Theories on executive pay. A literature overview and critical assessment

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ABSTRACT

Executive pay is a major issue in the corporate governance debate. As well in practice as in theory debate still exists how executive pay levels and structures can be explained. This paper provides an overview of 16 theories that have been used in the literature to explain the phenomenon. The theories can be classified into three types of approaches; 1) the value approach; 2) the agency approach; and 3) the symbolic approach. A critical assessment of the theories shows that the dominant use in the literature of the perfect contracting approach of agency theory neglects: 1) the socially determined symbolic value that executive pay could represent, and 2) the contextual conditions under which executive pay is set. A more conclusive understanding of executive pay would be based on considering executive pay as an outcome of socially constructed corporate governance arrangements in which the actors involved have considerable discretion to influence the outcomes. Incorporating such a view in attempts to explain executive pay provides a more conclusive explanation of the recurrent debate on executive pay in theory and practice.

INTRODUCTION

There is hardly any other aspect of business life that catches the newspaper headlines as much as executive pay. Almost every day, the media display outrage about the tremendous heights that executive salaries, bonuses and other financial gratuities have reached. Amidst all this turmoil, boards of directors still have problems explaining how, how much, and why they pay their executives as they do.

Not only in practice but also in theory the debate on what determines executive pay levels and structures is still ongoing. Although many different theories can and are used to explain executive pay, the field is still dominated by the perfect contracting approach of agency theory as introduced by Jensen and Meckling (1976). This “official story” on executive pay (Bebchuk and Fried, 2004) holds that executive pay is an instrument to alleviate agency problems. To render the separation between firm ownership and firm control harmless, the wide spread story told is that executive pay is an instrument to align the interests between shareholders and management (Bebchuk and Fried, 2004). Based on arguments of market forces and behavioral assumptions of actors risk preferences, pay setting is “simply” seen as a matter of optimal pay design (Gomez-Mejia and Wiseman, 1997). Market forces are assumed to lead to optimal pay levels and structures, compensating executives for the risks they are willing to take to manage the corporation in the best interests of its shareholders (Jensen and Meckling, 1976, Jensen and Murphy, 1990b). It may come then as no surprise that one of the most studied relationships in the executive pay literature is the relationship between pay and firm performance (Gomez-Mejia, 1994; Barkema and Gomez-Mejia, 1998). After all, an observable positive pay-performance link would show that executive’s risk taking behavior can be influenced by incentives. Thereby, given conditions of imperfect monitoring in practice it would show that shareholders are able to write efficient contracts that align their interests with that of management.

As can be expected with literally thousands of empirical studies in search for pay-performance linkages empirical results are mixed. The results of these studies range from no significant relationships, to positive and negative relationships (See Tosi et. al. (2000) for an extensive overview of empirical studies). Although (methodological) debates about the strength and implications of the relationship are ongoing, the overall consensus seems to be that pay-performance relationships are not very strong (Conyon, Gregg and Machin, 1995; Gomez-Mejia, 1994; Gomez-Mejia and

Wiseman, 1997; Jensen and Murphy, 1990b; 2004; Murphy, 1999; Rosen, 1990; Tosi et al 2000).

These results weakens the case for the dominant use of the perfect contracting approach of agency theory for two reasons. First, the theory can only furnish weak explanations of the observable pay arrangements in practice. Its theoretical applicability could somehow be limited in the sense that incentives lead to other outcomes (in theory and/or practice). The effectiveness of incentives could be influenced by factors or theoretical assumptions that are not considered by the theory. And, second, actors involved in the pay setting process may in practice simply choose not to adhere to agency theory's prescriptions or are not able to do so. The theory's neo-classical economic assumptions of given and stable risk preferences, rational maximizing behavior of the actors, exclusion of chronic information problems (Hodgson, 1998) and focus on attained or movements to an "unique optimal that is guaranteed to be achieved" (March and Olson, 1984: 737), may in practice simply not hold to provide conclusive explanations of executive pay.

The dominant use of this single theory to explain executive pay leads us into a "blind alley" (Barkema and Gomez-Mejia, 1998). As Bebchuk and Fried (2004) argue, scholars often come up with clever explanations for pay practices that appear to be inconsistent with the dominant approach. "Practices for which no explanation has been found have been considered "anomalies" or "puzzles" that will ultimately either be explained within the paradigm or disappear" (Bebchuk and Fried, 2004, p3). As a consequence other potentially more fruitful approaches to explain executive pay have received much less attention. Largely overlooked in most of the executive pay literature, is that (implications of) theories and the determinants derived from these theories not only provide theoretical explanations of executive pay but also provide forms of legitimization for what is actually paid in practice (cf. Gomez-Mejia and Wiseman, 1997; Wade, Porac, and Pollock, 1997; Zajac and Westphal, 1995). Where some of the theories are rooted in economic theory and consider executive pay mainly as the result of market forces, other theories tend to focus much more on the contextual conditions under which actual decisions on pay are made. These theories tend to focus more on the socially constructed symbolic value that executive pay could represent. The use of positive (economic) theories to settle debates in practice seem to get a normative bend when empirical results disconfirm the theory or when the theories are unable to provide conclusive or satisfactory explanations of the phenomenon in the public eye. For instance, the most often hypothesized relationship between pay and performance and the overall weak relationship found in empirical tests seem to fuel debates in practice. Especially in cases where executive pay rises and where firms show bad performance results or have to downsize, the general public seem to consider it a matter of fairness that pay should be (more) related to firm performance (cf. Gomez-Mejia, 1994; Jensen and Murphy, 2004; Murphy, 1997). The in practice also widely debated seemingly high pay levels and high option grants to executives and the (growing) differences between pay levels at the top and lower level employees seem simply to be widely perceived as unfair (cf. Conyon and Murphy, 2000; Core, Guay, and Larcker, 2005; Kolb, 2006).

To advance our understanding of executive pay and to find a way out of the blind alley of a single dominant approach, this paper provides an overview of the state of the art in theorizing executive pay. Besides the dominant perfect contracting approach of agency theory, 15 other theories are discussed. The theories are categorized in three types of approaches. 1) The value approach, comprising of theories that focus on the question how much to pay; 2) the agency approach, comprising of theories that focus more on the question how to pay; and 3) the symbolic approach, comprising of theories that focus more on the question what executives “ought” to be paid.

