; that is, the study takes no position on whether executives at Mississippi firms are paid too little or too much. Instead, careful attention is given to the ratio of incentive-based compensation to total compensation - allowing for conclusions about the structure, rather than the level, of executive compensation.

2 This chapter is based on Cline and Benefield (2010).

3 Jensen and Meckling (1976).

4 Becker, Cronqvist, and Fahlenbrach (2009).

firm's headquarters. Clearly, the good work done by many non-profit firms can have a very stimulating effect on the state economy.

Incentive-Based Pay

In recent years, executive compensation has become a popular topic among academics, politicians, and members of the popular press. Critics of the route taken in America argue that executives are simply overpaid. The common response to this argument, as voiced by Kay (1998), among others, is that companies have to reward executives fairly in order to attract, retain, and most importantly, motivate high-quality employees. A third group, exemplified by Jensen and Murphy (1990), would argue that the type of compensation is the important factor, rather than the level of compensation.

The statistics reported in this chapter are consistent with the third group. Note that we do not focus on the amount of compensation. We assume that businesses pay what is required to retain valuable employees. Instead, we focus on the proportion of total compensation that is made up of incentive-based pay.

Should evidence be found that Mississippi executives receive less performance-based compensation than executives at similar firms in other states, then it may well be the case that encouraging Mississippi businesses to shift the composition of their executive compensation toward incentive pay results in executives that are better motivated to increase firm performance, which would in turn improve economic growth statewide.

Many firms tie a significant portion of their executives' total compensation to firm performance. Most of these pay-for-performance arrangements connect executive payment and firm performance through the use of stock options or restricted stock. Executive stock options grant executives the right to buy company shares, usually over the next five to ten years, at a specified price that typically equals the market value of company shares on the day of the option award. Restricted stock plans provide an executive with a block of company shares, but disallow the sale of those shares prior to a specified vesting date. Both types of performance-based pay increase incentives for executives to maximize firm value, since executives now profit with rising stock prices through their equity position in the firm.

Although performance-based payment as a primary means of compensating executives is a relatively recent phenomenon, paying executives according to firm performance has been around for quite some time. In fact, executive stock options were authorized as early as the 1950 Revenue Act. For many years after the passage of the Act, executive stock options were granted only to top executives. However, in more recent years, stock options have become increasingly common at all levels of management and have even been granted to non-managerial employees. As documented exhaustively in the mainstream media, and quite regularly in the academic literature, executive pay has increased drastically since the early 1980s. Hall and Liebman (1998), among others, attribute a large part of this rise in executive compensation to increased use of executive stock options, pointing to a 683% surge in the average value of stock option awards during a sample period from 1980 through 1994.

Agency theory predicts that linking executive compensation to firm performance better aligns managerial and shareholder incentives. Research shows that research and development activity, which can be seen as proxies for future positive value project opportunities, are significantly better for firms in which incentive compensation makes up a larger proportion of total compensation. Therefore, it seems that increased executive equity ownership does indeed have a positive influence on firm performance.

Overall, the literature largely supports utilizing performance pay to make executive employment contracts more incentive-compatible with shareholders. In short, using performance-based pay to align the

incentives of managers and firm owners is well supported by many rigorous academic studies and should be considered carefully by both government policy-makers and business decision-makers.⁵

Incentive-Based Pay and Taxation

Executive stock options give the holder the right, but not the obligation, to buy a share of stock at a specified price, called the strike price. Executive stock options usually cannot be exercised immediately; rather, some percentage of an option grant will become eligible for exercise each year over a set period of time, often five to ten years. Executive stock options usually make up a substantial proportion of an executive's income; therefore, the tax treatment of executive stock options can have significant implications. Since the income tax treatments for the two types of executive stock options differ greatly, each are discussed separately.

Regardless of the form of compensation, taxes vary primarily along two dimensions. The first dimension is whether the income can be treated as capital gain or as ordinary income for the executive. The second dimension is whether the company can expense the incentive compensation granted and the timing of any such deduction. For non-performance-based executive pay that exceeds \$1,000,000, the second dimension is irrelevant, since the federal government prohibits any corporate expense deduction for such payments in an attempt to encourage firms to utilize incentive-based payment plans.

Non-Qualified Stock Options (NQSOs) require that the executive be taxed at his or her personal income tax rate when the options are exercised, and that the firm defers taking a corporate expense deduction for the options granted until exercise. If the executive holds the shares received at exercise beyond the exercise date, any appreciation realized upon sale is taxed as a capital gain. Incentive Stock Options (ISOs) are given much less frequently than NQSOs because the firm can grant only \$100,000 worth of ISOs per executive per year, and they also are taxed differently than NQSOs. ISOs are taxed when the executive sells the shares gained from exercise, instead of at the point of exercise. Thus, ISOs require executives to pay only the lower capital gains tax rate, provided they hold the acquired shares for at least one year beyond the exercise date. From the firm's perspective, the drawback to the ISO is the forgone corporate deduction, making ISOs attractive only to firms facing low marginal corporate tax rates. Obviously, a tradeoff exists between the two types of options as to whether the employee or the firm will realize the tax benefit. However, as shown by Hall and Liebman (1998), there is no question that stock options provide greater net tax benefits than straight cash compensation.

