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Contracts, Markets, Power, and Institutionalism - Explaining CEO Compensation

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Abstract

Chief Executive Officer (CEO) compensation is an issue of great public concern, one which involves acute stratification, and is a question at the heart of theoretical and social characetarizations of the contemporary capitalist system. Yet is is an issue around which there exists no empirical, and to a lesser degree, no theoretical consensus. The field has for a long time been dominated by economic theories, which however have been unable to explain the shape of contemporary CEO compensation. This paper traces the foundations for the dominant theories, agency theory based on contract theory, and examines their explaining power in the light of transaction cost theory as well as theories of power and resource dependency.

In order to create a more comprehensive framework for explaining CEO compensation a breed of institutionalism, drawing on the logic of appropriateness, is introduced. The conclusion is that agency theory by itself is poorly suited to explain the shape of CEO compensation while it does highlight the tension between delegation of authority and monitoring. Other ways that market processes are usurped are discussed, such as network theory.

Keywords: CEO Compensation, Agency Theory, Resource Dependence, Transaction Costs, Institutionalism.

Contents

1 Introduction

Chief Executive Officer (CEO) compensation is an important issue for several reasons. It is an issue of public concern (Walters & Schick, 1995), it is an issue which is heavily researched yet remains unexplained (Boyd, 1994), (Hambrick & Finkelstein., 1995), (GomezMejia & Wiseman., 1997) and it is an issue that in itself implies stratification. CEO compensation is an issue squarely at the center of the firm and of financial capitalism, salient features of contemporary capitalistic societies. CEO compensation is not only empirically interesting but also highly interesting from a theoretical vantage point. This is because conceptualizations of CEO compensation, both in terms of typical theories deployed as well as typical policy derivatives thereof are a vertex of questions of the degree of the social constructedness of reality. This is a centrally important but complicated issue. Conceptualizations of CEO compensation are at the heart of both a theoretical and a practical debate about the nature of the contemporary economic system.

The research on CEO compensation can be found within several streams. The dominant one is agency theory (Jensen & Meckling., 1976), followed by power perspectives (Bebchuk, 2002). Other perspectives include social comparison and tournament theory (O'Reilly & Crystal, 1988), institutional decoupling (Westphal & Zajac, 1994) and relative social capital (Belliveau *et al.*, 1996).These different approaches have so far been unable to satisfactorily explain the shape of CEO compensation. In fact, the central hypothesis coming out of agency theory has quite famously been firmly refuted (Jensen & Murphy, 1990).

Are CEO:s justifiably high-salaried because of the inherent complexities of their task, and as the result of rational market processes, or are they rent-seekers on the backs of shareholders not to mention other stakeholders, or yet again, is CEO compensation the result of institutional processes and the application of logics of appropriateness? This paper aims to shed light on these questions by developing some of the theoretical issues implicated by these questions. This paper outlines the central tenets of agency and power theory, as well as associated problems, and develops an alternative framework drawing on institutionalism.

2 Market Explanations

The primary market based explanations of CEO compensation are those based on agency theory. This theory in turn is based on certain conceptions of what a firm is, how firms work, and, by extension, how the world works.

2.1 Contracts

Fama takes as a point of departure the view of the firm as a set of contracts among factors of production that (Alchian & Demsetz, 1972) and (Jensen & Meckling., 1976) outline, but goes further:

The firm is just a set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs. (Fama, 1980, p 290). In this ”nexus of contracts” perspective, ownership of the firm is irrelevant. According to Achian and Demsetz, a firm is a contractual structure with

1. joint input production,
2. several input owners,
3. one party who is common to all the contracts of the joint inputs,
4. who has the right to renegotiate any input’s contract independently of contracts with other input owners,
5. who holds the residual claim, and
6. who has the right to sell his central contractual residual status

The central agent is the firm’s owner and the employer. (Alchian & Demsetz, 1972, 783)

Fama however separates the manager, ie the agent of points 3 and 4, and the risk bearer, the agent of points 5 and 6. This is in order both to yield a closer description of a modern corporation, but also to develop a perspective on management and risk bearing as separate factors of production, each with a market for its services that provide both alternative opportunities and motivation toward performance (Fama, 1980, 291).