Despite the many (fundamental) differences between the theories, the assessments of the theories and the sketched current state of the literature as advanced here give rise to signs of convergence in theorizing about executive pay. Observing executive pay is more and more considered to be an observation of the fundamental governance processes in an organization (cf. Hambrick and Finkelstein, 1995). Thereby, the pay setting process and the result of this process in given pay levels and structures are increasingly seen to have implications for and be influenced by socially constructed (national) corporate governance arrangements, organizational processes, and to have implications for executive motivation and motivation for lower level employees (c.f. Bebchuk and Fried, 2004; Bratton, 2005; Conyon and Murphy, 2000; Finkelstein and Hambrick 1988; 1989; Gomez-Mejia, 1994; Jensen and Murphy, 2004; Rosen, 1986; Ungson and Steers, 1984).

It is argued here that further theorizing and any future attempt to explain what is truly going on in the world of executive pay should more be focused on all mechanisms that actually shape executive pay. Following Elster (1989:3): "[E]xplaining events is logically prior to explaining facts." To unravel all of the "nuts and bolts" (Elster, 1989) of executive pay, logical more fruitful explanations thus focus much more on the actual decision making process in which pay is set, rather than finding explanations of pay it self. The here sketched state of the art of the executive pay literature reveals at least three major implications for our understanding of executive pay and for further theory development. In contrast to the dominant approach it is argued that: 1) executive pay is not merely a "tool" to align interests between shareholders and executives, but is much more an outcome of pay setting practices; (2) the actors involved in these pay setting practices have considerable discretion not only to influence their own pay or the pay of others, but also have discretion to influence the development and workings of the mechanisms of these practices; and (3) pay setting practices cannot be fully understood without a thorough understanding of the implications of socially constructed corporate governance arrangements.

THEORETICAL APPROACHES

Extending previous overviews by Gomez-Mejia (1994) and Balsam (2002), the 16 theories that are addressed here are categorized into three approaches. The classification is based on the main role that pay plays in a specific theory and on the underlying legitimizing arguments/ mechanisms of pay within a given theory. The three approaches are labeled respectively as: 1) The *value approach*, which focuses mainly on the question *how much* to pay executives. Executive pay is legitimized here by arguing that pay is set by market forces and pay is mainly regarded as the market value of executive services. 2) The *agency approach* considers pay mainly as a consequence of agency problems, and focuses on the question as to *how* to pay executives. Legitimizations of pay levels and structures are based on arguments of market forces and conceptions of executive pay at risk. And 3) the *symbolic approach* considers pay as a reflection of expectations, status, dignity or achievements, and plays a more secondary role in executive motivation. The arguments used to legitimize executive pay are based on social constructed beliefs about the implications of being in an executive position. The approach deals mainly with the question of *how socially constructed beliefs influence what pay ought to reflect*. Table 1 provides an overview of the 16 different theories and their classification according to the three streams of thought.

Following Machlup (1978: 496 as cited in Koppl, 2000: 595), theoretical "rules of procedures" cannot be termed "true" or "false"; they are either useful or not useful and are empirically meaningful (Koppl, 2000; see also North, 1990). As with most classifications, a tendency exists to oversimplify. Theories in general can be contradictory and complementary at the same time. This seems especially true for theories used in the executive pay literature (cf. Gomez-Mejia, 1994; Gomez-Mejia and Wiseman, 1997). Some theories could be classified within a certain approach as indicated by table 1, but may be complementary or based on theoretical principles from a theory classified in the same or another approach. Nevertheless, and keeping these points in mind, classifications are based on the underlying legitimizing arguments of specific pay levels and structures and are based on the main role that pay plays within the theory.

As can be seen in table 1, the first cluster of 5 theories are categorized in the value approach. The agency approach, the second cluster of theories, consist of 2 groups, each comprised of 2 theories. The distinction between these two groups is made between (group 1) theories that argue that pay design is a (partial) solution to agency problems and (group 2) theories that argue that pay setting is influenced by executive discretion and that therefore executive pay is not a solution to agency problems, but rather an agency problem in itself. The third and last cluster, comprised of 7 theories, makes up the symbolic approach. The table reports the fundamental role that executive pay plays in all 16 different theoretical approaches.

Insert Table 1 here

THE VALUE APPROACH

The value approach generally regards pay as the reflection of the market value of an executive's services. This approach uses the laws of economics of supply and demand as determinant factors for executive pay. Legitimizing executive pay is grounded in arguments of market forces and market mechanisms. The value approach consists of the following five different theories: 1) marginal productivity theory, 2) efficiency wage theory, 3) human capital theory, 4) opportunity cost theory, and 5) superstar theory.

Within this value approach, the marginal productivity theory is presumably the most fundamental theory. The input from executives, i.e. the services they provide to the firm, is treated as any other input factor of production (e.g. Roberts, 1956). The value of this input is equal to the intersection of supply and demand on the labor market for executives. In this equilibrium pay is equal to the executive's marginal revenue product. Marginal revenue productivity can be defined as the observed performance of the firm minus the performance of the firm with the next best alternative executive at the helm, plus the costs of acquiring the latter's services (Gomez-Mejia, 1994). Under the basic market assumption that "competition on both sides of the [executive] labour market and a continuum of alternative jobs open to the executive and of executives available to the firm" (Roberts, 1956: 291), executive pay can be understood as the result of the value of the executive's marginal revenue productivity. In equilibrium this is equal to the intersection of supply and demand on the market for executives.

Based on this, human capital theory, the second theory in the value approach, argues that an executive's productivity is influenced by his accumulated knowledge and skills, i.e. his human capital. The more knowledge and skills an executive has, the higher his human capital will be. An executive with a greater quantity of human capital would be better able to perform his job and thus be paid more. The market for executives determines the value of this capital (see for human capital approaches in the executive pay literature e.g. Agarwal, 1981; Carpenter, Sanders, and Gregersen, 2001; Combs and Skill, 2003; Harris and Helfat, 1997).