Restricted stock awards are a second form of performance-based pay in which the executive is granted ownership of firm shares. However, in the case of restricted stock, the shares cannot be sold until a specified "vesting" date. Interestingly, the Internal Revenue Service (IRS) does not consider restricted stock to be performance-based pay; consequently, it is taxed at the executive's personal income tax rate. Although the IRS does not consider restricted stock to be performance-based, it clearly helps align the interests of managers and shareholders and thus helps mitigate the agency problem. For this reason, restricted stock is included in the incentive-based measure described in the next section.

Although they have not been mentioned as a major part of performance-based compensation to this point, bonuses can also help align managerial and shareholder incentives, if properly structured. Bonuses

⁵ Arguments against the use of performance-based payment exist as well. Most notable is the argument made by Chaudri (2003) that executives are sometimes rewarded or punished for performance that is outside their control. For example, it is quite easy to envision a scenario in which the firm's overall stock performance was quite poor, but the firm actually performed substantially better than its close competitors. Unless the firm's pay-for-performance plan is carefully structured, firm executives might see reduced incentive-based compensation even though they outperformed their peer group.

differ a bit from the other types of incentive-based compensation, as they can be more easily awarded for individual or group performance, while restricted stock or stock options almost by necessity are tied to overall company performance. As for taxation, executive bonuses are taxed as ordinary income and are usually deducted as an ordinary business expense for most companies under Section 162 of the IRS Code. If the bonus was paid in stock grants, then Section 162 limits the corporate expense deduction available to the firm.

Results

The question is whether poorly structured compensation contracts could be one factor contributing to the subpar economic performance in Mississippi. As a first step towards addressing this question, we analyze whether there is in fact a relationship between incentive compensation and state economic performance. To investigate this issue, we examine the association between incentive-based compensation and state economic performance using a relatively standard OLS model of gross state product (GSP). We control for education expenditure, cost of living, median household income, unemployment, and population.⁶ The results suggest that the percentage of performance-based compensation relative to overall compensation is a significant predictor of State GSP. This suggests that performance-based pay indeed plays a crucial part in explaining overall growth in a state.

Next, we examine the ranking of performance-based compensation across all states in terms of the proportion of incentive compensation utilized in total compensation packages to determine where Mississippi ranks. Data on executive compensation are obtained from Standard and Poor's ExecuComp database from 2002 through 2016. Following Cline and Benefield (2010), multiple stock option and restricted stock grants within the same year and observations that are missing essential data are eliminated. After these restrictions, the sample includes 152,521 firm-year observations.

Figure 7.1 reports the ranking for all top executives. The mean percentage of total compensation that is performance-based, the mean percentage of total compensation that is option-based, and the mean total executive compensation are reported. However, the focus of the analysis is on the proportion of incentive-based compensation relative to total compensation (i.e. Column 1). Panel A reports results for all executives from all states plus the District of Columbia, while Panel B provides the rankings across all 50 areas sorted by the ratio of incentive-based compensation to total compensation.

Panel A shows that the average executive earns slightly more than \$2 million annually over the sample period. Approximately 47% of that \$2 million is provided in the form of performance-based pay. Many financial economists argue that stock options are the best tool to align managerial and shareholder incentives due to differences in risk preferences between the two groups. Therefore, the proportion of total compensation attributable to stock option grants is of special interest. Across all states, the average executive receives 20% of their compensation from stock options.

Panel B reveals that Mississippi ranks 47th among these states. Interestingly, only North Dakota, West Virginia, and Montana rank lower. Mississippi corporate executives earn on average \$721,360 each year, of which only 30.53% is provided as incentive-based pay. This low percentage differs significantly from the 47% reported for all states in Panel A. Firms in neighboring states such as Louisiana, Tennessee, and Alabama structure the pay for their executives much differently. On average, businesses in these states pay a much higher percentage of total pay in the form of incentive pay (54%, 50%, and 45%, respective-

⁶ The GSP data are obtained from the Bureau of Economic Analysis website. Other independent variables, in addition to the data on percentage of performance-based compensation, are collected from the Department of Education website, the Bureau of Labor Statistics, the Census Bureau, and the Bureau of Economic Analysis website.