In this view, a particular firm, or a set of contracts, or a team of cooperating factors of production, is in competition with other firms. It is not clear that it is the risk-bearers who have the greatest interest in the viability of the team. The risk-bearers, as residual claimants, do suffer from the failing of the firm, but they also have access to a market for their services - capital markets - which allow them to hedge against the failing of a particular firm. (Fama, 1980, 291) According to Fama management and labor are also protected by markets, in which rights to their services can be sold in the case of a particular team failing.

Since it is the purpose of management, more so than other factors of production, to ensure the viability of a particular firm, the rates at which management can sell the rights to their services in the market for managerial labor depend on that management's past association with success or failure. The association with success or failure for a CEO or manager becomes information about his or her talents as a manager or CEO. (Fama, 1980, 292) Because of this management will have a higher stake in the success of the team than other team members, according to Fama. The securities market works in the same way, if it works correctly, according to Fama. Against this backdrop Fama poses the fundamental question of to which degree the markets for managerial labor market and securities discipline managers?

According to Fama the outside managerial labor market exerts many pressures on a particular firm to compensate managers according to performance. (Fama, 1980, 292) One of these pressures is that a particular firm is always in the market for new managers, and that these managers will have to be sufficiently induced in order to join. Another pressure is that current managers are free to leave in case they find better conditions elsewhere. (Fama, 1980, 292)

Within a specific firm there is also monitoring. One such form of monitoring is the monitoring of lower managers by higher managers, but there is also a form of monitoring from the bottom and up: There is usually the possibility of a lower manager stepping over a higher manager if this manager is less competent. Moreover, in the nexus of contracts, all managers are concerned with the performance of all other managers because his or her marginal product is most likely a positive function of theirs (Fama, 1980, 293). Most managers stand to gain if the firm performes well. Apart from these forms of monitoring exists the aforementioned

control exerted by the managerial labor market by way of linking wages to past successes or failures.

The body designated for the control of top management is the board of directors (Fama, 1980, 293). Fama argues that a board of directors solely consisting of securities owners is not optimal since, securities owners in general are diversified across securities and therefore lack incentive to scrutinize a particular firm closely enough.

In a situation of competition among top managers, they are perhaps most suited to control the board - the competion amongst them will ensure discipline. However, once in control top managers might decide it is more worth their while to collude and extract security holder wealth. A safeguard against such collusion is so called outside directors. These are viewed as professionals whose task is to oversee top managers, and these outside directors are in turn disciplined by a labor market for their services. In the end, argues Fama, the board is a market-induced institution, and the most likely methods of monitoring are those with the lowest costs. (Fama, 1980, 294)

Another mechanism of controlling top management is the one provided by the market for corporate control. Manne is one proponent of this type of control (Manne, 1965). Fama, however argues that the primary mechanism of control of top managers is the market for managerial control.

2.2 Agency Theory

Agency theory has indeed been deemed the dominating perspective in CEO compensation research. The theory stems from a paper by Jensen and Meckling. They draw upon theories of property rights, agency, and finance and create a conception of the ownership structure of the firm (Jensen & Meckling., 1976, 305). the firm is viewed as a nexus of contracts, which regulate agency relationships. These agency relationships are characterized by a principal delegating decision-making authority to an agent, in order for the agent to act upon the principal's behalf. Since both are utility-maximizers, it is likely that the agent will not act completely in the interest of the principal.

Several costs are incurred through agency relationships. Such costs are the

costs of monitoring the agent for the principal, the cost of bonding for the agent, and the residual cost, which is the cost for the principal of the agent diverging from the optimal path of action in light of the interest of the principal. Jensen and Meckling declare that these agency relationships are quite general (Jensen & Meckling., 1976, 308-309). Furthermore, it makes little or no sense to try to distinguish those things which are ”inside” the firm from those that are ”outside” of it.

This view follows first from the view of Coase that the bounds of the firm is the range of exchanges over which the market system is suppressed and resource allocation is accomplished instead by authority and direction. Those exchanges which can be effectuated to a lower cost in a relationship of authority will be effectuated within a firm, and those that are more expensive, will be effectuated outside, in this view. (Coase, 1937, compare). Jensen and Meckling dispute that authority and direction are the primary means of resource allocation within a firm, and instead

Jensen and Meckling focus their theory on how these contractual arrangements are constructed, in relation to a market for claims to the organization (Jensen & Meckling., 1976, 310).

