6 Can powerful managers extract rents?

The extant financial literature has typically examined compensation decisions from the perspective of a board of directors that attempts to establish an optimal contract in order to mitigate agency conflicts. Recent research, however, suggests that the process of determining compensation is better described as a negotiation between the board and the CEO and that the power of CEOs to influence boards provides an explanation for the lack of pay-performance sensitivity. For instance, Hermalin and Weisbach (1998) model a bargaining game in which the CEO's compensation is negotiated between the two parties. Bebchuk et al. (2002) argue that the CEO's power over the board of directors distorts optimal compensation contracts and that the existing empirical evidence better supports the bargaining model than the optimal contracting paradigm. In a large review of the executive pay literature Gomez-Mejia and Wiseman (1997: 320) suggest that "executive pay is a compromise between CEO power to inflate their compensation and societal pressures on boards to limit CEO pay" and that "the power of CEOs to influence boards provides a better explanation for the lack of pay-performance sensitivity than alternative explanations" (Gomez and Wiseman, 1997: 321).

The power view of executive pay is reflected in the widespread popular belief that CEOs and other top managers are overpaid (e.g. Schütz, 2004; Wittwer, 2005a). Academics such as Gomez-Mejia and Wiseman (1997: 329) support this view and argue that "the reservation wage[16] is often far lower than the payment received by CEOs...". This suggests that CEOs are able to extract rents on top of their reservation wage. Today, high corporate profits coupled with low investment activity (Economist, 2005c) may have helped managers to deviate large parts of firm profits to their own books, as it seems the case with cash windfalls (Blanchard et al., 1994). Academic research adds that excessively paid managers may actually manage lower-performing firms (Brick et al., 2002) and that CEOs may be rewarded for luck (Bertrand and Mullainathan, 2001).

[16] The reservation wage is a concept from labor economics and refers to the minimum amount a person is willing to accept to hold a job or perform certain services.

6.1 Towards a framework of power and pay

From a financial economics perspective, managers' pay arrangements are a (partial) solution to the agency problem. This "optimal contracting approach" assumes that compensation schemes determined by the board of directors or its compensation committee provide managers with efficient incentives to maximize shareholder value. Major conclusions of the "optimal contracting approach" for existing pay practices are that compensation schemes are not sufficiently high-powered (Jensen and Murphy, 1990a) and that divergence from optimal contracting can never be an equilibrium situation (Core and Guay, 2003). Under the "managerial power approach" (Bebchuk and Fried, 2003) executive compensation is viewed not only as a potential instrument for addressing the agency problem but also part of the agency problem itself: Some features of pay arrangements reflect managerial rent-seeking rather than the provision of efficient incentives. Support for a power explanation of executive pay is given by the fact that compensation practitioners report huge (unexplained) variance in salary, bonuses and long-term income of executives for firms of similar size, in the same industry, and performance at similar levels (Gomez-Mejia and Wiseman, 1997).

6.1.1 Defining executive power

There exists no agreement about the appropriate definition of power (Hardy and Clegg, 1999). Management researchers differentiate between legitimate and illegitimate power. Legitimate power is a reflection of an organization's hierarchical structure. It concerns the hierarchical structure of offices and their relation to each other (Hardy and Clegg, 1999). In the context of boards and the CEO, corporate structure clearly assigns higher formal power to the board over its CEO, with the ultimate power to hire and dismiss the CEO. Because such power has been viewed as a normal and inevitable consequence following from the structure of the organization, researchers instead focused on illegitimate power, i.e. power exercised outside formal hierarchical structures and the channels that they sanction. A consequence of this distinction has been that the use of power is being equated with dysfunctional and self-interested behavior.

Two theories of power focus on intra-organizational dependencies. "Strategic contingency theory of intra-organizational power" (Hickson et al., 1971) builds on the idea that power is related to uncertainty or at least to its control. According to this model, strategically contingent sub-units are the most powerful, because they are the least