Figure 7.1: Rankings by Incentive-Based Compensation for all Executives

	Mean% performance comp (median)		Mean% option based comp (median)		Mean total executive comp (median)		Number of Obs.
Panel A: All States							
All States	47.11	(52.62)	20.24	(11.86)	2,092,780	(1,078,040)	152,521
Panel B: State Rank							
RI	62.26	(64.11)	24.89	(22.91)	3,153,709	(2,088,428)	338
DE	56.68	(61.06)	27.21	(22.80)	2,746,536	(1,415,929)	327
ME	54.76	(54.03)	26.19	(30.41)	1,370,644	(916,609)	135
LA	54.08	(62.91)	13.41	(0.00)	1,535,202	(1,092,532)	756
WY	53.33	(66.20)	17.14	(14.84)	1,333,037	(1,072,373)	47
AZ	52.53	(57.23)	18.88	(0.00)	2,041,665	(1,043,101)	1,266
CA	52.20	(60.23)	23.36	(13.54)	2,618,605	(1,211,090)	14,564
NC	51.17	(57.54)	13.94	(0.00)	2,272,316	(1,282,322)	2,350
MO	50.98	(55.71)	19.09	(8.90)	1,847,513	(1,168,769)	2,318
MA	50.48	(56.13)	21.01	(10.12)	1,901,891	(960,111)	5,312
NH	50.34	(51.12)	3.94	(0.00)	1,161,345	(778,751)	232
TN	50.25	(56.92)	22.06	(14.90)	1,799,591	(1,147,147)	2,241
CT	50.11	(55.57)	20.28	(10.02)	2,370,428	(1,257,987)	2,902
KY	50.00	(55.23)	22.48	(19.08)	1,904,881	(1,152,341)	811
IL	49.21	(54.35)	21.30	(16.26)	2,023,444	(1,240,225)	7,113
NJ	49.01	(55.13)	20.44	(13.77)	2,448,122	(1,392,797)	3,565
MN	48.99	(54.10)	25.15	(21.96)	1,911,638	(945,238)	3,141
TX	48.62	(55.16)	18.18	(4.10)	2,002,483	(1,106,588)	11,699
WI	48.39	(52.41)	21.85	(18.84)	1,565,536	(1,013,896)	2,290
PA	48.14	(53.95)	21.83	(17.36)	1,899,883	(1,098,029)	5,055
FL	48.07	(53.31)	16.03	(0.00)	2,121,821	(1,250,770)	3,801
ID	47.98	(50.77)	16.73	(0.00)	1,429,602	(647,939)	336
MI	47.85	(51.30)	17.66	(11.40)	2,072,197	(1,098,326)	2,406
CO	47.83	(56.44)	17.95	(5.62)	1,835,580	(1,057,133)	2,520
VA	47.53	(54.21)	17.21	(7.14)	2,222,255	(1,318,591)	3,553
GA	47.47	(51.46)	16.53	(6.87)	2,013,964	(1,081,287)	3,426
OK	47.38	(53.51)	13.88	(0.00)	2,206,953	(1,054,080)	954
OH	47.35	(52.12)	18.45	(14.31)	1,944,839	(1,139,293)	5,223
MD	47.27	(55.52)	20.29	(6.75)	2,491,060	(1,371,300)	1,531
NY	46.94	(52.15)	17.99	(7.60)	3,564,452	(1,575,180)	9,769
WA	46.14	(52.38)	18.91	(0.00)	1,941,191	(915,336)	1,875
IN	45.03	(50.34)	15.93	(2.05)	1,778,119	(970,069)	1,923
AL	44.78	(50.35)	17.06	(0.00)	1,298,091	(903,200)	763
DC	43.72	(53.08)	12.74	(0.00)	2,605,112	(1,486,347)	413
AR	42.64	(43.86)	14.35	(0.00)	2,407,791	(859,629)	896
KS	42.39	(50.65)	9.15	(0.00)	1,940,676	(769,269)	549
NV	41.12	(45.30)	22.15	(12.55)	2,306,932	(1,257,500)	805
OR	41.07	(44.26)	18.05	(0.00)	1,251,617	(672,538)	802
SC	41.07	(43.16)	13.45	(5.67)	1,176,772	(761,171)	711
NM	40.75	(41.82)	10.03	(9.58)	832,894	(546,952)	79
HI	39.06	(44.15)	11.91	(0.00)	935,378	(695,674)	418
AK	38.24	(40.15)	11.80	(0.00)	1,054,681	(844,641)	82
UT	37.72	(39.94)	24.56	(12.14)	1,155,420	(685,603)	711
NE	33.45	(36.29)	15.93	(0.00)	1,773,921	(888,521)	557
SD	32.56	(33.11)	10.12	(0.00)	555,617	(452,778)	297
IA	31.16	(32.15)	17.76	(14.14)	1,285,156	(745,790)	777
MS	30.53	(32.51)	4.39	(0.00)	721,360	(528,585)	404
ND	29.55	(40.44)	0.00	(0.00)	851,014	(672,185)	90
WV	21.35	(20.32)	6.07	(0.00)	488,342	(353,750)	181
MT	6.43	(4.94)	6.14	(4.84)	330,522	(305,907)	53

ly). Executive stock option grants account for an average of only 4.39% of total executive compensation at Mississippi firms, which is also significantly lower than the 20% of total compensation from options reported for the full sample.

Figure 7.2 reports this ranking for Mississippi for each year of the sample period. It illustrates that Mississippi's average rank of 47th is driven from the fact that Mississippi has consistently ranked among the lowest states year in and year out in terms of performance based executive compensation. With the exception of 2003 through 2006, Mississippi records a rank of 44th or worse in every year.