These claims are the so called residual claims, i.e. claims on the assets and the cash flows of the corporation (Jensen & Meckling., 1976, 311). This market essentially provides the constraints on manager (agent) action. The mechanism by which this works is in the context of publicly traded firms is that if agent (i.e. manager) action diverges much from principal (i.e shareholder) interests, this will show in the value of the stock. Since the stock entails control over the firm, too much divergence will drive the stock price down, thus increasing the incentives for somebody to buy up the stock, gain control of the firm and oust the manager. This mechanism induces optimal contracting in agency relationships, such as the relationship between shareholders and managers.

This would predict that CEO compensation would be associated with firm performance, i.e shareholder wealth. This is what Jensen and Murphy (1990) test for, and it is also the relationship that they find little evidence for (Jensen & Murphy, 1990, 227).

3 Power Perspectives

Another large portion of the CEO compensation literature focuses on the power of managers. One such approach shares the characterization of shareholder-manager relations as agency relationships, but views CEO compensation not as a solution but as part of the problem (Bebchuk, 2002, p 33).

This approach accords managers great power, that CEO:s use to extract rents. Rents are any pay CEO:s receive in excess of what they would receive under a contract that maximizes shareholder value. The more power a CEO has, the more rents will be extracted. Important determinants of managerial power are the ownership structure and composition of boards of directors.

Rent extraction may also result in costs beyond the value of the rents, due to the adoption of inefficient compensation arrangements. (Bebchuk, 2002, p 34).

According to a study by Core et al the ownership structure and characteristics of the board of directors have a substantial association with the level of CEO compensation. CEO compensation levels are higher when the CEO is the board chair, when the board is larger, when a greater percentage of directors are outside directors, and these are appointed by the CEO. CEO compensation is also higher if directors serve on more than three boards. Effects of ownership structure include that the existence of an outside director who owns at least 5% of the shares is associated with a lower level of CEO compensation. (Core, 1999)

These perspectives differ in fundamental ways from the contractual approach to the firm. In fact, according to Alchian and Demsetz the notion that the firm is characterized by the power to settle issues by fiat, authority or by disciplinary action superior to that of the market is delusion (Alchian & Demsetz, 1972, 777). However, by employing a transaction-cost perspective it is possible to reconcile these at first glance very different views. First, let us explore the theoretical basis of power in the firm.

3.1 Firms as Political Coalitions

March argues that the firm is best viewed as a political system. (March, 1962, 663). This argument is buttressed by a basic conception of purposive systems:

1. There are consistent basic units. Each such units has a consistent preference ordering defined over the possible states of the system, and there is a multitude of such states.

2. There is conflict. The preferencee orderings of the elementary units are mutually inconsistent relative to the resources of the system. Conflict arises when the most preferred states of all elementary units cannot simultaneously be realized.

These assumptions can underlie a wide variety of systems, from individuals to groups to organizations, and they can be called conflict systems (March, 1962, 664) An important feature of conflict systems is that they are often nested - the elementary units of one conflict system may be conflict systems in themselves. To still view conflict systems as elementary units of another conflict system, either one of two characterizations of the larger system involved must be made. The preference ordering may be causally antecedent and independent of the decision of the larger system, or, that variation in the behavior of the larger system due to conflict within the elementary units is trivial because of the differences of scale involved. (March, 1962, 665) Let us for now accept this postulate, while keeping the possibility of nestedness in mind.

In order to analyze or describe a conflict system as 'acting', the introduction of a mechanism for conflict resolution needs to be introduced - 'acting' is in this sense the system choosing one preference order over another. There are in general two types of conflict resolution theories. One is to impose a superordinate goal of the system, to the furtherance of which the whole system acts, and the other is to describe a process by which decisions are reached. The latter is typical of the study of political coalitions, while the former often has been applied to firms. (March, 1962, 666)

The imposition of a superordinate goal implies that there is a joint preference ordering for the system, and that the system chooses the preference order that is most preferred. According to March, the analysis of firms as conflict systems by the imposition of a superordinate goal have failed empirically. (March, 1962, 669-670)

The analysis of political systems by the imposition of superordinate goals has likewise suffered from serious problems. In general students of political systems have instead employed process-oriented theories. While there is no consensus, certain general assumptions can be discerned. These are that there are various interest groups in the system and that these interest groups make demands. Furthermore, decisions within the system on resource allocations are made by coalitions of interest groups, and each potential coalition has a certain potential control over the system (March, 1962, 671). The process that is postulated is that a broker, the politician, attempts to organize a coalition of interest groups that is viable.

