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Negotiating executive pay: How can psychological theories complement classical and behavioural economics?

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ABSTRACT

Agency theory is the dominant economic model in executive pay research, assuming profit-making organisations and rent-seeking agents, whilst dismissing non-pecuniary motivations, behaviour and agent preference entirely. The assumption of rationality continues to underpin the design of executive compensation, despite ongoing criticism that the validity of agency theory is not represented in the empirical research. This literature review considers both economic and behavioural research in the context of executive pay. Furthermore, it argues in favour of challenging the status quo in a manner which is both different and complementary to the current rational choice models, and which recognises certain pay-related judgements are psychological in nature where individuals are constantly driven to evaluate their own options and abilities.

Key words: executive, pay, agency, behavioural, economics, psychology

LITERATURE REVIEW

The financial economic perspective

Agency theory is the dominant theory underpinning research on senior executive reward in general, and incentives in particular (Fama & Jensen, 1983; Jensen, 1986; Jensen & Meckling, 1976; Jensen & Murphy, 2004; Murphy, 1999). It focuses on the efficiency outcomes of compensation arrangements for the benefit of shareholders seeking a return on investment and is the basis from which much corporate governance research is constructed (Filatotchev & Allcock, 2010).

Classical agency theory assumes profit-making organisations, financially motivated, or “rent-seeking” managers, and dismisses non-pecuniary motivations (e.g. achievement, recognition, responsibility, influence and personal growth) entirely (Besley & Ghatak, 2005). These factors characterise a relationship where the owners or shareholder of a firm, the “Principals”, delegate the running of the company to managers, the “Agents”, who are employed by the company (Fama, 1980; Jensen & Meckling, 1976). This distinction between company ownership and control establishes the “agency relationship”, characterised by a linear dynamic between pay and performance whereby an agent’s utility is positively contingent on efforts (Jensen & Meckling, 1976). Thus, the greater component of compensation in the form of incentives, the better the principal-agent alignment.

The separation of ownership and control gives rise to the “agency problem”, an asymmetry of information between the Principals and Agents, from which emerges an opportunity for Agents to engage in self-serving behaviour (Berle & Means, 1932; Bruce, Buck & Main, 2005). CEOs may, for example, engage in empire building, hoarding cash, or resorting to entrenching actions (Bebchuck & Fried, 2004). The outcome of such broadly divergent interests and differing attitudes towards risk is

referred to as the “agency cost”, which reflects the threat posed by such inefficiencies to the value of the corporation concerned (Filatotchev & Allcock, 2010).

In order to address the potential for self-serving opportunities on the agent’s part, agency theory adopts arm’s-length contracting as a solution to the agency problem and its associated costs. In theory, the threat of intervention by the Board of Directors in listed businesses is assumed to serve as a deterrent to such behaviour. The board partakes in arm’s-length contracting on behalf of the shareholders and corporation, the goal of which is to align pay with performance, thus reducing agency costs whilst simultaneously adding to shareholder value and motivating executives. This premise underlies the treatment of executive compensation decisions in corporate law, as well as underpinning the majority of academic research into executive pay (Bebchuck & Fried, 2004; Merchant, van der Stede & Zheng 2003; Werner & Ward, 2004).

Performance sensitivity is the key metric in determining positive organisational outcomes (Bruce et al., 2005) and a well-designed incentive scheme is necessary which serves to counter the agency problem and its associated agency costs is necessary. To that end, a diverse range of corporate governance mechanisms have been developed with this goal in mind, and over the last two decades, long-term equity-based incentives have made up an increasingly large component of total executive compensation (Pepper & Gore, 2015).

Despite agency theory dominating the executive pay literature, it has attracted considerable criticism. Jensen & Murphy (1990) failed to establish a conclusive link between CEO pay and stock performance, whilst Tosi, Werner, Katz & Gomez-Mejia (2000) concluded incentive alignment was of almost negligible utility as an agency construct for CEO pay. Based on a review of US executive compensation data between 1936 and 2005, Frydman & Jenter (2010) argue that agency theory is not consistent with the evidence. Roberts (2010) notes the poor performance of agency theory during the financial crisis and asserts that incentives may actually exacerbate misaligned behaviour which fundamentally undermines the validity of agency theory, particularly where satisfactory performance assessment criteria are lacking, when multitasking is necessary and where inter-agent cooperation is required, all common scenarios in the modern corporation.

