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Executive Pay Drivers: Evidence Review and Research Options

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ABSTRACT:

This study attempts to investigate market and firm level variables that may influence or drive compensation of chief executives' of firms'. The methodology is based upon review of evidence presented in the existing literature on the subject. The paper examines the (i) theoretical frameworks used in the studies (ii) variables or determinants of executive compensation utilized in the studies and (iii) research conclusions.

Key Words: Corporate Governance, Executive Pay, Agency Problem

INTRODUCTION

The rapid rate of growth in executive remuneration in the recent decades beyond what could be explicitly explained by firm or industry characteristics has drawn conscientious attention of stakeholders as well as the law makers. The soaring trend in executive compensation is evident across all developed and emerging economies. The trends in executive pay growth are explosive. From 1978 to 2013 CEO compensation in US, inflation-adjusted, increased 937 percent, a rise more than double the stock market growth whereas there is only 10.2 percent growth in a typical worker's compensation over the same period*. In India the earnings of chief executives have grown to 180 times that of the average worker, compared with 60 times as much in the 1990s**. U.S. CEOs earn from 400 to 500 times the median salary for workers. For CEOs in the U.K., the ratio is 22; in France, it's 15; and in Germany it's 12 [***]. The chief executive officers of the S&P 500 Index US companies received, on average, $12.3 million in total compensation for 2012[****]. A Chief Executive Officer (CEO) in India, as per 2014 data, earns an average salary of Rs 3,324,027 per year [*****].

The remuneration for executives usually comprises of base salary, annual bonuses tied to accounting performance, perquisites, stock options and long term incentive plans though the structure of individual executive compensation may differ country or industry wise. The executive pay arrangements have been scrutinized, particularly, with respect to long term firm performance, shareholder returns and substantial pay differences with other highly paid workers. The association of corporate failures with high profile and highly paid CEO's has led to an obvious inquiry into the relationship between compensation arrangements of these executives and the long term performance of the firms they served. Is very high executive pay relative to market returns precursor to just another corporate collapse waiting to happen? What exactly drives huge executive compensation and how it can be explained in relation to firm performance, in light of major corporate collapses, has baffled financial economists for a long time. Researchers have attempted to answer these questions by approaching the problem from different

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gates such as (i) talent market drives executive pay (ii) level of corporate governance system influences executive pay (iii) executives are incentivized for risk taking and (iv) firm size, industry, competition and ownership structure impact executive pay. This paper aims to assess existing research on drivers of executive pay and identify the most significant research options.

REVIEW OF RESEARCH

The research can be divided into two broad categories: theoretical studies and empirical studies. While theoretical studies utilize time series data for analysis and interpretation, instrumental studies aim to empirically test the impact of determinants on executive pay. Research on executive compensation is based upon a strong theoretical framework. Competition for scarce managerial talent, managerial labor market and industry type are market level variables and level of corporate governance, size of firm and ownership structure are firm level variables used in most of these studies. We assess both kind of studies for the purpose of our assessment and conclusions.

THEORETICAL FRAMEWORK

Executive compensation has gained curious attention and scrutiny due to apparent inability of the public to relate downfall of big corporate firms such as Enron, WorldCom, Lehman Brothers etc. with the huge pay and perverse incentives garnered by the key executives in these firms plausibly due to their superior competencies. Berle and Means (1933) suggested that managers (or executives) who are "hired hands" are more likely to be interested in personal gains than shareholder wealth maximization. There is a possibility that a professional manager hired by a firm due to his superior managerial talent may take business decisions to obtain short term gains or may take less risky decisions to save his job. In either case the motivation is personal and not shareholder wealth maximization. Corporate governance is a mechanism that enables firms to monitor, evaluate and control actions of executives and ensure that they work in the best interest of shareholders. But an important question is how much boards can actually monitor, evaluate and control actions of executives in a given managerial labor market?

Executive pay is much higher than that of average worker and other highly paid jobs. The fundamental question is if agency problem is inherent in public companies and yet managers are hired and hugely paid for their superior business competencies and skills, then how this huge compensation could be explained in light of incredible corporate failures and also in relation to pay trends of average worker and other highly paid similar jobs. Most of the studies have tried to establish through theoretical and empirical underpinnings one of the three propositions (i) pay is driven by the power that executives' wield over their boards (ii) pay is driven by competition in talent market (iii) pay is driven by a combination of these and other factors.