A coalition is viable when the demands are equal to or less than the resources available to the coalition. (March, 1962, 671-672). Emphasis in such analysis is on power, internal struggle, and expediency, whereas order, cooperation and problem solving is de-emphasized. (March, 1962, 672)

March argues that economic theory of the firm has moved to the imputation of the superordinate goal in order to gain analytic simplicity (at the cost of empirical validity), and the theory of political systems has moved towards process description in order to gain empirical validity (March, 1962, 670).

March develops a theory of the firm as political coalition against this backdrop. In this theory, the executive is a political broker. The composition of the firm is not given, and neither are the goals. They are both the results of negotiations. It should be noted here that in my view the mention of the executive is to emphasize its role of broker, and not to specifically detail the activities of the executive. The firm has a number of potential participants, such as shareholders, employees, etc. Each potential participant make demands on the system, essentially the demands that they want satisfied in order to join the coalition. Since these demands occur along several dimensions they are not completely inconsistent, but since they often also involve scarce resources they are neither completely consistent. The marginal cost of any participant to any coalition can be given by this varying complementarity.

The demands of the participants are subject to two changing properties. The level of demands depend on experience, and attention to demands depend on perception of problems. Furthermore, each potential coalition will be able to extract a certain value from the environment involved (March, 1962, 672-673). What is important here is that there is a potentail for extraction of value, not an exact

specification of which environment, or of what the environment consists of.

The problems then for the executive (or whoever is the broker) is, on the one hand, to select a coalition that has relatively low costs and relative high returns from the environment. On the other hand the broker must structure the payments (i.e. the demands that are met) to the coalition members in such a way that the shifts in demands become conducive to increasing the difference between total demands and total resources. According to March, such a coalition is political as opposed to economic in four ways.

1. The focus of attention shifts from the owners to the actual operators of the coalition. In this view the stockholders are analogous to the citizens of political systems. Their demands form loose constraints on the more active members of the coalition.

2. The non-uniqueness of short run solutions to the coalition problem is emphasized. There exists at any time a number of possible viable solutions.

3. The problem of conflict is not solved by simple payments and agreement on a superordinate goal.

4. Institutional constraints on the solution of the coalition problem are emphasized. These constraints are imposed by the institutionalization of commitments through the organizational structure, precedents and budgets, by the reification of attachments through identification and indoctrination, and by the limitations in coordination and control imposed on an executive.

(March, 1962, p 674-675). The last point is in many ways a glimpse of what is to come later in this paper. For now, the central points are that preferences, i.e. that which lies behind demands, and resources, i.e. which both determines the ability to satisfy demands and the ability to extract values from the environment, are unevenly distributed, and these distributions in turn affect which coalitions are formed.

Let us now turn to another characterization of the firm, one which focuses resources and power.

3.2 Resource Dependence

Pfeffer and Salancik concur with March in the view of organizations as coalitions (Pfeffer & Salancik, 1978, p 24). The maintaining of this coalition is the central task of the organization - the coalition *is* the organization. It is however likely that once established, these coalitions or organizations will persist. Not all participants contribute equally to the coalition, and those participants who contribute whatever behaviors, resources and capabilities that are valued the most come to have more influence and control over the organization. This is also one of the strongest inducements for a participant to provide the most resources. Out of sustained exchange among participants with varying contributions arises the situation where some participants have more power than others. The power of the participant is a function of the dependence of others in the organization on his or her contributions, activities and capabilities. (Pfeffer & Salancik, 1978, p 26-27)

However, it is presumed that all those participating in a given coalition stand to gain from their participation, at least in comparison with participation in other conceivable coalitions. Coalitions or firms are most likely dependent on certain inputs or resources. The importance of these resources vary along two dimensions: the proportion of total exchanges depending on the resource, and the criticality of those exchanges to the organization (Pfeffer & Salancik, 1978, p 46 - 47).

