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Relational Signalling and the Rise of CEO Compensation "…It is Not Just About Money, It is About What the Money Says…"

Kees van Veen, Rafael Wittek

The continuous rise in CEO compensation over the past few decades has been attributed either to efficient labor market processes (efficient market theories) or to corporate governance failures leading to insufficient control of boards over CEOs (managerial power theories). We argue that both approaches are incomplete and fail to explain why executive compensation remained stable for almost forty years, before it suddenly started to increase in the early 1980s. We present an alternative framework that complements both approaches, relational signalling theory. It conceives the transactions between boards and CEOs as a "gift exchange relationship" and explains the consistent use of premiums on top of reservation wages as an inherent element of the exchange. We argue that the sudden and subsequently continuous rise of CEO compensation is due to a major change in the signalling environment caused by the requirement to publicly disclose perquisites, introduced by the SEC in 1977.

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Introduction

Since the beginning of the 1980s, CEO compensation levels have risen dramatically in both absolute and relative numbers. This rise is especially obvious in the U.S., where companies have to disclose CEO's compensation packages. As can be seen in Figure 1, CEO compensation levels were quite stable in the period 1940–1970. After that, they quickly started to rise, and they have continued to do so until today (Frydman and Saks, 2010). Other sources report similar trends concerning the absolute compensation levels (Walsh, 2008): "…the average CEO in the S&P 500 made $14.2 million in 2007." And, relatively speaking: "…the average CEO made 42 times the average worker's salary in 1980, the ratio increased to 107 in 1990 and 525 in 2000. The latest data (for 2006) put the ratio at 364." According to the New York Times, the compensation levels in the USA soared again in 2010, after a short decrease in 2009 caused by the financial crisis[1]. Although these enormous leaps might be most prominent in the USA, the same phenomenon can also be observed in other countries (i.e., Van Uffelen, 2008; Van der Laan et al., 2010; Conyon and Schwalbach, 2000).

Insight into the mechanisms behind this trend is important to understand the labor market of top executives (Filatotchev and Boyd, 2009; Van Ees et al., 2009), the underlying board processes (Tosi and Gomez-Mejia, 1989), and more general legitimacy issues concerning "excessive" executive compensation and rising inequalities. As a result, an extensive debate has unfolded concerning the question of why these compensation levels have been rising so drastically in a relatively short period[2].

Two prominent explanations dominate this debate. First, efficient market theories (EMT) consider the rise of CEO pay as a natural consequence of fluctuations in supply and demand on the executive labor market: boards react to an increased shortage of executive skills (Murphy and Zábojník, 2004) or increase their efforts to control the CEO (Hermalin, 2005). Second, the managerial power theory (MPT), most prominently represented by Bebchuk and Fried (2006), insists that failing corporate governance is the root cause of the rise in compensation levels. Corporate governance systems incorporate an unbalanced power distribution in the board, which creates opportunities for powerful CEOs to dominate the negotiations about their own compensation. In their bargaining efforts with the CEO, boards fail in their attempts to prevent excessive compensation packages even though that is what shareholders expect them to do.

[1] New York Times, http://www.nytimes.com/2011/04/10/business/10comp.html (accessed 17 May 2011).

[2] In the Web of Science, until 1980, an average of one publication a year had the words "executive compensation" or "CEO pay" or "CEO compensation" in the title. In the thirty years that followed, this figure gradually increased to thirty in 2011.

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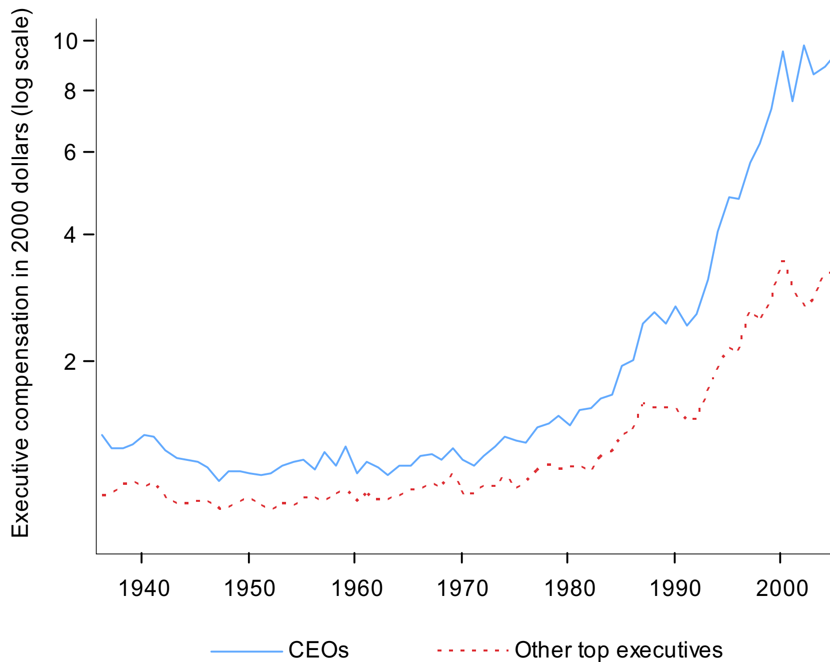