Figure 7.2: Mississippi Performance Pay Rank over Time

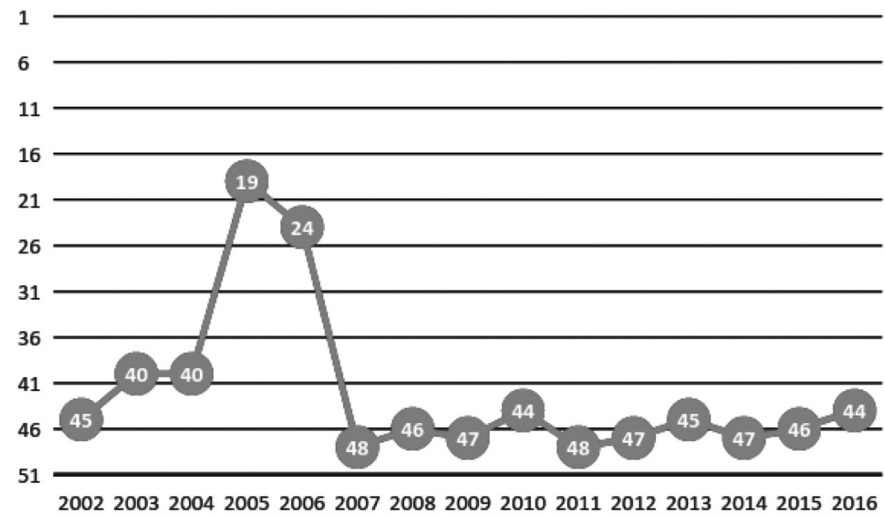
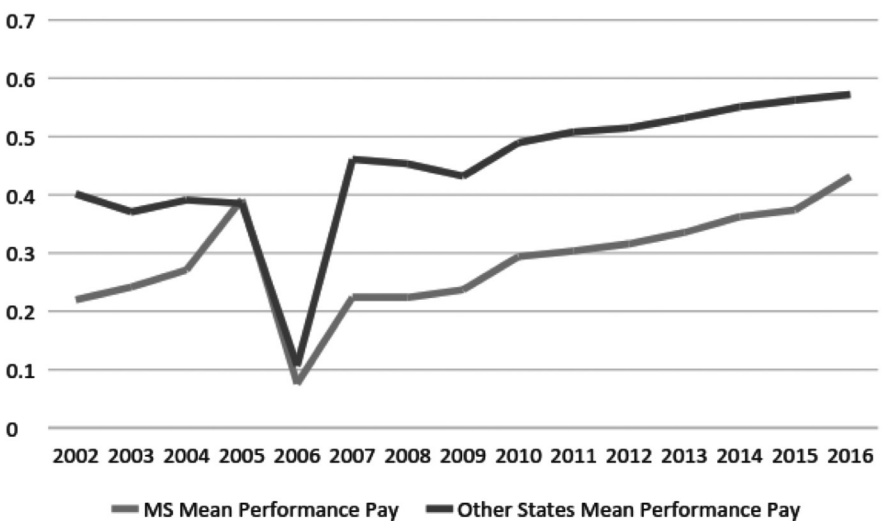


Figure 7.3 plots the percentage of performance-based compensation for Mississippi during each year of the sample period and the mean percentage-based compensation for all other states. Consistent with the pattern in Figure 7.2, we see that with the exception of a short period in the mid-2000s, Mississippi firms have consistently offered low performance-based pay relative to firms headquartered in other states.

Figure 7.3: Mississippi Performance Pay vs. Other States over Time



A number of studies argue that the structure of CEO compensation has the largest influence on firm performance. We therefore make a similar comparison for a sample including only CEOs in Figure 7.4. The results in Panel A demonstrate that the average CEO earns slightly more than \$3.8 million annually. Of that \$3.8 million, on average 55% is provided as incentive-based pay, with an average of 21% of total compensation being paid in the form of stock options.

The rankings by state in Panel B are very similar to the rankings provided by Panel B of Figure 7.1. Most important to us is that Mississippi ranks 48th, with West Virginia and Montana being the only states where CEOs receive a lower percentage of their compensation in the form of performance-based compensation. The results show that on average Mississippi CEOs earn just under \$1.4 million per year with an average of 33.56% of total compensation coming from incentive-based payment plans. This 33.56% average is statistically significantly less than the average 55% of total compensation from performance pay for all CEOs across all states. Panel B also shows that Mississippi CEOs earn only 4.04% of total compensation from stock option grants, which again is statistically significantly lower than the 21% for all CEOs across all states.

Multivariate Analysis

Figures 7.1 and 7.4 clearly indicate that Mississippi firms on average rank low relative to other states with regard to their percentage of incentive-based compensation. But couldn't other factors be contributing to this? There are a number of factors that might influence the average percentage of incentive-based compensation provided by firms in a particular state. For example, firms from a particular industry that eschew the usage of performance pay may be more highly concentrated in a certain state, or the majority of firms in a particular state may be small enough to believe complicated incentive-based compensation schemes are too costly and unnecessary. It's entirely possible that Mississippi firms naturally concentrate in these industries or have characteristics that are associated with firms that offer less performance-based pay for a reason. Hence, an additional test is needed that takes these other factors into account.

In the brief analysis that follows, we control for these other factors in multivariate regressions and discuss the results. Specifically, the percentage of performance-based pay is estimated using ordinary least squares (OLS) regression, while controlling for other factors known to affect executive compensation.

In the regression model, the dependent variable, Mean % performance comp, is the same variable used in developing the rankings in Figures 7.1 and 7.4. Other factors include firm size, book-to-market, leverage, dividend yield, prior 5-year stock performance, stock return variance, CEO indicator, CEO tenure, CEO age, CEO gender, director indicator, rural indicator, urban indicator, industry controls, and year control.⁷

The final term in the model, the regression residual, represents the portion of incentive-based compensation that remains unexplained by the variables included in the regression.⁸ Viewing the regression residual in this way, you can think of the residuals as the unexplained portion of compensation. Using the average regression residuals for each state, we can then determine in which states firms are offering performance-based pay above or below the percentage expected. States that rank lowest are paying less than the amount suggested from the model after taking into account the other factors that predict performance-based compensation.