The degree of dependence on a certain resource for a certain organization furthermore varies with the extent of discretion over the allocation and use of the resource possessed by another social actor. Such discretion is a major source of power, and becomes more important if the resource is scarce. Such discretion is however rarely absolute, but a matter of degrees. Discretion can be based on possession, as is the case with knowledge - individuals possess whatever they know, and control however they use their knowledge. Possession in the form of ownership accords a lesser degree of control, since ownership is a social structure and is dependent on others respecting and or enforcing that ownership. Access to a resource is also a basis of control, as is the actual use, or control over the use of a resource. Lastly, the ability to regulate the possession, allocation, and use of resources is a source of control. (Pfeffer & Salancik, 1978, p 48 - 49).

That a certain resource is under the discretion of another social actor does

not matter greatly however if control over the resource is not concentrated. The important point is whether the organization in need of a particular resource can obtain that resource from another source, or from a multitude of sources. (Pfeffer & Salancik, 1978, p 50).

The importance of a resource and the concentration of control over the resource together determine the dependency of the organization on the resource. Control over resources on which others depend does not immediately translate into power. The relationship most also be asymmetric. it might be the case that the power one organization would wield over another by the control over some resource is canceled out by the dependency the first organization has on a resource controlled by the second organization. Therefore, there must be an asymmetry in the net exchanges between the organizations for power to amass, and conversely, and more consequentially, when there is asymmetry in resource dependency in exchanges there is power. (Pfeffer & Salancik, 1978, p 51-53).

By this point it should be apparent that the contractual approaches to the firm are lacking in important aspects. Following March, which contractual arrangements are entered into is a function of the distribution of resource prior to the contract being entered. Moreover, following Pfeffer and Salancik, a large variety of factors affecting the dependence of the parties in the exchange on resources and the net resource interdependence affects how the contractual exchanges are played out.

However, the contractual approach to firms is susceptible to attack even from within an economic framework.

4 Transaction Costs

Transaction costs are central to economics. This is because if transaction costs are negligible, the organization of economic activity is irrelevant since any way of such organizing will be eliminated by contracting. (Williamson, 1965, p 1) The fact that there exists different firms, and that these firms are differently successful in the marketplace, seems to contradict this notion of all-out contracting as the most efficient mode of economic organization.

Governance structures, the institutional matrix within which transactions are

negotiated and executed, vary with the nature of the transaction (Williamson, 1965, p 239) The three critical dimensions of transactions are

1. uncertainty
2. frequency of recurrence
3. degree to which durable transaction-specific investments are incurred

Of these dimensions, uncertainty is most critical, while frequency matters the least. The crucial point of the transaction-specific investments dimension is to which degree transaction specific (non-marketable) expenses are incurred (Williamson, 1965, p 239). Non-marketability problems occur when the specific identity of the parties has important cost-bearing consequences. These types of transactions are referred to by Williamson as idiosyncratic transactions. (Williamson, 1965, p 240) As examples, Williamson mentions when a buyer induces a supplier to invest in specialized equipment which locks both parties into the transaction, but also specialized training.

There is the possibility of additional transaction-specific savings in transactions that occur over time - specialized language, and both institutional and personal trust and relations evolve. (Williamson, 1965, p 240) Williamson emphasizes transactions of a recurring kind, and argues that these have profound contractual consequences.

Recurrent spot contracting has the benefit of curtailing the risks of opportunism, since the market allows a victimized party to seek out other, hopefully less opportunistic parties, as well as spreading information about such opportunistic parties. Such contracting is not inefficient in idiosyncratic activities - the non-marketable investments are lost each time a transaction is not enacted again, and economies of costs in such transactions are only realized after transaction-specific investments.

There is thus a trade-off, or a dilemma, between curtailing opportunism, and minimizing transaction costs. This creates the need for governance structures that reduce opportunism. Transaction-specific investments are perhaps most easily conceived of in terms of physical capital such as a plant that only produces a

specific chemical, or a machine that only produces a specific part, but these investments are just as applicable to investments in human capital (Williamson, 1965, p 243).