The third theory, efficiency wage theory (Lazear, 1995; Prendergast, 1999), argues that executives will put in extra effort if they are promised an above-market-level wage. Because pay is set at a level above market level, executives are less likely to leave the firm or to shirk their work, and will feel their contributions to the firm are valuable. Executives subsequently have the incentive to put in extra effort, which reduces executive turnover and increases productivity (Balsam, 2002; Prendergast, 1999). Executive pay is considered to be the result of the value of executive's marginal revenue productivity plus a premium above market level to provide extra incentives.

An opportunity cost approach, which is the fourth theory in this approach, argues that the transparency of job-openings on the executive labor market makes it possible for executives to change employers. The opportunity cost perspective argues that in order to hire or retain an executive the level of pay must at least be equal to the amount that would be paid to an executive for his next best alternative (Thomas, 2002; Gomez-Mejia and Wiseman, 1997).

The fifth theory is superstar theory (Rosen, 1981). Although Rosen (1981) does not specifically address the implications of this theory in regard to explanations of executive pay, the theory does address the skewness in the distribution of income. Following Rosen (1981), less talent is hardly a good substitute for more talent. And thus imperfect substitution among different "sellers" of talent exists. Given imperfect substitution, demand for the better talented increases disproportionately. If production costs do not rise in proportion to the size of the sellers market, it is argued that a concentration of output is possible. Economy of scale of joint consumption allows for relatively few sellers to service the entire market. Then again, fewer sellers are needed if these sellers are more capable of serving the entire market. When combining the joint consumption and the imperfect substitution features, it becomes apparent that talented persons can serve very large markets and subsequently receive large incomes (Rosen, 1981).

The skew-ness in the distribution of executive pay could thus be explained by the disproportionate premiums that firms are willing to pay for executives' talent or capabilities for which no good substitutes exist. Furthermore, albeit in relatively smaller proportions as indicated by Rosen (1981), the distribution of executive pay can be explained by possible joint consumption of executive services. The possibilities for better talented and/ or more capable executives to serve on (multiple) boards implies that fewer executives are needed to serve the market, and that subsequently their pay would increase disproportionately.

THE AGENCY APPROACH

Rather than determining how much to pay executives, the central legitimizing issue in the agency approach is how to pay them (cf. Barkema, Geroski, and Schwalbach, 1997; Jensen and Murphy, 1990a). Pay levels are in this approach mainly assumed to be based upon the market value of executives' services. As pay is seen as a consequence of agency problems, the question how to pay the executive is the main issue addressed in these theories. Agency problems exist in any situation where one party entrusts responsibility of tasks to another party. In this agency approach a distinction can be made between two groups. Group 1 consists of theories that consider executive pay as a (partial) solution to overcome agency problems by incentive alignment and the transference of risks. Group 2 comprises of theories that consider pay as a result of executives' discretionary powers resulting in turn from agency problems. The theories in the first group are the complete contract approach, referred to in the literature as agency theory (Jensen and Meckling, 1976), and prospect theory. The second group consists of managerial power theory and class hegemony theory.

Problems of agency are central in the corporate governance literature. Gomez-Mejia and Wiseman (1997) sum up three basic assumptions of a simple agency model. First, agents are risk averse, second, agents behave according to self-interest assumptions, and third, agents' interests are not in line with the principals' interests. Based on these assumptions they also identify two cases. The first is the case of complete information about agents' actions. In this case no information asymmetries between principals and agents exist. Under these conditions the principal is completely aware of the agent's actions. Providing the agent with additional incentives is unnecessary in this case, as the principal is completely aware of how results are achieved and would unnecessarily transfer risk to a risk averse agent.

The second case is when the principal has incomplete information on the agent's behavior. In this case the principal is not completely aware when the agent deviates from the interests of the principal. In this case, agency problems could arise because of two factors. One is moral hazard, by e.g. shirking, and the other is adverse selection, by e.g. hubris actions. Agents can, for instance, be so involved in pursuing their own interests that they neglect their duties and/or overestimate their own capabilities. To solve these problems of incomplete information, the principal has two options. Either obtain (more) information about the agent's efforts and behavior by increased monitoring, or provide the agent with incentives in a way that the interests of the principal and agent become aligned. By providing incentives, the risk of deviation from the interests of the principal is transferred back to the agent. Because the agent is assumed to be risk averse and maximizes his self interests, he is presumed to adhere to these incentives in a way that his behavior will result in an outcome that is preferable to the principal. The optimal pay package would minimize agency cost and is a tradeoff between the costs of (additional) monitoring and incentives (Gomez-Mejia and Wiseman, 1997). To minimize residual losses for the principal, problems of optimal risk-bearing from the agent's point of view and optimal incentives from the principal's point of view are conflicting in the design of executive pay (Eisenhardt 1989, Rajagopalan 1996).

The central issue of agency problems has developed into two groups of approaches within the agency approach on executive pay (cf. Bebchuk, Fried, and Walker 2002). The first group consists of complete contracting and prospect theory. The complete contracting approach (Jensen and Meckling, 1976) is the most prominent one in academic research on executive pay and is most often simply referred to as "agency theory". Both theories in this group consider executive pay as a "tool" with which to alleviate agency problems.

The second group in the agency approach is managerial power theory and class hegemony theory. These theories (convincingly) argue that because of principal agent relationships, agents are in the natural position to have discretion in setting their own pay (cf. Bratton, 2005; Jensen and Murphy, 2004).

Complete contract theory is classified as the first theory in group 1 (see table 1). As this theory is by far the dominant theory in the executive pay literature Bebchuk and Fried (2004) labeled it as "the official story" on executive pay. The central issue of the optimal contract problem is formulated by Gomez-Mejia and Wiseman as: "the tradeoff between the cost of measuring agent behavior and the cost of transferring risk to the agent, that is, balancing the insurance and incentive properties of compensation design" (1997: 296). Basically the theory argues that executive pay is a "tool" with which to align the interests of executives with that of shareholders. By arms' length negotiations, a contract with the right incentives is made up that transfers risks to a risk averse executive. In a simple model of this theory one could argue that what setting executive pay really comes down to is the incentives that are needed to bring a risk averse executive's interests and behavioral outcomes in line with the expectations and interests of the shareholder. Typically, the contract is made up between the board of directors, as representatives of the shareholders, and management. Pay levels are based on the market value of executive's services and pay structures are based on the necessary incentives from the shareholders' point of view to uphold the perfect contract following given levels of monitoring. The outcome based complete contract is made up based on efficiency arguments and is the most efficient tradeoff between different types of agency costs that minimize residual losses for shareholders (Jensen and Meckling, 1976).