Although the rankings change considerably for a number of states, the results suggest that Mississippi firms pay less in the form of incentive-based compensation when considering these additional factors. Using multiple specifications, Mississippi continues to rank in the lowest six states with respect to incentive pay. These results are consistent with the analysis in Figures 7.1 and 7.4. Collectively, the evidence suggests that Mississippi firms on average offer less performance pay relative to other states and less than optimally predicted by the compensation model. Thus, considerable support is offered for the notion that

7 A number of additional variables were considered; however, due to data limitations, these variables are not included.

8 For a detailed description of variables and the model see Cline and Benefield (2010).

Figure 7.4: Rankings by Incentive-Based Compensation for CEOs

	Mean% performance comp (median)		Mean% option based comp (median)		Mean total executive comp (median)		Number of Obs.
Panel A: All States							
All States	54.91	(64.47)	21.33	(10.34)	3,808,650	(2,204,780)	21,321
Panel B: State Rank							
Panel B: CEOs by State							
NH	76.74	(77.14)	2.12	(0.00)	2,994,363	(2,948,333)	29
RI	75.45	(78.65)	24.83	(26.47)	6,817,136	(5,568,168)	51
DE	64.45	(76.41)	18.94	(14.91)	4,767,715	(4,036,345)	30
LA	64.11	(71.10)	16.95	(0.00)	2,840,182	(2,040,151)	126
ME	63.54	(59.22)	35.18	(35.32)	2,805,784	(2,602,251)	26
MN	62.70	(72.09)	29.39	(27.34)	3,710,600	(2,614,201)	392
NC	61.79	(69.78)	16.47	(0.00)	3,895,943	(2,446,122)	357
MO	61.59	(64.57)	21.54	(8.11)	3,511,422	(2,315,000)	347
ND	60.74	(65.63)	0.00	(0.00)	1,762,241	(2,070,135)	5
AZ	60.39	(67.21)	18.95	(0.00)	4,280,386	(2,089,637)	177
WY	60.23	(74.99)	18.06	(17.71)	2,921,393	(2,959,986)	9
MI	59.31	(64.34)	20.39	(13.99)	3,626,709	(2,089,631)	310
IL	59.08	(66.34)	23.78	(18.01)	3,842,396	(2,488,700)	927
CA	58.16	(70.10)	22.73	(0.00)	4,408,159	(2,490,497)	2066
MD	58.01	(71.88)	22.36	(6.71)	4,810,110	(2,766,463)	257
CO	57.82	(69.58)	20.64	(9.30)	3,685,510	(2,259,454)	337
CT	57.77	(67.19)	20.59	(4.21)	3,935,641	(2,477,897)	425
MA	57.44	(68.13)	19.45	(0.00)	3,367,294	(1,691,109)	704
OK	57.17	(64.30)	14.03	(0.00)	2,872,049	(1,978,872)	118
TN	57.01	(66.39)	22.86	(14.72)	3,287,550	(2,192,854)	312
NY	56.99	(66.96)	18.91	(0.00)	6,616,727	(3,557,756)	1264
NM	56.87	(63.97)	4.40	(0.00)	1,826,449	(2,063,956)	10
OH	56.73	(65.61)	19.63	(16.35)	3,334,873	(2,478,894)	639
WI	56.69	(65.97)	22.92	(20.09)	2,676,778	(2,076,425)	290
GA	56.66	(63.98)	15.61	(0.00)	3,761,223	(2,249,799)	499
FL	56.31	(69.63)	16.04	(0.00)	4,245,151	(3,012,865)	573
PA	56.13	(64.77)	22.42	(16.33)	3,065,727	(1,897,535)	688
NJ	55.77	(64.17)	22.13	(16.09)	4,483,377	(2,677,820)	504
TX	55.45	(67.07)	17.74	(0.00)	3,411,125	(2,190,212)	1594
KY	55.37	(66.86)	18.93	(8.04)	3,337,579	(2,271,281)	98
ID	54.99	(61.83)	19.19	(0.00)	2,048,113	(1,283,936)	58
IN	53.99	(59.22)	17.59	(4.14)	3,238,045	(1,633,950)	292
DC	53.71	(69.06)	14.60	(0.00)	3,018,754	(1,858,500)	55
OR	53.70	(61.55)	17.81	(0.00)	2,448,618	(1,191,307)	113
AL	52.24	(55.48)	17.89	(0.00)	2,177,808	(1,375,404)	130
VA	51.35	(64.52)	15.35	(0.00)	4,065,810	(2,225,717)	440
WA	50.61	(63.08)	18.56	(0.00)	3,378,706	(1,722,084)	260
SC	50.61	(62.43)	15.78	(0.00)	2,383,922	(2,023,396)	87
AR	50.25	(54.85)	12.81	(0.00)	3,122,800	(1,501,460)	114
KS	46.23	(64.28)	2.50	(0.00)	2,746,120	(1,647,305)	67
HI	44.99	(50.30)	9.35	(0.00)	1,601,722	(1,128,084)	68
UT	44.99	(51.31)	26.48	(14.02)	1,991,693	(1,507,000)	118
NV	43.96	(53.75)	23.52	(17.52)	3,293,446	(2,708,461)	112
SD	42.60	(47.56)	12.96	(0.00)	967,023	(984,886)	49
AK	37.91	(38.67)	12.36	(0.00)	1,653,924	(1,521,776)	15
NE	37.74	(49.49)	17.43	(0.00)	2,598,609	(1,939,445)	97
IA	34.05	(32.03)	20.04	(16.10)	2,169,295	(1,266,258)	118
MS	33.56	(46.24)	4.04	(0.00)	1,394,293	(1,153,543)	54
WV	27.06	(18.32)	6.89	(0.00)	1,041,943	(1,010,988)	36
MT	5.64	(4.16)	4.54	(1.78)	468,752	(449,547)	14