From this follows the general argument of Williamson, which is that special governance structures supplant standard market-cum-classical contract exchange when transaction specific values are great. Examples of such relationships are idiosyncratic commercial, labor and family relationships.

In the context of this paper the argument of Williamson becomes important because it shows that firms are not the fluid, voluntary associations among equals that the contracts-based approach to firms presume. The pre-contractual distribution of resources is likely do decide which contracts are entered into, both, as we have seen, according to March, but also because such disributions most likely affect which transaction costs will be lower for which contracts. Furthermore exchanges in themselves affect the distributions of resources by inducing transaction-specific investments, which are marketable to varying degrees.

So far, the contractual approach seems flawed because, first of all, resources are seldom evenly distributed and resource distributions affect which contracts are entered into, and secondly, because exchanges themselves affect the distributions of resources, thus further skewing future exchanges.

However, in a contractual approach these resource-distribution problems are circumvented by utility-maximizers by way of markets - labor markets for employees and stock markets for investors. If one party in a contractual relationship defects, extracts rents or otherwise acts opportunistically, the other party can escape by either engaging in, or simply threatening to engage in another potential contractual relationship available through the markets.

This is true, if the market mechanism in fact is in place and working. It is however likely that the market mechanism is not always in place, due to other forms of patterned human interaction. One such form of interaction is institutionalism.

5 Institutionalism

There are various aspects of institutional theory: DiMaggio and Powell outline three processes of institutional isomorphic change: coercive, mimetic and nor-

mative (Dimaggio & Powell., 1983, p 150). Scott has described the three pillars of institutionalism as regulative, normative and cultural-cognitive systems (Scott, 2000, p 51). Meyer and Rowan define institutionalized rules as classifications built into society as reciprocated typifications or interpretations. These rules however can be normative and cognitive as well as socially made up of behaviors, relations and expectations (Meyer & Rowan., 1977, p 341, citing Berger and Luckmann 1967, p 54).

Institutional in this context refers to cognitive, normative and regulative aspects. These three aspects refer to meanings, norms and laws. To situate this in a broader context of sociological theory, meanings refer to subjective meanings (Ross & Witich, 1978, Weber, in Ross and Witich 1978, p 4).

Regulative aspects refer to orders whose legitimacy is guaranteed by the expectation of external effects, specifically coercion applied by a staff, i.e. what Weber calls laws (Ross & Witich, 1978, Weber, in Ross and Witich 1978, p 33-34). These three aspects involve different degrees of reflexivity - meanings are created and transformed in interaction, with very little or no reflexivity among the involved actors, norms are invoked specifically, and actors can relate to them reflexively. Regulative aspects are referred to explicitly when invoked, and are created and transformed by decree or within large, complex institutional arrangements with this explicit purpose, such as parliaments or regulative agencies.

Meyer and Rowan devise a continuum of organizational environments, ranging from the relational to the institutional. The relational pole, is however also to a large degree institutional (Meyer & Rowan., 1977, p 354). This continuum is analogous to a continuum between interests and institutional aspects, where interests implicate resources and relations. Such a continuum is useful for conceptualizing the institutional environments not only organizations but individuals are situated in. There are however two important differences between individuals and organizations in this context.

There are certain individual interests that are not the result of social processes, these are interests which must be fulfilled in order to sustain the individual, such as access to air, water, food and shelter. Moreover certain interests pertaining to relations to other individuals can be thought of as non-constructed, although they are certainly subject to construction in various settings. The point is here not

to delve into this at great length but to recognize that certain individual interests are absolute. This is not the case with the institutional aspects - meanings are explicitly subjective (Ross & Witich, 1978, Weber, in Ross and Witich 1978, p 4), and norms the outcomes of philosophical and theological reasoning. Regulations and laws are very much constructed by institutional arrangements.

The second difference is that individuals span environments - organizations may of course analytically be part of different environments, but this is different. Individuals span institutional environments across time and space - that this during a life course a person partakes in several institutional environments, but at a given time a person also partakes in different concurrent institutional environments. These may also be nested. Examples of such environments are institutions of education, families, and workplaces.