The second theory in group 1 of the agency approach is prospect theory and is based on the same agency problem. In contrast to the complete contract approach which is based on risk aversion assumptions, prospect theory (Kahneman and Tversky, 1979) uses loss aversion assumptions. Building on prospect theory and on agency theories, Wiseman and Gomez-Mejia (1998) formulated a behavioral agency model of risk taking. Their approach argues that prospect and agency theories are complementary and, by combining internal corporate governance with problem framing, help to explain executive risk-taking behavior (Wiseman and Gomez-Mejia, 1998). The theory argues that the executive is willing to take risks under certain circumstances, i.e. to avoid losses or missing goals or targets. The executive is unwilling to take risks once he has received his performance goals, as the benefit to the executive of increasing performance is more than offset by the possibility of falling below target (Balsam, 2002). In this theory, wealth maximization is a less accurate explanation for executives' decisions making preferences than a loss minimization perspective. Executive decisions are argued to generally seek to limit losses to wealth while also increasing opportunity costs (Wiseman and Gomez-Mejia, 1998). Influences from prospect theory on executive pay could be brought back to a loss aversion perspective on executive behavior. Strategic decision making and governance mechanisms have effects on executive risk bearing and thereby affect the executives' perceived risk of his wealth. Setting executive pay is thus a result of the amount of risk bearing of executive's wealth. Governance arrangements, such as monitoring mechanisms, and implications of risk levels, risk shifting, and risk sharing, determine the pay of a loss averse executive (See Wiseman and Gomez-Mejia, 1998).

Group 2 of the agency approach consists of managerial power theory and class hegemony theory. The separation between ownership and control has resulted in conditions where the interests between owners and executives can diverge and the checks to limit the use of power (from owners as well as ultimate managers) can disappear (Berle and Means, 1932/2004). The relative balance of power between the principals and agents are argued to influence the outcome of the contract and therefore influence the level and structure of executive pay. The managerial power approach to agency problems does not exclusively see pay design as a "tool" to alleviate agency problems. Managerial power theory argues that because of principal-agent relations, agents are in the natural position to use their discretion to set their own pay. Pay design is not a solution to agency problems but is seen as part of the same problem; it is an agency problem in itself (Bebchuk et al., 2002). Executives are in the position to use their power to influence those decision making authorities especially designed to keep them in check (i.e. the board of directors; Fama, 1980; Fama and Jensen, 1983). In contrast to the complete contracting theory, natural relationships between principals and agents and the consequent possible use of discretion are considered as real possible behavior (Grabke-Rundell and Gomez-Mejia, 2002). In the perfect contract approach, discretion is effectively ruled out, as managers are expected to behave according to the contract, because of the incentives they receive for upholding this contract. In this sense, discretion is not considered as a possible behavior, but only as a cost (Grabke-Rundell and Gomez-Mejia, 2002).

Managerial power theory argues that executive pay is an outcome of power relationships and that pay setters and pay receivers are able to use discretion in the pay setting process.

A theory that extends managerial power theory is class hegemony theory. This theory argues that executives within a firm and executives from other firms share a commonality of interests. Where managerial power theory stops at the boundaries of firms, class hegemony theory extends managerial views beyond these boundaries (Gomez-Mejia, 1994). Shared interests and objectives create bonds between executives that extend beyond a single organization. These bonds form relationships which in turn form a class across different organizations. By using (shared) power the executives can protect their privileges and the wealth of their class. Although primarily executives' input is used to legitimize high executive pay, setting high pay is also a token of executives' power to protect shared interests and objectives (Gomez-Mejia, 1994). Setting executive pay is thus a result of the social managerial class's power to protect their interests and objectives that are at potential risk.

THE SYMBOLIC APPROACH

The third approach to legitimizing executive pay comprises of theories that consider pay more as a social constructed symbol fitting the expectation, status, or role that executives play in a society or firm. Executive pay has a primary role in reflecting executive status, dignity, and expectations and plays a more secondary role in executive motivation. The legitimizing arguments are based on social (or social-economical) constructed beliefs about executive roles and how pay ought to reflect this. The symbolic approach consists of the following 7 theories: 1) tournament theory, 2) figurehead theory, 3) stewardship theory, 4) crowding-out theory, 5) implicit/ psychological contract theory, 6) social enacted proportionality theory, and 7) social comparison theory.

Tournament theory (Lazear and Rosen, 1981) treats pay as a prize in a contest. First prize in the tournament is the highest pay received by the CEO, the highest-ranking position in an organization. Setting a high prize provides incentives for the contestants to climb higher on the corporate ladder (Rosen, 1986) and indirectly increases the productivity of competitors at lower levels (Balsam, 2002). Although high levels of executive pay also provide executives themselves with incentives, they serve more as incentives for their subordinates (Balsam, 2002). When the top price is set at a disproportionately high level it has the effect of lengthening the career ladder of high-ranking managers (O'reilly, Main, and Crystal, 1988). "Contestants who succeed in attaining high ranks in elimination career ladders rest on their laurels in attempting to climb higher, unless top-ranking prizes are given a disproportionate weight in the purse. A large first-place prize gives survivors something to shoot for, independent of past performances and accomplishments" (Rosen, 1986: 701). The symbols needed to keep the tournament going result in highly differing pay levels at the different levels in the organization, with a disproportionately high first place for achieving the top position.