top executives at firms headquartered in Mississippi receive less performance-based pay than top executives at firms headquartered in other states.

Conclusion

Literature offers considerable evidence that linking executive compensation to firm performance helps align managerial and shareholder incentives. Properly structured employment contracts provide top executives with the motivation necessary to encourage efficient corporate risk-taking and desirable pursuit of value-enhancing projects. Mississippi rates poorly across a wide range of economic indicators. This study provides evidence that one contributing factor to the condition of Mississippi's economy might be the failure by Mississippi businesses to properly motivate executives by providing enough performance-based income.

The results of this study illustrate that, over the sample period of 2002 through 2016, Mississippi ranks poorly relative to other states in terms of the proportion of incentive-based compensation. Pay-for-performance on average makes up only 30% of total compensation for top five executives in Mississippi firms, compared to 47% nationally. Likewise, performance-based compensation makes up only 33%, on average, of total compensation to CEOs for firms headquartered in Mississippi, compared to a national average of 55%. Relative rankings for Mississippi firms fare no better after controlling for firm-specific features that might influence the prevalence of incentive compensation within a firm. This leaves only state-specific characteristics as the culprit behind low performance-based compensation utilization in Mississippi. Additional analysis highlights that the proportion of incentive-based pay has a significantly positive impact on state level gross domestic product.

The state-specific characteristics preventing further use of incentive-based compensation can be addressed by increasing awareness on the part of firms regarding the benefits of these compensation plans and by adjusting the state tax code to more closely resemble the federal tax code described above, which is designed to encourage incentive-based compensation. As long as executives at the largest firms in Mississippi remain inadequately motivated to maximize shareholder value, residents of Mississippi will not enjoy as much positive economic spillover from these firms as they otherwise could. Given the condition of the state economy, every small percentage increase in economic growth helps and shifting policy to encourage more incentive-based executive compensation can be one of the factors to help produce this growth.

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Summary of Chapter Conclusions

PART 1. Introduction: The Role of Government and Economic Growth

Chapter 1: The Case for Growth—Russell S. Sobel, The Citadel, and J. Brandon Bolen, Mississippi State University

- Mississippi is the poorest state in the United States in terms of per capita income. Mississippi underperforms economically relative to all of its bordering states.
- Focusing on policies that generate economic growth is the most viable pathway to alleviating Mississippi's weak economic condition.
- Very small changes in economic growth rates may yield vast positive changes in the quality of life for Mississippi residents within as little time as one to two generations.
- Focusing on economic growth does not mean that other important policy goals such as improving health and education and reducing crime are neglected.

Chapter 2: The Sources of Economic Growth—Russell S. Sobel, The Citadel, and J. Brandon Bolen, Mississippi State University

- The economic activity of a state necessarily occurs within that area's institutional context, including the legal, regulatory, and tax environments, as well as the degree of private property rights. The quality of these institutions affects the output of economic activity.
- Capitalism is an economic system based on the private ownership of productive assets within an economy.
- Abundant evidence demonstrates that areas with institutions that allow capitalism to thrive experience much higher levels of prosperity relative to areas that do not rely upon capitalism.

Chapter 3: Why Capitalism Works—Russell S. Sobel, The Citadel, and J. Brandon Bolen, Mississippi State University

- The prosperity of an area is determined by the total quantity of production and quality of goods and services that individuals value. This prosperity is influenced by factors such as the degree of specialization of labor, capital investment, and entrepreneurship.
- Capitalism is an economic system that generates prosperity because its decentralized nature supports the specialization of labor, capital investment, and entrepreneurship.
- Government policies, even when well-intentioned, often create harmful unintended consequences. This is often due to the more centralized nature of government decisions.

PART 2: Promoting Prosperity One Issue at a Time

Chapter 4: Why are Taxes so Taxing? —Brandon N. Cline and Claudia R. Williamson, Mississippi State University

- High taxes can be extremely costly. In addition to the cost of the tax itself, taxes create indirect costs including enforcement costs, administrative costs, and costs incurred from distortions of the market economy.
- Mississippi has a higher tax burden compared to its bordering states. This may negatively affect the location decisions of businesses and individuals, causing them to leave the state.
- Empirical evidence demonstrates that high tax rates significantly dampen rates of economic growth.

Chapter 5: Make Business Taxes More Competitive—Brandon N. Cline and Claudia R. Williamson, Mississippi State University

- State and local taxes represent a significant cost for businesses. These tax costs affect the location decisions of businesses and deter them from operating in Mississippi.
- In addition to corporate income taxes, there are a myriad of other taxes businesses pay, such as property taxes and inventory taxes. Some taxes such as the inventory tax and intangible property tax do not exist in the majority of other U.S. states.
- To generate more prosperity within the state, Mississippi should consider reducing its tax burden upon businesses.