These environments are all constituted by different configurations of interests, meanings, norms, and to a lesser degree, laws and regulations. This last case is special, since it is a feature of modern systems of law to intrinsically resolve questions of applicability across time and space - by for example jurisdictions and non-retroactive laws.

The multiplicity of laws and regulations is a question which in general can be resolved to satisfaction empirically. The other aspects must however be part of a general theoretical model. This means that the individual will be adorned with a complex of institutional interests, meanings, and norms, which is accumulated and sedimented over time and space. These interests, meanings and norms may conflict or concur to any degree.

Individual action is carried out in pursuance of these interests, on the basis of meanings and in relation to norms and regulations. The probability of action in a certain direction is a function of how these interests, meanings, norms and regulations are oriented in that direction, the degree of concurrence among them, and the relative strength among them.

The institutional environments of individuals are in general sufficiently complex to include all these aspects. Therefore the relative strength of them becomes important. To further complicate matters , it can be argued that the pursuance of interest is in itself an institutional meaning or even norm. That is to say - the logic of consequences is in itself a logic of appropriateness. This point is argued

by (Dimaggio & Powell., 1991, p 28), and it can also be inferred from (Meyer & Rowan., 1977, p 354).

This leads to a model of action where most action is defined by institutional configurations, which at fist glance seems to promote reproduction of current orders. There are however ample possibilities for change. Since individuals span different environments conflicting institutional configurations are brought to bear on single situations, individuals may due to processes of the institutional environments be subject to large variations within their institutional aspects, thus increasing the probability of action in new directions, and individuals are able to overcome conceptual constraints, thus opening new avenues of action.

Outcomes of, and conditions for action are fundamentally related to power and capabilities. To a large extent these work within the institutional environment. This means that power perspectives such as resource dependency (Pfeffer & Salancik, 1978, p 101-108) are incorporable. Perspectives focusing influence on decision processes (Pfeffer & Salancik, 1978, p 115), i.e the institutional arrangements where institutional aspects are created, are also compatible. While Pfeffer and Salancik portray their perspective as objective and contrast this with a social construction of reality perspective (Pfeffer & Salancik, 1978, p 124-125) it should be clear that this contrast is in fact not very great.

Defining power and capabilities within institutional aspects seems to lead to a static model - capabilities come from the current order, and these capabilities in turn are used to sustain the current order.

Attempts to define power and capabilities as extrainstitutional are collective action (Dimaggio & Powell., 1991, p 30) and, I would argue, social skill (Fligstein, 2001). This is because social skill is the ability to induce cooperation in others by the creation of a positive sense of self that resonates with others (Fligstein, 2001, p 112-113). Social skill is located within individual actors and is not reducible to institutional aspects, although portions of it may be learned - if not only by repeatedly engaging in attempts to induce cooperation.

5.1 The Logic of Appropriateness

According to March and Olsen, students of social action generally employ one of two models for the logics of actions of actors. These are a logic of consequences and preferences, and a logic of appropriateness and sense of identity. Models of action based on a logic of consequences and preferences construe actors as having exogenous preferences, and engaging in action to further interests arising from those preferences. (March & Olsen, 1998, p 949)

Actors in the logic of appropriateness school evoke an identity or rule and act according to how that identity or rule relates to a specific situation (March & Olsen, 1998, p 951). While discerning four general interconnections between these two logics, March and Olsen judge their differences to be great enough to render them separate explanatory devices (March & Olsen, 1998, p 954). The interconnections are that a clear logic dominates an unclear logic; that one logic is used to establish fundamental constraints for a decision, and the other logic is used to make refinements within the constraints. Furthermore that the relation between consequential action and rule based action is developmental, and lastly that either logic can be seen as a special case of the other (March & Olsen, 1998, p 952-953).

For logics of consequences, interests are central. While interests may be common to groups of individuals, any action to further those interests, even if those interests are completely evenly distributed across individuals, will introduce interest disparities. There are two ideal type ways for groups to act. One is for all members of the group to perform the exact same action, and the other is for group members to perform specialized functions. Actual groups may employ ways of action in any combination or degree of these two ways of acting.

In this case, even if all members have the same interests at the outset, the introduction of group action towards these interests introduces the opportunity for individuals to act to a lesser degree than their peers, but still have their interests pursued by the totality of the group.