Filatotchev & Allcock (2010) describe agency theory as a “closed system” (Filatotchev & Allcock, 2010, p. 21) approach rooted in an Anglo-American context which attempts to establish a universal set of linkages between executive incentive and performance, but devotes little attention to the unique contexts within which individual firms are embedded. However, empirical tests and meta-analyses of these causal linkages have thus far failed to identify consistently significant effects (e.g. Core, Guay & Larcker, 2003; Daily, Dalton & Rajagopalan, 2003; Hall, 2003; Tosi et al., 2000), perhaps to agency theory’s “undercontextualised” nature, abstracting away from important organisational and environmental complexities (Aguilera, Filatotchev, Gospel & Jackson (2008).

Reconciling agency theory with the behavioural perspective

Pepper & Gore (2015) assert that compensation plans which lean heavily toward incentives are neither efficient nor effective. A fundamental flaw in agency theory is that it is firmly rooted in financial economics which assumes “rationality” and current practise in designing executive compensation largely neglects behavioural elements and agent preference. Indeed, agency theory is built on the premise that Agents are both (a) rational and (b) rent-seeking, that organisations are profit-driven and that non-pecuniary motivation is absent (Allcock & Pass, 2006). The standard model of rationality claims to be both descriptive and normative, capturing both how people behave and how they ought to behave in order to accomplish particular objectives in an optimal manner (Wilkinson & Klaes, 2012). However, as Wilkinson & Klaes (2012) observe, why individuals make certain pay-related judgements is actually a psychological issue which can have significant policy implications.

The consideration of psychology in economic theory and financial decision-making (e.g. Fisher, 1930; Pareto, 1935; Keynes, 1936). Keynes (1936) used the term “animal spirits” (Keynes, 1936, p. 161) to refer to a preference for action over inaction, and to describe the impact of confidence and intuition on risk assessment and decision-making over quantitative analysis. Since the mid twentieth century, however, economists have favoured mathematical rigour and reduced

behaviour to a few simplified assumptions. A re-assessment of the validity and application of the standard agency model, however, has given rise to a number of alternative conceptualisations of rationality aimed at more adequately accounting for observed economic behaviour against a backdrop of complex environmental and psychological scenarios (Wilkinson & Klaes, 2012).

Hall & Murphy (2000) argue that executives in mature organisations discount the value of their equity holdings in response to vesting requirements and insider share restrictions which, from a diversification perspective, require them to hold sub-optimal levels of equity.

Filatotchev & Allcock (2010) draw attention to environmental interdependencies of corporate governance. Combining behavioural agency models (Wiseman & Bromiley, 1996; Wiseman & Gomez-Mejia, 1998) and Prospect Theory (Kahneman & Tversky, 1979), to provide a psychological variant of subjective expected utility, in the analysis of executive stock options in IPO firms, they conclude that post-IPO restrictions may produce transaction costs which prevent executives from maintaining an optimised portfolio. Using locked-up equity as a reference point for framing problems as either a loss or a gain in a behavioural model, Filatotchev & Allcock (2010) demonstrate executives should exhibit risk-averse preferences when considering the appropriateness of different IPO schemes.

Utilising the assertions of Wiseman & Gomez-Mejia (1998) that prospect theory (Kahneman & Tversky (1979) should be incorporated into the risk assumptions of the standard agency model, to create a behavioural agency framework, Pepper & Gore (2015) propose a “behavioural agency theory” in an attempt to reconcile the differences between executive compensation, agent performance, organisation performance and shareholder interest.