Figurehead theory argues that behavior is assumed to reflect purpose or intention and that a diversity of goals and interests co-exist within firms (Ungson and Steers 1984). Because of these different, possibly conflicting, goals and interest "actions and decisions result from bargaining and compromise, with those units with the greatest power receiving the greatest rewards from the interplay of organisational politics" (Ungson and Steers, 1984: 316). Three perspectives of executives roles can be identified (Ungson and Steers, 1984). First, executives act as "boundary-spanners" for owners, governments, employees and the general public. In this regard executives, and especially the CEO, play political/symbolic figurehead roles when communicating within and outside the firm. Second, the executive manages political coalitions within and outside the firm and plays the role of political strategist. And third, the executive plays the role of internal politician in the relationship between members of the board of directors when new directors are hired and executive pay is set (Ungson and Steers, 1984). Because of the different roles that managers play and represent, the "appropriate role for the manager may be [that of an] evangelist" (Weick, 1979: 42). As a reflection of these different roles executive pay is set by the individual's ability to manage the complexity of the symbolic political roles and is used as a token of the executive's mandate. The makeup of the pay mix depends on the complexity of these roles and accommodates political processes in the best interest of the firm (Ungson and Steers, 1984). Executive pay is part of the status the executive has within and outside the firm and is intended to reinforce this figurehead image (Gomez-Mejia, 1994).

The third theory in the symbolic approach is stewardship theory. Stewardship theory argues a contradicting view on governance (Davis, Schoorman, and Donaldson, 1997; Donaldson and Davis, 1991). Stewardship theory does not provide a-priori clear hypotheses about pay levels or pay structures and could therefore be questioned as a useful theory to legitimize executive pay. Nevertheless, stewardship views are addressed because the theory does attempt to explain that executive pay does not have to be (strongly) related to shareholder wealth or other measures of the firm's financial performance (Davis, Schoorman, Donaldson, 1997). Using sociological and psychological approaches, stewardship theory sees subordinates as collectivists, pro-organizational and trustworthy as opposed to e.g. agency theory, which assume subordinates to be individualistic, opportunistic, and self-serving (see Donaldson 1995). Stewardship theory defines situations in which managers' motives are aligned with the objectives of their principals, rather than motives of individual goals (Davis, Schoorman, Donaldson, 1997). Executives are motivated to act in the best interest of their principals and the firm (Donaldson and Davis, 1991). Even in situations where the interests of stewards and principals diverge, Davis et al. (1997) argue that stewards place higher value on co-operation and thus perceive greater utility in co-operative behavior. Stewardship theory assumes a strong relation between the firm's success and principal satisfaction. The theory argues that there is no general executive motivation problem, because executives act as true stewards of the firm, in pursuit of organizational goals. Executive pay plays a secondary role in executive motivation, because non-financial rewards are of more importance (Donaldson et al., 1991). The theory focuses more on intrinsic, rather than extrinsic rewards. Executives are intrinsically motivated by the need to achieve and to receive recognition from others (Donaldson et al., 1991). Executive pay could be legitimized by arguing that it is merely a relatively minor part of executive motivation and forms only part of the recognition executives receive for being stewards of the firm.

Extending on the balance of intrinsic and extrinsic motivation, crowding-out theory argues that monetary incentives can crowd-out intrinsic motivation and thereby also good intentions (Frey, 1997a; 1997b). Pay plays a part of executive motivation, but intrinsic motivation to pursue organizational goals is likely more important. There is a delicate balance between intrinsic and extrinsic motivation. Pay levels that are too high or the provision of too many extrinsic incentives could drive out intrinsic motivation, resulting in lower efforts by the executives. In turn, high pay levels and high incentives could result in behavior that pursues goals that are not in line with the best interests of the firm (e.g. corporate fraud) (Frey and Osterlőh, 2005). Executive pay plays a secondary role in executive motivation. A higher level of intrinsic motivation from executives requires lower pay levels and fewer incentives to balance intrinsic motivation with extrinsic motivation.

The fifth theory in the symbolic approach is implicit contract or psychological contract theory (see e.g. Rosen, 1985; Kidder and Buchholtz, 2002; Baker, Gibbons, and Murphy, 2002). This theory argues that a contract exists between an individual and another party that is composed of the individual's beliefs about the nature of the exchange agreement. Based on social exchange theory, relational contract theory tends to rely on principles of generalized reciprocity. The psychological contract is an individual's personal set of reciprocal expectations of his obligations and entitlements which do not necessarily have to be mutually agreed upon between the contractors (Kidder and Buchholtz, 2002). In this respect Baker, Gibbons, and Murphy (2002) use the term relational contracts. Baker et al. (2002) argue that a relational contract is composed of informal agreements and unwritten codes of conduct that affect individuals' behavior. The relationship contract is based on trust and the common beliefs of the parties regarding fairness and sense of justice. The job characteristics of executives and the nature of their positions create a relational psychological contract. Pay is seen as a symbol that reflects appreciation, accomplishment, and dignity (Kidder and Buchholtz, 2002).

The sixth theory is referred to here as the socially enacted proportionality theory. This theory argues that the value of an executive is the result of positions of different ranks within a firm. Simon argues that executive pay is "determined by requirements of internal "consistency" of the salary scale with the formal organization and by norms of proportionality between salaries of executives and their subordinates" (1957: 34). Because of hierarchical structures induced by authority relations, large organizations are roughly pyramidal shaped. Furthermore, it is widely (socially) accepted that executives and their immediate subordinates have different salaries. This line of arguing can be followed down to the lowest organizational level where employees are hired outside the firm, e.g. school graduates. Salaries at this level are set by forces of market competition. The socially enacted norm of proportionality determines the ratio of an executive salary and the salaries of his immediate subordinates (Simon, 1957). According to the socially enacted proportionality theory, executive pay is the result of socially normative proportional differences between socially enacted hierarchical levels within firms, with a market-based pay at the lowest level.

The seventh theory of the symbolic approach is social comparison theory. This theory is also based on comparison but comparison is made at the top level of the firm and with executives externally to the organization. With the help of Goodman (1974) and Festinger's (1954) theories of social comparison processes, which in turn are related to equity theory, O'Reilly, Main, and Crystal (1988) argue that executives use their own pay as a reference point when setting the pay of other executives. This theory originates from the argument that people have the drive to evaluate their abilities and options. People tend to use other people with similar performances and/or ideas to themselves when selecting reference points. People preferably compare themselves with others who are seen as slightly better or more expert than themselves. In the case of setting executive pay, executives rely on normative judgments of their own pay and experience and on judgments of the experience and pay of other executives (Gomez-Mejia, 1994; O'Reilly et al., 1988). Executive pay reflects normative judgments of other executives and in this sense serves a function of symbolic judgment.

