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Agency Theory and Executive Pay

The Remuneration Committee's Dilemma

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Chapter 5 is based in part upon my article entitled “Applying economic psychology to the problem of executive compensation” published in 2017 in *The Psychologist-Manager Journal*, 20 (4), pp. 195–207. Other material is drawn from Chapter 3 of my book *The Economic Psychology of Incentives* published in 2015 by Palgrave Macmillan.

London, UK

Alexander Pepper

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CHAPTER 1

Agency Costs, Coordination Problems, and the Remuneration Committee's Dilemma

Abstract This chapter provides a context for the rest of the book, explaining what is meant by the problem of executive pay, how agency theory has contributed to the problem rather than solved it, and how the critique of agency theory set out in the following chapters might help to solve the problem.

Keywords Theory of the firm • Agency theory • Executive pay

INTRODUCTION

Michael Jensen and William Meckling began their famous article, “Theory of the firm: managerial behavior, agency costs, and ownership structure”, which was published in the *Journal of Financial Economics* in 1976, with a quotation from Adam Smith’s *The Wealth of Nations*:

The directors of such companies, however, being the managers rather of other people’s money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master’s honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

Adam Smith (1776) *An Inquiry into the Nature and Causes of the Wealth of Nations*. Book V, Chapter 1, Part III

This much-quoted paragraph appears towards the end of Smith's book in a chapter entitled *On the expenses of public works and public institutions*, which discusses a series of topics that modern economists still wrestle with: the provision of public goods such as roads, bridges, canals, and harbours; collective action problems, where the costs of actions which benefit many fall disproportionately on a few; monopolies—which should be permitted, which discouraged, and how they should be regulated; and agency problems in public corporations, where costs arise because of the different interests of stockholders and managers. Two of these topics—agency problems and collective action—lie at the heart of this short book.

In the language of modern economic theory, agency costs arise when one or more person(s), the principal(s), engage(s) another person or persons, the agent(s), to perform some activity on their behalf, such that decision-making authority is substantially delegated by the principal to the agent. If both persons are utility maximisers, then there is good reason to believe that the agent will not always act in the interests of the principal, resulting in costs—agency costs—which are typically borne by the principal. A specific example of a principal-agent relationship, according to modern economists, is the contractual arrangement between the shareholders and managers of a public corporation.¹

Adam Smith argued that because the managers of a public corporation do not have the same proprietorial interests as (active) partners in a (trading) partnership they could not be expected to exercise the same level of care and attention in their management of the enterprise. The inevitable result, he concluded, is “negligence and profusion” or, in other words, ineffectiveness and inefficiency. He goes on to argue that joint-stock companies have seldom succeeded without “excessive privilege”, such as monopoly trading rights, and he suggests that, even when granted such excessive privilege, they have often mismanaged their enterprises. Adolf Berle (a lawyer and legal scholar) and Gardiner Means (an economist and Berle's one-time research assistant) reached a similar conclusion in their seminal text *The Modern Corporation and Private Property*,² which examines the nature of ownership and control of large corporations in the

¹Jensen, M., & Meckling, W. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, 3 (4), pp. 305–360.

²Berle, A., & Means, G. (1932). *The Modern Corporation and Private Property*. New York: Macmillan.

United States in the 1930s. They argued that the dispersal of shareholdings in public corporations fundamentally undermined the unity of property rights. Small shareholders holding only fractional property rights over corporations had little incentive or ability to influence the day-to-day management of a company or to hold the managers accountable. Berle and Means identified three different types of relationship comprised in any enterprise: (1) “having an interest in” (in the sense of “Person X has an interest in Enterprise E”, i.e., some kind of legal property right); (2) “having power over” (“X has power over E”, i.e., de facto possession and control, in the sense of “possession being nine-tenths of the law”); and (3) “acting with respect to” (in other words, “managing”, in the sense of “X has the right to manage the day-to-day activities of E”). They go on to describe the evolution of the modern corporation in North America in the following terms. Before the industrial revolution, (1), (2), and (3) were combined and held by the same person or persons. In the nineteenth century, (3) became separated from (1) and (2) with the rise of the professional manager in, for example, the railroad, oil, and steel industries; however, legal and de facto ownership, that is, (1) and (2), remained firmly in the hands of the industrial barons—the Vanderbilts, Rockefellers, Carnegies, and others. In the twentieth century the dispersion of stock ownership over ever-greater numbers of stockholders caused “interest in”, that is, (1) to become separated from “power over”, that is, (2), so that stockholders became, in the words of Berle and Means, “owners without appreciable control”. This power vacuum encouraged managers to exercise greater influence over the enterprises that they managed, described by Berle and Means as “control without appreciable ownership”.³

It might be said that *The Modern Corporation and Private Property* is long on analysis of the problems of dispersed ownership but relatively short on possible recommendations. Berle and Means do describe (remembering again that they were writing in the early 1930s) three possible futures. First, the traditional logic of property rights, whereby corporations “belong” to their shareholders, might be substantially reinforced, such that managers controlling corporations are placed explicitly in the position of trustees who are required to operate the corporation for the sole benefit of shareholders; although Berle and Means are silent on the point, this would presumably require corporate law and securities

³ Both quotations in this paragraph are from Berle and Means (1932) p. 121.

regulation to be tightened to make these objectives specific. Alternatively, the inexorable logic of laissez-faire economics and pursuit of the profit motive might lead to “drastic conclusions”:

If, by reason of these new relationships, the men in control of a corporation can operate it in their own interests, and can divert a portion of the asset fund of income stream to their own uses, such is their privilege. Under this view, since the new powers have been acquired on a quasi-contractual basis, the security holders have agreed in advance to any losses which they may suffer by reason of such use.⁴

To put it another way, if shareholders’ reasonable expectations are satisfied in terms of (1) receiving regular dividends and (2) having the ability to release the value of their shares at any time by selling them on a stock market, then the rent-seeking activities of managers should be regarded as an inevitable and acceptable cost of investing in company shares. This hardly seems a desirable conclusion.