Behavioural agency theory builds on four key elements identified by behavioural economists: (1) loss aversion and reference dependence; (2) preferences related to risky and uncertain outcomes; (3) temporal discounting; and (4) fairness and inequity aversion. The model also integrates motivation crowding theory (Frey & Jegen, 2001), which suggests that pecuniary incentives or punishments may work to either undermine or strengthen intrinsic motivation, in order to address intrinsic versus

extrinsic motivations, as well as goal-setting theory (Locke & Latham, 1990) as a practical mechanism to facilitate principal-agent contracting. Contrary to the standard agency model, behavioural agency theory emphasises agent performance and work motivation, rather than costs and incentive alignment. Specifically, it proposes that the interests of principals and agents will be better aligned if executives are motivated to perform to the best of their abilities within the boundaries of the available opportunities.

Behavioural agency theory measures the relationship between costs and performance through a combination of efficiency and effectiveness criteria, rather than relying on efficiency alone. Non-pecuniary motivation is also accounted for, rendering agents boundedly-rational, loss, risk and uncertainty averse, and managing a trade-off between intrinsic and extrinsic rewards. Finally, rather than assume a linear relationship between pay and motivation, Pepper & Gore (2015) propose a more sophisticated pay-effort relationship which is influenced by loss, risk and uncertainty aversion, discounting of delayed rewards, inequity aversion and an intrinsic-extrinsic motivation trade-off.

Despite the contribution of behavioural agency towards acknowledging reward strategies require an understanding of individual differences between agents with regard to variables such as risk, appetite for risk, inequity aversion and the discounting of future rewards (Pepper & Gore, 2015), agency-based approaches nevertheless represent an extension of prevailing thought rather than a radical overhaul of how the subject of executive compensation is approached.

The reassessment of the validity and applications of classical agency theory has paved the way for alternative conceptions of “rationality” aimed at more adequately accounting for observed economic behaviour against the backdrop of complex scenarios (Wilkinson & Klaes, 2012). Tversky & Kahneman (1986) argue that no theory of choice can simultaneously be normatively and descriptively adequate, but psychological models can increase the explanatory utility of economics by integrating more realistic psychological foundations. Indeed, psychology favours an alternative approach to rationality than that favoured by financial economists, which themselves present challenges for the classical agency model (Wilkinson & Klaes, 2012).

Firstly, the misjudging of what is in our self-interest does not constitute a failure of rationality, rather it reflects decisions which are compromised by incomplete knowledge, cognitive failures or time and is referred to as “bounded rationality” (Simon, 1945). Secondly, Prospect Theory (Kahneman & Tversky, 1979) contends that a heuristic approach to decisions which employ unconscious cognitive shortcuts to manage information and uncertainty suggest that bounded rationality is not concerned with “optimising” so much as “satisfying”. Thirdly, self-serving biases may also result in misjudging what is in our own interests (Wilkinson & Klaes, 2012). Fourthly, “arationality” or instinctive behaviours can neither be categorised as rational nor irrational. Wegner (2002) suggests that unconscious cognition only gives way to conscious processes once we have had sufficient time to reflect and override the automatic response.

Beyond the conscious decision-making assumed in financial economics and the heuristics and instinctive behaviours associated with behavioural economics, a psychological position may argue that the formation of values and beliefs which influence decisions are entirely unconscious and *arational* (Wilkinson & Klaes, 2012). Sen (1990) asserts that the nature of our objectives transcends the confines of rationality, but is captured within the scope of our well-being and happiness. Although Sen (1990) utilises material elements as proxies for wellbeing and refrains from including wider psychological definitions, the argument further extends the notion of the individual as more than just a rational decision-maker.

One area which has been left largely unexplored in the literature concerning executive pay is the process by which executive compensation is determined and, specifically, how social mechanisms play a role in that process. According to social comparison theory, individuals are constantly driven to evaluate their own options and abilities (Festinger, 1954). In the absence of objective criteria, people may look to similar others with whom they can compare and evaluate themselves (Festinger, 1954; Goodman, 1974).