CRITICAL ASSESSMENT OF THE APPROACHES

As also indicated by Gomez-Mejia (1994), many empirical studies test hypotheses derived from a variety of theoretical models. The (often contradictory) results of these studies have implications for more than one theory. The still ongoing debate about a link between pay and performance is a case in point (cf. Rosen, 1990). Where some argue that the link is not strong enough to support incentive (alignment) arguments, others argue that the link at least exists and would show support for these type of theoretical implications (Gomez-Mejia, 1994; Gomez-Mejia and Wiseman, 1997; Jensen and Murphy, 1990b). Overall, empirical studies on the determinants of executive pay lack theoretical foundations and show a rather weak fit with the data (Hambrick and Finkelstein, 1995; Mueller and Yun, 1997)[2]. Subsequently, scholars' known biases and ideological orientation often serve as the best predictors of the findings presented (Gomez-Mejia, 1994; Gomez-Mejia and Wiseman, 1997) [3].

Although the theoretical (behavioral) assumptions of the theories are at times fundamentally different, the implications of the different theories provide more insights than each theory would provide on its own. The question that arises is how the different approaches as set out above can be useful to provide more conclusive explanations for executive pay, and by that provide a better understanding of the legitimization of executive pay in theory and in practice (cf. Gomez-Mejia and Wiseman, 1997; Wade, Porac, and Pollock, 1997; Zajac and Westphal 1995).

Central roles for economic reasoning, pricing and market mechanisms are apparent in the value and agency approaches on executive pay. These theories argue that market forces could form a solid basis for explaining executive pay. When adhering to arguments of market forces explaining known variance between executive pay levels and structures, also across countries, ultimately lie in addressing market imperfections (cf. Abowd and Kaplan, 1999; Conyon and Murphy, 2000). The value approach contributes to our understanding of how economic theories could help to explain

[2] See for overviews of determinants and empirical studies e.g. Gomez-Mejia and Wiseman, 1997; Murphy, 1999; Tosi, Werner, Katz and Gomez-Mejia, 2000).

[3] It could be argued that the dominant use of the perfect contracting approach of agency theory in the executive pay literature has become "institutionalized" as scholar's wide spread use of this theory has evolved as the standard, or "official story" (Bebchuk and Fried, 2004), when explaining executive pay. This development has led us into a "blind alley" (Barkema and Gomez-Mejia, 1998) resulting in limited attention to explore other (possible more fruitful) ways to explain the social phenomenon of executive pay in theory and legitimization of executive pay in practice.

differences in pay between executives and between executives and other employees. It could further be helpful in signaling possible market inefficiencies or market outcomes under certain conditions of market inefficiencies. Legitimizing executive pay exclusively based on efficient market assumptions is however problematic. As also made clear from the theories in the agency approach, the actual decision making process within the firm is of importance. Markets cannot decide on anything and provide only signals to inform the decision making process (cf. Cyert and March, 1963/1992; Kay, 2000). Markets are simply not strong enough to completely influence efficient decision making on executive pay. Incomplete information about firms' hiring practices and available executives and about the assessment of executives' capabilities across the globe causes problems with regard to the legitimization of executive pay based solely on market and pricing mechanisms (Finkelstein and Hambrick, 1988; Perkins and Hendry, 2005).

The theories in the agency approach argue that the fundamental issue is the agency problem between shareholders and management. In these theories pay is argued to depend on market values and optimal levels of risks of executive wealth (Gomez-Mejia, 1994). Extending the solid economic theories of the value approach, the agency approach highlights the importance to address other mechanisms besides markets that influence the level of risk. An important insight is that monitoring, risk sharing and the transfer of wealth at risk are important to set executive pay. In general, efficient executive pay is argued to be set as a tradeoff between the cost of steering behavior by incentives and the cost associated with monitoring and bonding. The important central mechanisms of monitoring are often thought of as mechanisms operated by the board of directors (Fama, 1980; Fama and Jensen, 1983). The theories in the agency approach allow for investigating the crucial role this and other monitoring mechanisms play in the design of executive pay (cf. Michael and Pearce, 2004). The legitimization of pay is nevertheless still based on implications of market forces, but the agency approach extends this approach by pointing out the crucial role of pay design and the relationships between principals and agents. A second important insight from the second group of theories in the agency approach is that executives have discretionary power to influence corporate governance outcomes and the ability not to adhere to market signals. Executives can influence the board of directors and the pay setting process. They are in the position to influence the board of directors when negotiating their own pay. The insight that executives could be seen as a social class, as indicated by class hegemony theory, emphasizes the notion that the relative balance of power in societies of different classes could influence corporate governance arrangements and their outcomes in, for instance, certain pay levels and structures.

Especially apparent in the dominant perfect contract approach, but also in many other economic theories on executive pay, individuals are most often reduced to a set of "ontological actors, frozen in space and time and isolated from social and cultural context" (Aquilera and Jackson, 2003; 449). In the ex-ante perfect contracting view of agency theory, the designer of the contract has to anticipate all future possible problems that clearly exist ex-post (Zingales, 1998). As complete contracts are simply not possible in practice, other mechanisms have to be in place to resolve problems regarding (mis)use of discretion. This problem becomes apparent especially when we have to admit that executives have discretion over their own pay arrangements (cf. Bratton, 2005; Jensen and Murphy, 2004). Not only checks and balances outside the firm, such as social, political or legal institutions play a role in organizing corporate governance arrangements, but also firm internal checks and balances such as the board of directors and other employees play a role. Other mechanisms inside and outside the firm are clearly at play in solving or alleviating agency problems. Other mechanisms besides explicit contracts and markets have to be in place to alleviate problems of incomplete contracting and determining over the (mis)use of executives' discretionary powers (cf. Williamson, 1988; Zingales 1998).

