THEORIES OF EXECUTIVE REMUNERATION

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Abstract

The aim of the article is to present the theories of remuneration. Both classical and modern theories are presented within their time and economic environment. The anchor of article is the model principal-agent and reducing asymmetric information through remuneration.

The conclusions of the article define a wide range of theories. All theories aim to solve the principal-agent problem through a new tool - the remuneration. The nuances of individual theories can be determined from the different periods of their occurrence and from the dominant economic environment for the essence of the remuneration.

Keywords: corporate governance, information asymmetry, principal-agent

JEL Codes: D82, G35, J33, M12

Introduction

The effects of global financial crisis have led to efforts to reassess the principles and requirements for remuneration policies and practices. There is a need to analyze and assess the modern situation and to outline the challenges of introducing new good practices for remuneration at international level.

At the core of modern remuneration theories, long-term interest in the financial results of the company is set. The reassessment of remuneration theories occupies an important place in the management of anti-crisis development. The main thrust of the changes that emerges from the modern remuneration theories aims at better risk management (Stankovska, Dimitrieska, Stamevska, 2018). The end idea of modern remuneration theories is to reach a financial stability and a sustainable economic growth.

The presentation of remuneration theories will allow revealing the negative consequences of the construction of existing pay systems, underpinning the incentive to undertake excessive risk.

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Classical theories of executive remuneration

The Industrial Revolution (XVIII century) has led to the expansion of companies’ activities and the emergence of the need to employ executives to manage the family business (Madgerova, Kyurova, 2014). The separation of management and ownership determines the existence of information asymmetry, which can be reduced by a new tool - the formation of executives’ remuneration.

In classical economics, Adam Smith considers the executive’s remuneration and defines it as the value of his control and management work. The formation of remuneration is not directly dependent on the size of managed capital, but is determined by skills and trust in the executive. To align the interests, profit is distributed as a dividend to shareholders and a remuneration for executives.

At a later stage, John Stuart Mill defined the profit as a “remuneration for labor”, i.e. a wage for shareholders. In the spirit of Utilitarianism, J. Mill offered a protection of certain social causes by criticizing taxes and as a private case of the progressive system – a proposal to eliminate the remuneration of executives according to profits and to introduce the co-operative remuneration system.

At the end of the 19th century, Alfred Marshall defined the economy as a positive science. He further develops market demand and supply by defining “management salary” for executives as a premium for the undertaken risk.

After the effects of the Great Depression, the concept of executives’ remuneration changes. The pioneer work of A. Berle and G. Means (Berle, Means, 1932) puts accent on maximizing of shareholders’ wealth - people unknown and without power. Neo-Economics has the following views on remuneration:

- The content of remuneration is expand and already includes incomes and prestige for executives (Galbrait, 1987). On executives’ agenda is the size of the company, which provide a power equivalent to the salary. Led by such motives, executives initiate a wave of mergers and acquisitions (Filipova, 2010).

- Similar to the classical economy, one of the main tools of competitive advantage is to reduce employees’ salaries in order to increase the shares’ cost (Georgiev, 2013). A new point in economics is begin for comparing the executives’ and employees’ salaries.

- According to the Theory of imperfect contract, the focus is on incentives other than company characteristics that stimulate an optimal outcome. As a perfect incentive system, the motivation of the sole trader in the classical economy is mentioned. A new form of agent problem emerges – the executives use profits for their empire-building projects instead of increasing the wealth of the shareholder (Bratton, 2001).
Modern theories of executive remuneration

The remuneration of the executives enter into researches in the years of the World War I due to nationalization of the railway companies in the United States. Public disclosure of remuneration information began in the 1920s for railway and bank executives through the mass press (Borisova, 2017).

In the 1930s, all sectors began to disclose information on the remuneration of executives. The rationale for expanding information is the effects of the Great Depression and the requirement of information from US supervisory authorities. At a later stage, with the establishment of the Securities and Exchange Commission in 1934, the supervision of remuneration practices was centralized.

In the 1960s, a significant share of the remuneration was provide in options and parallel long-term incentives were introduce. The last change, the extension of remuneration period, was define by the tax policy and the growth of the market value of the companies. The structure of executive remuneration changes to balance the interests of principal and agent (Frydman, Saks, 2005).