**Chapter 6: “Selective Incentives,” Crony Capitalism and Economic Development—
Thomas A. Garrett, University of Mississippi, and William F. Shughart II,
Utah State University**

- This chapter evaluates the costs and benefits of targeted tax incentives designed to lure new private business enterprises to Mississippi.
- Our analysis demonstrates that Mississippi is poorer, not richer, by funding incentive programs.
- Reasons that incentive packages fail include no new employment since many individuals hired were previously employed, the additional tax cost to accommodate the new population growth, and resources allocated to funding the subsidies could have been spent on better schools, roads, or used to finance a reduction in tax rates for all.
- The funds now being spent to benefit a handful of private business owners could be used to finance broad-based reductions in tax rates and lightening the regulatory burden on all Mississippians.

**Chapter 7: Incentive-Based Compensation and Economic Growth—
Brandon N. Cline and Claudia R. Williamson, Mississippi State University**

- Incentive based compensation is a payment method where an individual’s pay is in some way tied to their performance. Economic literatures studying incentive based pay for executives show that use of incentive based pay improves company performance and by extension state economies.
- Empirical data shows that firms in Mississippi use incentive-based compensation less than similar firms in other states.
- Mississippi can help improve its economic position by restructuring parts of its tax code to allow for greater use of incentive based executive compensation.

**Chapter 8: Mississippi Shadow Economies: A Symptom of Over-Regulated
Markets and Measure of Missed Opportunities—Travis Wiseman,
Mississippi State University**

- This chapter discusses Mississippi’s regulatory environment and the state’s cumbersome habit of maintaining outdated and burdensome regulation, far longer than other states.
- Several sensible and low-cost reforms are introduced that can help curtail unwanted shadow economic activity, and promote prosperity in Mississippi.
- A case study of one industry that Mississippi over-regulates – the brewing industry – is discussed.

Chapter 9: Occupational Licensing in Mississippi—Daniel J. Smith, Troy University

- Occupational licensing, the regulation of individual entry to a profession, enables industry practitioners to restrict entry to their profession and raise prices on consumers.
- The effects of occupational licensing fall heaviest on low-income residents who must pay higher prices or resort to lower-quality home-production or black market provision.
- Mississippi has at least 118 different occupational categories with licensing, representing nearly 20 percent of Mississippi's labor force.
- The total estimated initial licensing costs in Mississippi exceed \$48 million and the estimated annual renewal costs add up to over \$13.5 million.
- Mississippi policymakers can promote prosperity in Mississippi by removing unnecessary and overly burdensome licensing laws.

Chapter 10: Prosperity Districts: A Ladder Out of Last Place—Trey Goff, Out of Last Place Alliance

- Prosperity districts are geographically self-contained areas that reduce or eliminate unnecessary government restrictions on business activity, including regulation, taxation, and private subsidization
- Prosperity districts can be a unique and promising solution to the state's economic woes by allowing specific areas to be exempt from unproductive policies.
- Prosperity districts allow experimentation to determine which policies work best.
- Real world examples of the potential success of prosperity districts can be seen in the closely related concept of special economic zones, which have seen tremendous economic growth and development in places such as Singapore.

Chapter 11: Promoting Prosperity in Mississippi through Investing in Communities—Ken B. Cyree, University of Mississippi, and Jon Maynard, Oxford Economic Development Foundation

- We investigate the impact of investing in community livability and the relation to the change in total employment to promote prosperity in Mississippi.
- We document the decline in Mississippi employment, on average, from 2007-2016, and especially the decline in manufacturing employment.
- Our analysis shows that increased employment is significantly related to better school rankings, higher changes in wages, and higher changes in per capita retail sales. New business creation is not statistically related to employment.
- Our results suggest that in order to promote prosperity in Mississippi, we should invest in quality of life for the community.

Chapter 12: Local Governments Run Amok? A Guide for State Officials Considering Local Preemption—Michael D. Farren, George Mason University, and Adam A. Millsap, Florida State University

- Local governments sometimes implement regulations and ordinances that stifle economic growth.
- Preemption is a legal doctrine asserting that state law takes precedence over local law. In some cases it should be used by state governments to overrule local governments.
- State officials should consider preemption when local rules violate the principles of generality or free exchange. Such policies often involve barriers to entry, price controls, or business practice mandates.
- Violations of generality and free exchange harm economic growth because they inhibit economic activity and the efficient allocation of resources. Conversely, preempting such policies promotes economic growth.

Chapter 13: School Choice: How To Unleash the Market in Education— Brett Kittredge, Empower Mississippi

- The United States has fallen behind other countries in K-12 education. One study found that American students ranked 38th out of 71 countries when tested in math, reading, and science.
- A government monopoly has existed in our delivery of education in the United States. Students are assigned to a school based on their zip code and the year they were born.
- Because students are assigned to a school based on a district line, real estate prices naturally rise in neighborhoods within a desirable school district. This has the effect of pricing out many families and forcing them to live in areas with less desirable schools.
- To improve quality, our education system should be student centered and market based. Parents should have options available to craft a custom education for their child based on their specific learning needs.
- The legislature can adopt a market based education through a universal school choice program that has broad eligibility, autonomy for all schools, and level funding across the various educational sectors.

