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 maximiizing 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).

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