However, Berle and Means do also briefly set out a third possibility, which is frequently overlooked.⁵ This is that public corporations could be run in the interests of society as a whole, rather than primarily in the interests of shareholders and managers:

When a convincing system of community obligations is worked out and is generally accepted, in that moment the passive property right of today must yield before the larger interests of society. Should the corporate leaders, for example, set forth a program comprising fair wages, security to employees, reasonable service to their public, and stabilization of business, all of which would divert a portion of profits from the owners of passive property, and should the community generally accept such a scheme as a logical and human solution of industrial difficulties, the interests of passive property owners would have to give way. Courts would almost of necessity be forced to recognize the result, justifying it by whatever of the many legal theories they might choose. It is conceivable, – indeed it seems almost essential if the corporate system is to survive, – that the “control” of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion

⁴ Berle and Means (1932) p. 354.

⁵ Bratton, W., & Wachter, M. (2010). Tracking Berle’s footsteps: the trail of the Modern Corporation’s last chapter. *Seattle University Law Review*, 33(4), pp. 849–875.

of the income stream on the basis of public policy rather than private cupidity.⁶

Sadly, Berle and Means do not really develop their thesis; in particular, they do not explain how it might come about. But I shall return to this final and largely forgotten chapter of *The Modern Corporation* later in this book as I discuss how agency theory might be repaired and corporate governance systems redesigned for the twenty-first century.

The problem of executive pay is central to this book. By “the problem” I mean: (1) pay inflation; (2) the extent to which executive pay is contributing to growing inequality; and (3) public disquiet about how much public corporations pay their top executives. I regard executive pay as a “presenting problem”, in the sense that it is the immediate, highly visible, issue of the moment with current corporate governance practice, but it is not the only matter of concern. Commentators have pointed out other problems with contemporary Western corporate governance policy and practice, including short-termism (the way that financial markets force the hands of corporate managers by emphasising the importance of short-term gains over long-term benefits) and sustainability (the apparent inability of corporate governance systems to deal with negative externalities such as pollution and climate change, and the lack of focus generally on corporate social responsibility).⁷

Some people will argue that the level of executive pay is market driven and has nothing to do with agency theory or business ethics. This is not a satisfactory argument for a number of reasons. According to standard microeconomic theory, an efficient market requires many buyers and

⁶Berle and Means (1932) p. 356.

⁷The economist John Kay conducted a review of the long-term performance and governance of UK quoted companies at the request Secretary of State for Business, Innovation and Skills between June 2011 and July 2012, leading to the publication of the Kay report (Kay 2012). Professor Colin Mayer’s book, *Firm Commitment: Why the Corporation is Failing Us and How to Restore Trust in it*, published in 2013, covers similar ground. More recently, The Purposeful Company Task Force, a consortium of FTSE companies, investment companies, business schools, business consultancies, and policy makers, sponsored by the Big Innovation Centre, has investigated how corporate governance and the capital markets environment in the UK could be enhanced to support the development of value-generating companies, acting with a purpose for the long-term benefit of all stakeholders (Chapman et al. 2017). The Purposeful Company Task Force has also produced a report specifically on the subject of executive remuneration.

sellers, homogeneous products (or at least good substitutes), free market entry and exit, plentiful information, and little economic friction (any factors that inhibit the free operation of the market). The trouble with the market for senior executives is that practically none of these conditions holds good. At any one time only a few top jobs may be open, and only a limited number of suitable candidates may be available. No two senior executives are the same and information about them is far from perfect. Information about prices (what executives are paid) is far from perfect too, despite the best endeavours of governments and regulators in recent years. Finally, all sorts of legal, tax, and accounting factors have an impact on the way senior executives are paid and the types of contracts companies chose to enter into with them. So the standard theory of supply and demand has only a limited amount to say that is helpful about the question of executive pay. Senior executive pay is, on the face of it, certainly at the top end, an example of a “market failure”.⁸ The labour market for very senior executives does not work efficiently.

It is a curious feature of free markets that in many trades, professions, and occupations the few at the top often earn many times more than the average; in statistical terms, the arithmetic mean (the total of everyone’s earnings divided by the number of people in the relevant category) is significantly higher than the median (the mid point in terms of ranking). This phenomenon, which two American economists have called “winner-takes-all”,⁹ is most noticeable in professional sport. Why do top rank football, basketball, or baseball players earn more in a week than the majority of similar professionals earn in a year? If all the players of a particular sport earned modest amounts, then the coach of one team might reason as follows. If he was able to pay well above the odds, then he would be able to recruit the best players, win lots of trophies, attract large crowds, and secure the best sponsorship deals. The trouble is that other coaches will reason in the same way so that paying high wages becomes a dominant strategy. This is an example of a prisoner’s dilemma, where the inevitable logic of the situation leads to a position that is suboptimal for every team;

⁸Shorter, G., & Labonte, M. (2007). The economics of corporate executive pay. *DigitalCommons@ILR*. Retrieved from digitalcommons.ilr.cornell.edu

⁹Frank, R., & Cook, P. (1985). *The Winner-Takes-All Society: How More and More Americans Compete for Ever Fewer and Bigger Prizes, Encouraging Economic Waste, Income Inequality, and an Impoverished Cultural Life*. Free Press.