O’Reilly, Main & Crystal (1988) examine the economic and psychological factors influencing CEO compensation, using data from 105 Fortune 500 firms across nine industries. The study tested both tournament and social comparison models, where the former was viewed as an inward-looking

process and the latter as a process open to outside influence. O'Reilly et al. (1988) suggested that social psychological factors played a part in determining CEO compensation, offering the fact that members of the remuneration committee are selected because of their similarity to each other (Festinger, 1954), such as holding CEO positions themselves at other firms, as plausible explanation. Though the results demonstrated no support for tournament theory, strong correlations were found between CEO compensation and the compensation level of outside members of the board of directors, and particularly those holding a position on the remuneration committee, consistent with social comparison theory.

Boivie, Bednar & Barker (2015) offer a social comparison perspective on director compensation which emphasises a team-level reaction to perceived inequity and how social comparison processes affect boards. Boivie et al. (2015) present a theory based on directors' use of social comparison processes using fixed effects linear regression analysis to test the hypothesis that when director compensation at the focal firm is lower than the director compensation of social referents, then director compensation at the focal firm will rise accordingly. In a longitudinal study, Boivie et al. (2015) collected data on 288 firms which maintained membership of the S&P 500 from 1996 to 2005. The dependent variable was the change in the level of director compensation, and the independent variables were home company retainer pay difference, home company total pay difference, interlock total pay difference, and change in CEO compensation. The results demonstrated a correlation between the difference between board compensation at directors' other board appointments or their home firms and the compensation at the focal firm.

Boivie et al. (2015) also found evidence that directors may use themselves in other role contexts, as referent others when constructing social comparisons, and that directors view their other board appointments at the organisations where they hold executive positions, and even the executives of the focal firm as valid social referents, and are likely to engage them as points of comparison. They also demonstrated that director compensation and CEO pay are not independent and that rises in executive pay are positively conditionally correlated with rises in board compensation.

Finally, Boivie et al. (2015) also argue that as boards determine their own compensation, when they engage in social comparison across network ties, they are likely to use this information in a selective and self-serving manner in order to facilitate increases in compensation. This “non-linear diffusion” effect, they assert, is distinct from previous research which suggests that the diffusion of information or practices across board interlock ties suggests replication of policies through ties. The result is that directors are hyper-attuned to network information that suggests they are underpaid, but less sensitive to information suggesting they are adequately compensated, producing an asymmetric flow of information.

BEYOND BOUNDED RATIONALITY – A NEW RESEARCH PROPOSAL

The current executive pay literature is quantitative in nature and typically relies on behavioural proxies abstracted from economic and financial data. Furthermore, though research indicates social processes are a factor, it offers no insight into how the psychological business is being managed by individual agents when considering their own pay. Whilst the establishment of behavioural economics is encouraging, those responsible for researching and designing executive compensation are encouraged to look beyond the limited psychology upon which it is based, and instead consider how social practices and the construction of social identities in relation to pay influence reward-based decision making in executive employees. Such a perspective goes beyond the unconscious and *arational* processes inherent in cognitive judgement and decision-making to incorporating insights from the wider social sciences literature.

The proposed research aims to address these omissions. Researcher access to senior executive participants will facilitate the generation of a rich qualitative dataset drawn from a diverse sample of around fifty individuals. Participants will be employed across several commercial sectors and represent two culturally distinct countries, namely the United Kingdom and Thailand.

Such research is necessary if the status quo is to be challenged and the acknowledged shortfalls in current thinking and practise around determining executive pay addressed in a way that is both different and complementary to the dominant rational choice models where the motivations economic actors can be understood independently of context. This may be achieved by employing a qualitative approach to analyse how individual executives themselves, together with their embodied emotional, social and cultural dimensions, approach the topic of compensation, and specifically how they construct their own individual identities in relation to their pay. For example, Discursive psychology represents a theoretical and analytical approach to discourse which is concerned with psychology as it is lived by individuals in everyday life (Wiggins, 2017). By employing a discursive psychological analysis of the resulting transcripts, it will be possible to investigate how participants deploy language to negotiate and manage social interactions in order to achieve their personal objectives and manage matters of stake and interest pertaining to their own compensation.

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