Figure 1. Median Compensation of CEOs and Other Top Officers from 1936 to 2005
Figure 1 shows the median level of total compensation in a sample of the three highest-paid officers in the largest 50 firms in 1940, 1960 and 1990 (for a total of 101 firms). Firms are selected according to total sales in 1960 and 1990, and according to market value in 1940. Compensation data is hand-collected for all available years from 1936 to 1992; the S&P ExecuComp database is used to extend the data to 2005 (Frydman and Saks, 2010). Total compensation is composed of salary, bonuses, long-term bonus payments (including grants of restricted stock), and stock option grants (valued using Black-Scholes). The CEO is identified as the president of the company in firms where the CEO title is not used. "Other top officers" include any executives among the three highest paid who are not the CEO. All dollar values are in inflation-adjusted 2000 dollars

Both approaches provide competing explanations for organizational governance and boardroom processes in general and the rise in compensation levels during the past decades in particular. However, we argue that, although these conditions might be sufficient, they are not necessary to explain the upward trend. We argue that both are incomplete and fail to resolve important puzzles in the field. For example, both have difficulties in explaining why compensation levels a) remained stable for almost forty years (from 1940 to 1979), and b) suddenly increased and continued to rise in the thirty-year period that followed (from 1980 to 2010). Hence, an alternative theoretical perspective is needed that is able to explain *both* the long-term stability and the sudden and ongoing rise of CEO compensation developments.

Relational signalling theory (RST) provides such an alternative by delivering a powerful explanation for these phenomena. Not only because it incorporates an alternative labor market dynamic that pushes compensation levels up. Unlike earlier approaches, it delivers an explanation for the relative stability of compensation levels in the period 1940–1979 and the sudden upward break around 1980. Relational signalling theory defines compensation packages not so much as a monetary arm's-length transaction, but as one part of a necessary and ongoing gift exchange relationship between the board and the CEO. In such a dyadic gift exchange relationship, it is not only the absolute size of a compensation package that matters but also its signalling value. Put differently, in the illustrative words of an interviewed board member in the UK: "it's not just about money; it is about what the money says" (Perkins and Hendry, 2005).

Consequently, RST suggests that it was a change in the signalling environment that triggered the sudden and still-ongoing rise in CEO pay: the legal requirement for public disclosure of CEO *perquisites,* as introduced by the SEC in its release No. 5856 on August 18, 1977 (*pay* disclosure for top executives of publicly traded companies had already become enforceable in 1934; for a detailed reconstruction, see Conyon et al., 2013). We argue that up until then, boards used non-monetary perquisites to signal their commitment to the CEO. These perquisites were difficult to compare between CEOs yet costly enough to the company to be used as a relational signal. After that date, perquisites were publicly disclosed, which made them highly comparable. In order to credibly signal their commitment through gift giving, boards had little other options than to increase the size of the compensation in such a way that it compared favorably to compensation packages for similar companies. It is the increasing importance of the status value of the compensation package that pushed compensation levels above market wages and fuels their continuing upward trend.

Our study makes three distinct contributions to the CEO compensation debate. First, we introduce a new perspective for the analysis of corporate governance and especially the CEO compensation debate. The relational signalling perspective relates to earlier suggestions that signalling matters to corporate governance (i.e., Connelly et al., 2011) and to the exchange relationship between the board and the CEO (i.e., O'Reilly and Main, 2010). However, RST offers a more advanced

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