Chapter 14: Medicaid: A Government Monopoly That Hurts the Poor— Jameson Taylor, MS Center for Public Policy

- State health care policy revolves around Medicaid, which is a government-subsidized insurance program consuming one-third of Mississippi's budget.
- Health outcomes for Medicaid insurance patients are very poor; patients with no insurance at all fare better.
- Medicaid's number one problem, like that of many American insurance plans, is that it incentivizes the over utilization of health care while insulating recipients from the financial consequences of poor lifestyle choices.

- Medicaid is crowding out the development of innovative products and policy ideas.
- Reforms aimed at unleashing the power of health care pricing including large HSAs, direct surgical care, and comparative shopping incentives can begin to disrupt Medicaid's monopoly.

Chapter 15: Tipping the Scales: Curbing Mississippi's Obesity Problem— Raymond J. March, San Jose State University

- Widespread obesity has serious health and financial consequences in Mississippi.
- Government policy, although well intended, is associated with increased levels of obesity especially for lower-income households.
- State-led efforts to reduce obesity are costly and unlikely to succeed because they fail to address the underlying causes of why less healthy food options are consumed.
- Private and local solutions are more effective in promoting health and reducing obesity.
- The most effective way to combat widespread obesity is the market, not the government.

Chapter 16: Criminal Justice Reform in Mississippi—Trey Goff, Out of Last Place Alliance

- Despite decreasing rates of both violent and property crime since 1996, Mississippi incarceration rates have steadily increased.
- Mississippi has an incarceration rate that is among the highest in the world, most due to incarcerating non-violent crimes.
- The economic drain from this level of mass incarceration is extremely detrimental for the state economy in terms of both the cost of maintaining incarceration and the negative effects of incarceration upon individuals in the labor market.
- Reevaluating and restructuring the criminal justice system in Mississippi to reduce incarceration rates would be an extremely effective tool to increase the economic strength and wellbeing of the state.

Chapter 17: Property Takings: Eminent Domain and Civil Asset Forfeiture— Carrie B. Kerekes, Florida Gulf Coast University

- Secure private property rights provide incentives for individuals to undertake investments and make capital improvements to their property and businesses. To promote prosperity, Mississippi policy makers should continue to improve laws and policies to restrict property takings.
- Following reforms passed in 2011 to protect against development takings, property owners in Mississippi are reasonably protected from eminent domain takings.
- Citizens are significantly less protected in the case of civil asset forfeiture. Civil asset forfeiture laws in Mississippi provide incentives for law enforcement agencies to seize private property.

Chapter 18: The Small-Dollar Loan Landscape in Mississippi: Products, Regulations, Examples, and Research Findings on Interest Rate Caps—Thomas (Tom) William Miller, Jr., Mississippi State University

- The best fuel for economic growth and prosperity is free market prices, including interest rates.
- Despite the goal of improving consumer welfare, interest rate caps often harm the very people legislatures intend to help—especially users of small-dollar loan products.
- Despite their well-known harmful effects on consumers, laws continue to fetter consumer credit markets with interest rate caps.
- Setting good rules governing how legitimate businesses provide access to consumer credit is important for everyone living in Mississippi.
- The Mississippi legislature can greatly help consumers by eliminating, or greatly raising, interest rate caps in all small-dollar loan markets.

Chapter 19: Natural Disasters and Prosperity in Mississippi—Daniel Sutter, Troy University

- Extreme weather poses a severe financial risk for a state economy. Mississippi is particularly exposed to the threat of damage from natural disasters.
- Free market practices often perform better at meeting the challenges posed by natural disasters rather than government policies. Removal of harmful policies such as occupational licensing and building codes during disaster may better allow the market to speed disaster recovery.
- Some government policies such as flood and wind insurance may exacerbate exposure to natural disasters. Other policies slow recovery time by creating uncertainty after the occurrence of a natural disaster.

Chapter 20: Learning from Disasters in Mississippi—Stefanie Haeffele and Virgil Henry Storr, George Mason University

- This chapter examines disaster recovery in Mississippi and how policies that foster entrepreneurship might help spur disaster recovery going forward.
- Entrepreneurs can spur disaster recovery by providing needed goods and services, restoring disrupted social networks, and acting as focal points around which other residents can coordinate their recovery efforts.
- To promote prosperity in Mississippi, officials should develop policies that ensure that entrepreneurs have the space to act in the wake of disaster.

About the Institute for Market Studies at Mississippi State University

The Institute for Market Studies (IMS) at Mississippi State University, created in 2015, is a nonprofit research and educational organization conducting scholarly research and providing educational opportunities to advance the study of free enterprise.

The IMS's mission is to support the study of markets and provide a deeper understanding regarding the role of markets in creating widely shared prosperity. This includes advancing sound policies based on the principles of free enterprise, individual liberty, and limited government. The IMS pursues its mission by bringing together leading scholars to conduct timely research on current economic and financial issues.

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MISSISSIPPI STATE UNIVERSITY™
INSTITUTE FOR MARKET STUDIES

\$29.95
ISBN 978-1-7320353-0-0
5 2 9 9 5 >



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