In the 1970s, unlike previous periods, remuneration followed the development of economy and the growth of companies (Frydman, Saks, 2005). Modern theories of executives’ remuneration have marked their beginnings since the 1970s due to the lack of dependence between remuneration and performance (Nelson, Gallery, Reza, 2011):

- According to the model of B. Holmström (Holmström, 1979), the optimal contract between principal and agent increases the principal’ wealth if there are signals that are recognizable by the principal. Such signals are the agent’s compensation for his efforts. As the main tool for balancing the interests between principal and agent, the binding of remuneration and results is indicated (Holmström, 1999). For companies in the same sector, the optimal compensation scheme for executives is to compare results to other companies (Nedelcheva, 2016).

- According to the Principal-agent theory, the optimal remuneration contract should include internal debt to avoid the shareholder-debenture holder conflict (Edmans, Gabaix, 2009). In cases where the remuneration is only in shares, then executives have an incentive to increase company risk above the level preferred by bondholders and transferring wealth from bondholders to shareholders (John, John, 1993).

The 1980s are characterized by a focus on the personal and professional traits of executives in determining their remuneration (Keremidchiev, 2017). A number of correlations such as age-income and experience-bonus have been identified (Driver, Thompson, 2018). These theories are carried-out for individual countries instead of for specific sectors and companies (Escosura, Rosés, 2003).

Since the 1990s, researches has been geared not only to the level but also to the structure of executives’ remuneration (Conyon, Schwalbach, 2000). In practice, the theoretical point of view for reducing the conflict between principal and agent through the
remuneration begins to be imposed. According to the contract theory, the contract is incomplete due to the specificities of the executives’ activity compared to employees (Holmström, Milgrom, 1991):

- results are difficult for approval;
- objectives are multidimensional to be provided for in the contract;
- some of the activities are not disclosed and are kept secret, contributing to the company’s benefits.

In the theory of B. Holmström (Holmström, Milgrom, 1987), there is a negative correlation between a rising risk and an incentive remuneration. In contrast to the payment-to-income sensitivity (Jensen, Murphy, 1990), the remuneration should be determined depending on the risk undertaken. An important explanation for his theory is that it refers to a company with dispersed ownership. Indirect reflection of the theory of B. Holmström finds in a study of the formation of remuneration relative to the return on shares and not according to the dominant view - depending on the company’s risk (Aggarwal, Samwick, 1999).

An expanded model of remuneration theory based on optimal negotiation is the theory of self-interest (Bebchuk, Fried, 2004). The theory views an executive as a self-interested person who pay himself a larger remuneration based on the managed capital. The theory is seen as a counterbalance to the information asymmetry and the imperfect contract because executives have control over factors, such as the undertaken risk. According to this theory, the management contracts, including remuneration, must be public and transparent, as the motives are closely relate to factors under the control of management (Weisbach, 2006). Here is the concern the assumption that in mergers the executives of the target company have special benefits (retention of position or high compensations), which exceed the premium received from target shareholders (Hartzell, Ofek, Yermack, 2004).

The practical implication is in the paradox that executives control board members in terms of remuneration. For such a situation are have helped the reconciliation in one person the two functions, a board chairman and a CEO, as well as the small involvement of board members in the company’s activities. Data finds that if one person performs both CEO and board chairman simultaneously, the directors receive greater remuneration (Callahan, Millar, Schulman, 2003). The decisive factor for this conclusion is the presence of dispersed ownership and the accompanying free riding in exercise of control. The little attention that board members pay in carrying out their tasks leads to the so-called “entrenched” executives. Under the entrenched hypothesis, the entrenched executives have too much power over the board members and can set their own remuneration to the detriment of the shareholders. Executives as insiders for corporate governance have the opportunity to abuse not only for their own benefit but also to vote for friends or relatives high salaries, personal expenses, premiums and large pensions at the expense of shareholders (Samuelson, Nordhaus, 1985).
A direct consequence of the self-interested theory is the motive for “pay without performance”. L. Bebchuk and J. Fried describe the agent’s problem not in the separation of ownership and control but in the process of negotiating the remuneration for executives (Bebchuk, Fried, 2004). Namely the power that executives get when negotiating, give them raison to receive rent instead of salary. As a solution to the situation, the authors propose use of compensation committees as well as external indicators such as the labor market and the employees’ opinion. Compensation committees can reduce agent problems by restructuring incentive plans to align the interests of executives and shareholders (Conyon, He, 2004). The alignment of interests of executives and shareholders can be achieve with independent members of the compensation committee (Nelson, Gallery, Reza, 2011).