In the case of group members acting in differentiated ways to fulfill the common interests of the group, interests diverge among group members since they act in varying degrees, and are differentially effected by the action of other group

members. The logic of appropriateness is also a individual-based logic of action (March & Olsen, 1998, p 952). The invocation of identity is an individual process - it cannot be aggregated to groups.

March and Olsen argue that these two logics are different explanatory devices, and explicitly argue for the application of logics of appropriateness, and in part motivate this by the dominance of logics of consequences as models of explanation in the field they are concerned with, international political orders (March & Olsen, 1998, p 953-954). This approach could very well be applicable to the field of CEO compensation - a field dominated by theories employing logics of consequences as models of action, theories which so far have failed to provide satisfying explanatory accounts. Both agency theory and power perspectives are theories which employ consequences-oriented logics of action.

The position taken in this paper is however that one logic should not be adopted a priori, especially so since, as March and Olsen themselves argue, any particular action probably involves elements of both - actors calculate consequences and follow rules (March & Olsen, 1998, p 952).

An explanation of CEO compensation based on institutionalism and a logic of appropriateness would work along these lines.

CEO compensation is viewed as the outcome of specific decision-making processes conducted between certain types of actors in certain institutional environments. These actors are CEO:s and directors, which can both be members of the board and members of the compensation committee.

The specific logic of appropriateness that is at work is the logic of valuing the actions of an individual in money. The institutional complex of meanings and norms tells the actors that CEOs are competent, and capable of influencing their organization, but also that other factors may come into play. This complex also tells the actors that rewards for actions are monetary, and that monetary rewards are good measures of an individuals actions. Furthermore it also tells the actors that these measures are relative other actors, with whom they compete.

Specifically, the logic of appropriateness that is at work is a logic where CEO compensation is seen as a proper measure of the CEO:s worth, and that this worth is high, and, most importantly, that this CEO compensation should be higher than the compensations of other CEO:s. This is because members of compensation

committees and board of directors associate the worth of the company, and thus the worth of their own work and position in general, with the worth of the CEO.

The compensation of the CEO becomes a measure of their own worth. These meanings and norms are embedded in the corporate structures of the board of directors and compensation committees, and in CEO work. Some directors are CEO:s, or retired CEO:s or other high-ranking corporate officers.

So far contractual approaches to the firma and to CEO compensation has been shown to seriously understate the importance of pre-contractual resource distributions, to seriously unerstate the redistributive effects of contractual exchanges, and to be in fact based on a simplistic notion of human logics of actions. An institutional framework has been put forward as a more comprehensive alternative.

6 Conclusions

This paper has shown that the foundations for agency theory, a contractual approach to the firm, is flawed. This means that agency theory is also deeply problematic. The main problem with a contractual and an agency perspective is that it does not account for power. Power perspectives can both be introduced by referece to a resource dependency perspective, but also by reference to transaction costs.

Apart from this problem, agency theory does not take into account institutional processes and mechanisms, which stem from an alternative, or at least a broader conception of the basis for human action.

A related point is the degree to which market mechanisms are usurped by other forms of patterned human interaction. This is beyond the scope of this paper, but two directions seem likely: one is that institutional processes also are at work here, that for example the relationship between firms and the stock market is institutional. Another is that networks likely influence the interactions between CEO:s and directors, and amongst CEO:s and amongst directors.

Thus CEO compensation, and contemporary capitalism, is a mixture of market, power, institutional and social processes. While there are clearly markets at work, the market mechanism is in itself often usurped by institutional or social processes. These processes are to a varying degree driven by logics of appropri-

ateness and logics of preferences. A building block which has not been used in this paper is network theory, which has used by some scholars in explaining actions in markets (Uzzi, 1996), (Uzzi, 1999), (Granovetter, 1983). Networks are however most likely a part of the usurpation of market processes, alongside institutionalism.

This paper has shown the shortcomings of an agency theory approach to CEO compensation, and offers a more comprehensive framework taking into account resource distributions, resource redistribution, as well as institutionalism while also hinting at network theory. However, agency theory does highlight the problem of tension between delegating authority to others and the need for monitoring. This problem can most likely be applied systems of political representation, where the representative is in an agent position.

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