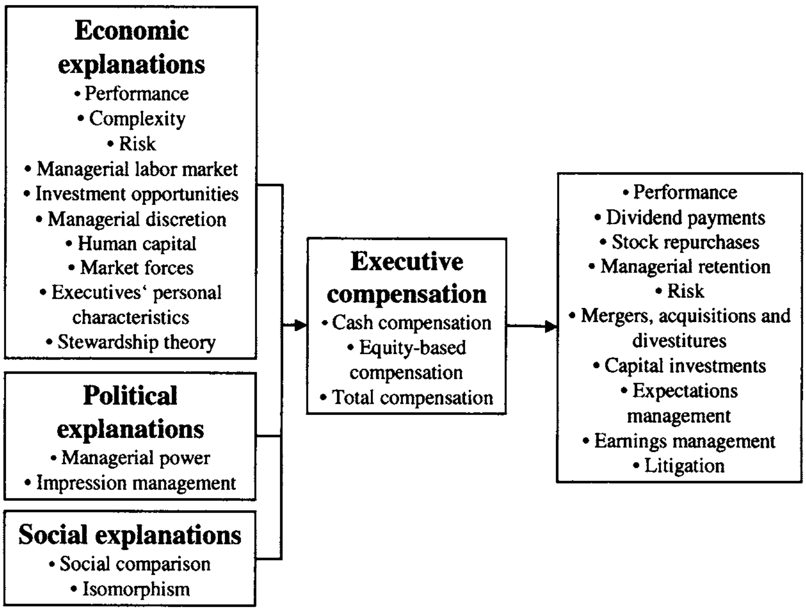
3 Research review on executive pay

The number of research papers on executive pay has increased dramatically over the last few decades. Academics of such diverse fields as accounting (e.g. Antle and Smith, 1986), economics (e.g. Jensen and Murphy, 1990a), finance (e.g. Baker et al., 1988; Carpenter, 2000), human resources (e.g. Kostiuk, 1990), management (e.g. Barkema and Gomez-Mejia, 1998), industrial relations (e.g. Agarwal, 1981) and sociology (e.g. Allen, 1981a) have published studies on the determinants and effects of executive compensation.

Figure 2: Determinants and consequences of executive compensation.



This vast body of literature has generated not only useful insights, but also many contradictory findings. Any review on executive pay will therefore have to remain incomplete. Good general reviews are provided by Gomez-Mejia (1994), Finkelstein and Hambrick (1996), Gomez-Mejia and Wiseman (1997) or Murphy (1999). Core and Guay (2003) review the literature on equity-based executive pay. Balsam (2002) provides a good introduction into and overview of executive pay. Figure 2 presents an overview of

the determinants and consequences of executive compensation level and structure, as discussed in this and subsequent chapters.

3.1 The relationship between pay and performance

3.1.1 The debate over size versus profits

Prior to 1980, only a handful of studies of executive compensation were published. Most of these studies focused on whether pay was more closely tied to company size or company profits. Economists were interested in examining hypotheses derived from the traditional theory of the firm that top managers operate to maximize profits. It was contended that executive compensation (i.e. salary and bonus[2]) would be closely linked with profitability (e.g. Lewellen and Huntsman, 1970). According to this view, competition in the managerial labor market (Fama, 1980) and the structure of the manager's compensation contracts unite managerial interests with shareholder interests. Consequently, managers act to maximize profits and shareholder wealth.

To recognize elements of oligopolistic competition, an alternative "managerialist" hypothesis was introduced. Due to the separation of ownership in large firms, managers seek their own personal goals, such as maximization of perquisites, power and control, and they achieve these goals by maximizing sales and not profits or shareholder wealth. The managerialist hypothesis therefore stated that compensation would be more closely related to sales revenues subject to a minimum profit constraint (Baumol, 1959). This alternative view was also termed "sales-maximization hypothesis".

This started the "sales versus profit" debate. Researchers examined whether changes in executive pay were more closely related to changes in sales revenues or changes in profits. For instance, McGuire et al. (1962), Ciscel (1974) and Schmidt and Fowler (1990) among others concluded that top executive compensation appears to be driven more by organization size than performance. At the other extreme, Deckop (1988), Lewellen and Huntsman (1970) and Masson (1971) accorded firm performance a stronger role than size. These early studies suffered from severe methodological problems. For example, collinearity can make a difference in how one interprets regression coefficients, if both firm size and profits are correlated (Ciscel and Carroll,

[2] At that time, the award of equity-based pay was still rare.