By the dominant use of the perfect contracting approach of agency theory the executive pay literature most often neglects these mechanisms and implications. The literature neglects the "social embeddedness" (Granovetter, 1985; Uzzi, 1997) in accounts of executive pay. This embeddedness plays however a central role in the symbolic approach. The symbolic approach relies heavily on socially constructed normative inclined beliefs (especially apparent in the implicit contracting theory) of how executive pay ought to look, rather than on market forces. In tournament theory, for instance, the level of pay is most likely set above the contributed value of the executive's services in order to increase the efforts and productivity of lower level employees (Lazear and Rosen, 1981). Executive pay is, however, set at some kind of normative level that provides enough incentives for lower level employees to believe that they must take part in and do their best to win the tournament. The legitimization of executive pay relies thus on the symbolic value of a prize that is big enough to start the tournament and to keep it going.

The arguments in the symbolic approach are based on the concept of pay as a symbol of accomplishment, good stewardship, dignity, normative judgments of reverence points, status, mandate, normative socially accepted proportionality, and reflections of a delicate balance between intrinsic and extrinsic motivations. They rely on arguments of legitimizing pay levels and structures on socially inclined beliefs and arguments about the informational value executive pay carries. Although economic reasoning of market forces may play (a small) part (e.g. socially enacted proportionality theory considers pay at the lowest level of the firm to be based on market value) or may influence the results (e.g. by implicit contracting it could be argued that in a relatively bigger and/ or better performing firm there may be higher (valued) expectations with regard to executive capabilities than in a smaller or more poorly performing firm), market forces are not explicitly considered the most determining factor for the setting of executive pay. Although market forces could influence decision making on executive pay, the symbolic approach focuses on the social construction of pay levels and structures. The answer to the question how and how much to pay executives is rooted here in the degree of social acceptance or "appropriateness" (cf. Cyert and March 1963/1992) of given pay arrangements. Decisions on executive pay are made and legitimized by referring to pay as simply being "appropriate" are "legitimate", given the contextual positions of the actors involved and given the perceived position, role, status, expectations, standards of comparison, and intrinsic (non-priced) motivation of being an executive.

Despite the so far blurred sketched status of the literature the growing notion is that studies that consider executive pay solely as a "tool" that provides (the right) incentives have been shown to be inconstant with theory and with each other (Tosi, Werner, Katz, and Gomez-Mejia, 2000). Views that consider executive pay as a "tool" have lost ground because they have to admit that executives have discretion in negotiating their own pay arrangements (Bratton, 2005). This seems to have led even former prominent proponents of this view to reconsider their views and shift in the direction of considering executive pay as an outcome of practices developed by the interactions of different corporate governance mechanisms. Jensen and Murphy (2004) are among these former prominent proponents who nowadays argue in this direction. The apparent recent consensus of considering executive pay as an outcome of pay setting practices further deepens and fuels the idea of socially constructed corporate governance arrangements that influence pay levels and makeup. Although the apparent recent consensus indicates that the time seems ripe to formulate an integrated approach, attempts to integrate different approaches are not new. Previous frameworks are, for instance, from Barkema and Gomez-Mejia (1998), Finkelstein and Hambrick (1988), Gomez-Mejia and Wiseman (1997). The seemingly growing consensus, as also reflected by these integrating frameworks, ads to the idea that the executive pay setting process is influenced by socially constructed corporate governance arrangements over which executives can exercise their discretion (cf. Bebchuk and Fried, 2004; Bratton, 2005, Jensen and Murphy 2004, Otten, 2007). Moreover, in the corporate governance literature increased attention goes out to the social construction and practicality of corporate governance systems (e.g. Aquilera and Jackson, 2003; Gordon and Roe, 2004; Heugens and Otten, 2007; Perkins and Hendry, 2005; Roe, 2003). Corporate governance arrangements and their outcomes are increasingly considered to be results of social action (cf. Becht, Bolton, and Roëll, 2002; Davis and Thompson, 1994; Guilén, 2000; Heugens and Otten, 2007; Roe, 2003). In the executive pay literature, however, still very little attention has been paid to the social construction of pay setting practices. Due to the dominant use of the perfect contracting approach of agency theory, which in the limited rules out their influence (cf Zingales, 1998), institutional evolved conditions are hardly considered. Most often overlooked in the executive pay literature is the risk of "under socialization" (Granovetter, 1985) when providing accounts of executive pay. Incorporating socially constructed arrangements(i.e. institutions) in accounts of executive pay could provide much-needed additional insights into how corporate governance and pay setting practices operate under different institutional conditions (cf. Aquilera and Jackson, 2003; Conyon and Murphy, 2000; Tosi and Greckhamer, 2004). The problem of under socialization becomes especially apparent when considering that most empirical research on executive pay uses US data. Generalizations of theories and conclusions of these tests, imply that the US example is considered to be the worldwide standard. However, well-known variances between executive pay levels and makeup across countries indicate that the US case, with its relatively very high pay levels and large proportions of pay components that are potentially contingent on performance, is more of an outlier than the worldwide standard (see e.g. Abowd and Bogananno, 1995; Kaplan, 1994; Conyon and Murphy, 2000; Murphy, 1999; Otten, 2007 for examples of large cross-country differences in pay levels and makeup). Thereby certain pay setting practices may be present in certain jurisdictions but not in others. Take for instance the presence of employee representation on the board of directors in large listed German firms, a feature not known in for instance the UK or the US. The very few studies that do incorporate institutional settings in empirical tests or in exploring conclusive accounts of executive pay, clearly indicate that such an approach could be very useful to provide more conclusive explanations (e.g. Conyon and Murphy, 2000; Jensen and Murphy, 2004; Tosi and Greckhamer, 2004; Otten, 2007).

An important theoretical implication of such a view is to consider executive pay as an outcome of pay setting practices rather then as a tool within these practices. Pay setting practices, defined as those firm level processes that serve to set, compare, and implement pay levels and structures, can be understood as being part of more broadly defined corporate governance arrangements. Both the pay setting practices and the corporate governance arrangements in which they are embedded, are developed and contested by developments in societies at large (cf. e.g. Agquilera and Jackson, 2003; Otten; 2007; Perkins and Hendry, 2005; Roe, 2003). The seemingly recent consensus in the literature that executives can exercise their discretion in shaping the pay setting process and subsequently can influence their pay levels and makeup, together with the growing notion from the corporate governance literature that corporate governance systems are socially constructed, provide a more integrated account of observable executive pay in practice. In this way executive pay can be understood as an outcome of firm level processes that are embedded in socially constructed corporate governance arrangements that can vary across countries, between firms and over time.

