1 Introduction

1.1 Why study executive pay?

Executive compensation has attracted widespread attention in recent years and has become one of the focus topics in corporate governance (Felton, 2004). At least three reasons have contributed to this increased attention on executive compensation for academics and practitioners alike: A fascination with – and sometimes lack of understanding for –the high levels of CEO compensation, the importance of the CEO as the main strategic decision maker and the increased transparency of executive compensation data in many countries.

First, the pay of corporate leaders has undisputedly escalated in the last few decades, while workers' pay has stagnated. The average real pay for chief executive officers of S&P 500 firms increased significantly during the 1990s, growing from 3.5 MUSD in 1992 to 14.7 MUSD in 2000. Most of this increase reflects the escalation in stock options valued at the time of grant, which now constitute the single largest component of executive pay (Hall and Murphy, 2003). Average real CEO pay in the S&P 500 decreased again to 9.4 MUSD in 2002.[1] Even for large stock-listed companies, these amounts are substantial. Average CEO compensation now constitutes around 8% of corporate profits for US firms (Balsam, 2002: 262; Bebchuk and Fried, 2003). Over the same period, the pay of most employees has increased only marginally, increasing the ratio of CEO pay to the average factory worker's pay from 1:42 in 1980 to 1:531 in 2000 (Felton, 2004) and 1:431 in 2004 (Economist, 2005a). In Switzerland, some CEOs seem to have multiplied their total compensation in recent years, in spite of modest stock market developments (Schütz, 2005). At *UBS*, a large bank, top executives now earn 230 times the average pay of low-paid employees (Wittwer, 2005a: 27). The rapid increase in CEO compensation is difficult to comprehend for many people, given simultaneous corporate downsizing, employee layoffs, plant closings (Abowd and Kaplan, 1999; Dial and Murphy, 1995; Murphy, 1999; Murphy, 1997) and poor financial performance (e.g.

[1] At the same time as average pay decreased, median pay rose, indicating that the declining average was the result of a significant fall in the earnings of a few extremely highly compensated executives (Useem, 2003).

Krauer, 2004). In short, there is a widely held belief that top executives are overpaid (Gomez-Mejia, 1994). Anecdotal evidence indicates that CEOs of large Swiss corporations are the best paid in Europe (Schütz, 2005: 73).

A second reason for the high attention paid to CEO compensation by practitioners and academics is the CEO's position at the apex of the firm. As the main strategist for the firm, his or her compensation may have a direct bearing on business decisions affecting the future of the entire organization. How a firm's top managers are compensated and how much equity of their firm they hold has a significant impact on corporate strategic decisions (Sanders, 2001a; Datta et al., 2001; Bliss and Rosen, 2001), the value development of the firm (Morck et al., 1988; McConnell and Servaes, 1990) or the compensation policies for middle and lower-level managers (Gomez-Mejia, 1994). Furthermore, the structure of executive compensation – mainly the large option grants – has been linked to recent corporate collapses in the US. With large stock options payoffs in view, executives manipulated their books and inflated stated earnings in the search for higher share prices (Hall and Murphy, 2003; Bebchuk et al., 2001; Bolton et al., 2002; Felton, 2004; Frey, 2004; Hambrick et al., 2005). This has led experts to conclude that much may be wrong with executive compensation (Elson, 2003) and stock options in particular (Hall and Murphy, 2003) today.

Third, executive pay is increasingly transparent, as companies are required to publish increasing details of remuneration data in various countries (e.g. Schildknecht, 2004: 140). The Swiss Stock Exchange SWX required its listed companies to disclose the compensation of the top management team and the board of directors in 2002. Subsequently, interest in top management pay rapidly increased and has been a regular topic in news publications. An amendment of the law to make more detailed disclosure mandatory is under way (Gerny, 2004; EJPD, 2003).

1.2 The evolution of executive compensation research

Along with the increase in executive compensation levels, the volume of related research papers has soared. Over the last several decades, hundreds of studies have been conducted on the determinants and – to a lesser degree – the consequences of executive compensation. Already more than a decade ago, Gomez-Mejia (1994) stated that probably no other single variable had received as much empirical attention across different business fields and related social sciences as executive compensation.