EVIDENCE REVIEW

The existing literature uses the terms "managerial power approach" and "optimal contracting approach" to explain drivers of executive compensation. When the stock is largely held [Wheelan & Hunger (2004)] and the CEOs wield power over their boards, they substantially influence their own pay arrangements [Bebchuk and Fried (2003)]; this is also understood as "managerial power approach" to executive compensation. Agency problem is fundamental to the

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managerial power approach that emphasizes upon executive power over boards with substantial departure from the goal of shareholder wealth maximization. Researchers [Jensen and Murphy (1990), Bertrand and Mullainathan (2001), Bebchuk and Fried (2004), Kuhnen and Zwiebel (2009), Fahlenbrach (2009), Yermack (1997)] attribute high pay of executives to weak corporate governance that allows managers to skim profits from the firm by taking decisions from short term perspective in their own interests irrespective of any negative long term impact of such decisions on shareholder value.

Optimal contracting approach to executive compensation proactively deals with the inherent agency problem through effective compensation packages. [Rosen (1981), Gabaix and Landier (2008)] attribute that competition for scarce managerial talent forces large firms to pay high compensation to its executives due to their ability to generate greater value for large firms. Hence the rise in CEO compensation is due to the increase in the market value of firms, rather than resulting from agency issues.

Both the approaches have been studied and analyzed over the years. Acharya et al (2012) propose that these views are not in conflict and there is a natural link between them. They argue that executive compensation is exogenous for a given firm. Firms do not decide overall executive compensation but conditions of competition for scarce managerial talent force firms to choose weaker level of corporate governance in order to retain top quality managers. Competition for managerial talent results in firms' inability to affect the rents of top quality managers and this enhances managers' influence over their own pay arrangements. Hermalin [2005] however argues that the rise in CEO compensation reflects tighter corporate governance and firms pay more to compensate CEOs for the increased likelihood of being fired.

To link executive pay to performance shareholder activists have pushed adoption of executive compensation packages with strong market-based incentives. There is a stronger positive correlation between the level of pay and the market value of firms in the recent decades [Hall and Murphy (2004), Bebchuk and Grinstein (2005)]. Cunat and Guadalupe [2005] found a causal link between increased competition and higher pay-for-performance sensitivity in their study on CEO compensation. In furtherance to this, Inderst and Mueller [2005] and Dow and Raposo [2005] discuss that higher incentives have become optimal due to increased volatility in the business environment faced by firms and that explains excessive executive pays.

Tervio (2008) shows a positive cross-sectional correlation between firm size, proxied by market capitalization, and compensation as managerial talent has a multiplicative effect on larger firms. Gabaix and Landier (2008) observed extremely small dispersion of CEO talent distribution and claimed that there are very small differences in CEOs talent but considerable compensation differentials among top talents, as these differentials are magnified by firm size. They predicted that a CEO's equilibrium pay increases with both the size of his firm and the size of the average firm in the economy and also with firm characteristics for a given firm size. In addition to firm size and industry characteristics, there are returns to age and experience [Kostuik(1990)].

Lambert et al. (1993) and Core et al (1998) find that CEO compensation is lower when the CEO's ownership is higher and when there is an internal member on the board other than the

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CEO who owns at least 5% of the shares. Kato and Long (2005) have also found that firm's ownership structure has important effects on pay- performance links.

DISCUSSION

Competition for scarce managerial talent drives high executive pay. Factors such as type of industry, size of firm and ownership structure also influence executive pay. It is generally understood that the level of corporate governance in a firm may help to check high executive pay but studies indicate that the level of corporate governance is chosen by a firm depending on a combination of the above and other factors in conditions of firm's competition for top quality managers. Hence competition for scarce managerial talent leads executives to wield power over boards and drives excessive executive compensation due to weak governance. Study on hidden compensation such as managerial perks, deferred benefits, pension plans, severance agreements and extent of disclosure at firm level will help to give a more accurate understanding of what drives executive compensation.

ENDNOTES:

* Available on: http://www .epi.org /publication/ceo-pay-continues-to-rise/[Date: 27/02/2015].

** Available on: http://www. dnaindia .com /money/report-debating-ceos-salaries-in-india-is-there-a-number-that-s-too-high-2002004[Date: 27/02/2015].

***http://www.aflcio.org/Corporate-Watch/Paywatch-Archive/CEO-Pay-and-You/Trends-in-CEO-Pay

****http://work.chron.com/ceo-compensation-vs-world-15509.html

*****http://www.payscale.com/research/IN/Job=Chief_Executive_Officer_%28CEO%29/Salary

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