Individuals can hold different positions of influence in the pay setting process and may hold different opinions, expectations, notions, and perceptions (cf. Jepperson, 1991) about appropriate levels and structures of executive pay for a given firm. Individual influences and attitudes on the firm's institutional environment, firm's processes, and thus on national and firm level corporate governance arrangements, provide a more conclusive explanation of observable executive in practice. Subsequently it provides a more conclusive explanation of the ongoing debate on executive pay as a social phenomenon.

CONCLUSION

The overview of theories on executive pay presented here has addressed 16 different theories. Classifying these theories is problematic. The different theories are overlapping and contradictory at the same time. The theories are also at risk of being oversimplified. Even so, based on the underlying main legitimizing arguments of the theories, an assessment is made of their usefulness for explaining executive pay levels and makeup. The differences in the theories with regard to their focuses for legitimizing arguments and the roles they give to pay resulted in a classification of 3 approaches; 1) the value approach, 2) the agency approach, and 3) the symbolic approach. The focuses of these approaches are regarding questions of how much to pay, how to pay, and what pay ought to represent or reflect, respectively.

The value approach main arguments for legitimizing executive pay are based upon market mechanisms and market forces. The main contribution of this value approach is the insight it provides into how economic theory can contribute to a general understanding of markets and market inefficiencies in determining executive pay. This approach is, however, less capable of providing irrefutable explanations for executive pay when addressing the question how decisions on pay are made. The value approach is incapable of providing explanations regarding questions around actual decisions on executive pay within a framework of corporate governance that at the same time address how corporate governance arrangements are organized within and outside firms.

The theories that comprise the agency approach, clearly indicate the importance of corporate governance arrangements at national and firm levels. Governance problems such as problems of agency, (ex-post) bargaining over (quasi-) rents and governing transactions indicate the need for corporate governance mechanisms. However, the complete contracting view of the firm is too narrow and result in the inability to raise questions about the centralized institutional configurations in which a perfect contract is made up. A power based view, one of the two sub-streams in the agency approach, indicates that power relationships between the actors involved influence both the pay setting practices and their outcomes. This approach, however, still mainly considers the firm as a nexus of explicit contracts. This is turn results in a conceptual problem regarding questions about the hierarchical structure within firms and the implications for corporate governance arrangements. According to the agency approach, explaining and hereby legitimizing executive pay is based on 1) the implication that executive pay is subject to risks and 2) possible discretionary powers of the actors involved.

The symbolic approach provides additional insights into the concept of pay as a social phenomenon. Decisions on pay in this approach are based on an institutional approach. The symbol of certain pay levels and structures reflects the contextual role of an executive in the firm and/or in society. At the same time, and possibly also problematic within this approach, is the normative inclined social construction of pay levels and makeup. The normative inclinations in this approach point out the problems of legitimizing executive pay in practice. Nevertheless, positive theoretical (economic) arguments play a background role in these theories. The legitimization of executive pay in this approach is based on arguments that address socially (or social-economically) normative constructed beliefs. The symbols that pay represents reflect the social belief of what is "appropriate" to pay an executive and what the executive role constitutes.

Most often overlooked in the executive pay literature, and especially in empirical studies, is the acquired notion that institutions influence and are influenced by decisions on executive pay. A more conclusive explanation of executive pay seems to rely on considering executive pay to be an outcome of pay setting practices. Pay setting practices, those firm level processes that serve to set, compare, and implement pay levels and structures, can differ from firm to firm and from country to country. Social configurations of tangible and intangible institutions co-determine corporate governance arrangements in which pay setting practices play a central role. Such an approach enables to incorporate socially constructed corporate governance arrangements in accounts of executive pay. It captures the apparent consensus in the literature that executive pay is an outcome of institutionally evolved corporate governance arrangements, rather than a tool within these arrangements. The comparative corporate governance literature suggests that the relative balance of power in society determines the configuration of institutions that influence how corporate governance arrangements function and how they develop (e.g. Roe, 2003). The seemingly consensus in theorizing on executive pay furthermore points out that executives have discretion over their pay setting practices and can influence their own pay levels and structures and that of others. In contrast to the dominant use of the perfect contracting approach, the executive pay literature seems to be hading into the direction of considering executive pay as an outcome of pay setting practices, embedded in socially constructed corporate governance arrangements over which the actors involved can influence their institutionally constructed discretion.

Table 1

Executive pay and theoretical approaches

Value approach		*Agency approach*		*Symbolic approach*	
Theory	***Role of Pay***	***Theory***	***Role of Pay***	***Theory***	***Role of Pay***
Marginal Productivity Theory	Value of input equal to marginal revenue productivity; equal to equilibrium on market	*Complete Contract Theory (Group 1)*	Overcome incentive misalignment; based on risk preferences	*Tournament Theory*	Highest price in a contest, motivation for lower level employees
Efficiency wage Theory	Idem Marginal Productivity plus incentive to increase productivity and reduce turnover	*Prospect Theory (Group 1)*	Incentive alignment caused by loss aversion preferences	*Figurehead Theory*	Token of executive's mandate and as accomplishment
Human Capital Theory	Value of capabilities and skills on the market	*Managerial Theory (Group 2)*	Exhibit of power when negotiating contract	*Stewardship Theory*	Secondary, intrinsic motivation is of more importance
Opportunity Cost Theory	The opportunity cost of next best alternative for the executive	*Class Hegemony Theory (Group 2)*	Use of power and protection of managerial class	*Crowding-out Theory*	Part of extrinsic motivation
Superstar Theory	Disproportionate pay for imperfect substitution			*Socially Enacted Proportionality Theory*	Result of socially normative proportion differences of socially enacted hierarchical levels
				Social Comparison Theory	Based on pay of comparable executives. Likely above going rate of benchmark
				Implicit / Psychological Contract Theory	Symbol of appreciation, accomplishment and dignity

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