Another variety of the optimal contract is the hypothesis of career impact (Gibbons, Murphy, 1992). The optimal contract is presented as explicit motives and implicit arrangements such as professional career. In this perspective, the executives are preliminary motivated in their professional development by creating a reputation in the labor market (Nedeltchev, 2004). Namely, this reputation partly replaces an explicitly stimulating contract. Over time, the executives are driven by the “pay-performance” motive to compensate for declining career opportunity.

Finally, there are theories that seeks a correlation between the qualities and remuneration of executives (Stoimenova et al., 2014). Some authors (Custódio, Ferreira, Matos, 2011) prove that in case of hiring an external executive the remuneration exceeds that of an internal executive. Other authors (Murphy, Zábojník, 2004) set a greater remuneration for executives with a broad range of knowledge that transcends the boundaries of a sector of the economy, and in case the executive director has experience in more than one company or sector. An additional argument for increased remuneration is the requirement in recent years for a wide range of knowledge rather than special knowledge (Murphy, Zábojník, 2008). This new moment for executives’ market is define because of the industrial deregulation (Hubbard, Palia, 1995) and the foreign competition (Cuñat, Guadalupe, 2009). The executives' remuneration is set before the deregulation from the market price, a premium of 1.65 per mille from the stock price (Murphy, 1999), and from the investments after the deregulation (Smith, Watts, 1992).

Other argument for shift in executives' market is the transition to a knowledge-based economy where technology and managerial practices increase corporate value (Garicano, Rossi-Hansberg, 2006). Therefore, the increase in remuneration reflects the company's growth from mergers and hiring executives-talents (Gabaix, Landier, 2006).

There is in the specialized literature a focus that analyzes the relationship between remuneration and the following corporate characteristics (Elston, Goldberg, 2003):
- profit and growth of the company (Patton, 1951);
- sales instead of profit (Roberts, 1956);
- market concentration and barriers to entry (Auerbach, Siegfried, 1974);
- cost per share instead of accounting results (Masson, 1971);
- institutional shareholders and levels of remuneration (Hartzell, Starks, 2003);
- hierarchical position and the company size (Conyon, Schwalbach, 2000);
- trend to prestige, which is expressed in the extended number of subordinate employees (Galbraith, 1987);
- rating by the supervisory authority (John, Mehran, Qian, 2007).

The second branch of the theories for results, risk and remuneration analyzes the opposite possibility - the impact of remuneration on risk behaviors and indirectly on the overall risk exposure of the company (Houbenova-Delisivkova, 2017). The focus of the literature is whether remuneration with options or shares leads to undertaking risk by executives. According to the data, remuneration with options does not entail any more risk (Ross, 2004). Other data indicates that share-based remuneration reduces principal-agent conflict, but does not produce better results (Fahlenbrach, Stulz, 2011). Shareholders use accounting data instead of stock market data to determine the remuneration of executives (Heimes, Seemann, 2011).

**Conclusion and Recommendations**

Remuneration linked to taking excessive risk is one of the causes of the global financial crisis. The modern theories aim to reconcile incentives with long-term viability and prudent risk management by improving the remuneration structure. The new remuneration framework is tied to long-term results and a reduction in risk appetite. The directors should be serve their function for control over executives. The shareholders will be involved in the adoption of remuneration policies and the control of remuneration is entrust to the supervisory authorities and auditors (Tsvetanova, 2014).

The re-evaluation of current remuneration practices occupies an important place in the management of anti-crisis development. The main direction of the changes that emerges in remuneration systems is for better manage risk. New remuneration policies and practices would lead to financial stability and sustainable growth at the international level.

**REFERENCES**


