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Optimal Executive Compensation versus Managerial Power: A Review of Lucian Bebchuk and Jesse Fried's *Pay without Performance: The Unfulfilled Promise of Executive Compensation*

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This essay reviews Lucian A. Bebchuk and Jesse M. Fried's Pay without Performance: The Unfulfilled Promise of Executive Compensation. *Bebchuk and Fried criticize the standard view of executive compensation, in which executives negotiate contracts with shareholders that provide incentives that motivate them to maximize the shareholders' welfare. In contrast, Bebchuk and Fried argue that executive compensation is more consistent with executives who control their own boards and who maximize their own compensation subject to an "outrage constraint." They provide a host of evidence consistent with this alternative viewpoint. The book can be evaluated from both positive and normative perspectives. From a positive perspective, much of the evidence they present, especially about the camouflage and risk-taking aspects of executive compensation systems, is fairly persuasive. However, from a normative perspective, the book conveys the idea that policy changes can dramatically improve executive compensation systems and consequently overall corporate performance. It is unclear to me how effective potential reforms designed to achieve such changes are likely to be in practice.*

1. *Introduction*

Over the last few years, corporate governance has become a popular topic in both the business and academic press. The large number of high-publicity scandals, the seemingly enormous salaries paid to executives, and the celebrity status of CEOs has created unprecedented public interest in corporate governance. All this attention highlights the importance of corporate governance in a well-functioning capitalist economy. The fundamental welfare theorems that justify competition in terms of general welfare presuppose that the internal organization of the firm is such that the desire for profit maximization by firms' security holders translates into efficient business decisions. In other words, corporate governance

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is a crucially necessary ingredient to a capitalist economy when the predominant form of organization is the corporation.

Thus, the attention given to corporate governance by the public at large is well-deserved and, in my opinion, long overdue. Not surprisingly, the public attention given governance has coincided with an astronomical boom in research about governance by economists. To an economist, corporate governance provides a natural subject for study, both because the issues in it are incredibly interesting and important and because it provides a place where our knowledge can provide guidance to practitioners and policymakers.

The appropriate approach to creating an economic model of governance is not obvious, however. An ideal model of governance would contain managers whose interests are not aligned with shareholders as well as shareholders who wish to maximize profits but face coordination and information problems and, to the extent that they can exercise control, must do so through a self-interested board of directors. This ideal model contains too many elements to be useful in most settings; consequently, economists typically make compromises and concentrate their efforts on some parts of it.

The most common approach to modeling governance is to assume away all coordination problems between shareholders and the board entirely, and to presume that the shareholders agree on an optimal incentive contract with the CEO. At first glance, this approach seems a natural one. Since it is infeasible for shareholders to agree on every business decision, they delegate decision rights to executives through their voting for the board of directors. Principal–agent theory provides a way of characterizing optimal contracts in this situation, which has been applied extensively in this literature. This approach was the foundation for the calls from economists for companies to have stronger links between pay and performance (Michael C. Jensen and Kevin J. Murphy 1990), and undoubtedly helped lead to the large increase in option-based executive compensation during the 1990s.

However, it is not the case that the principal–agent approach, in which management receives an optimal incentive contract given the underlying contracting problem, is an accurate, or even a particularly useful, way to characterize executive compensation. The principal–agent approach presumes that observed contracts are an optimal response to the contracting environment. But what if they are not optimal? Even a casual reading of the business press indicates that many CEOs have a great deal of control over their boards, and thus over the process by which their own pay is determined. An alternative approach to the principal–agent model involves explicitly recognizing that the contracts between CEOs and their firms are not those that would occur if CEOs bargained at arms-length with shareholders interested in maximizing profits. It is possible that the contracts we observe in practice represent something more like what is often described in the business press, in which managers extract enormous sums of money through their control of their own pay-setting process.

This alternative view concerning executive compensation has been developed by Bebchuk and Fried (sometimes with other coauthors as well) in an influential series of articles. They recently summarized and further developed this work in a book entitled *Pay without Performance: The Unfulfilled Promise of Executive Compensation,* which was published by Harvard University Press in 2004. In the course of developing this view, the authors summarize and synthesize the academic literature on executive pay in a way that is likely to appeal to a broader audience.[1]

[1] See Bebchuk and Fried (2004) for detailed references. I will primarily refer to their book in this review even though a number of the ideas discussed originated in other papers of theirs. In addition to their book, Bebchuk and Fried have also written two shorter and easily accessible surveys; see Bebchuk and Fried (2003, 2005).

Bebchuk and Fried's central hypothesis is that observed executive pay practices cannot be explained by a model in which shareholders contract optimally with shareholders. Rather, they argue that a more accurate characterization of the CEO pay process is one in which the CEO effectively sets his own pay, subject to some constraints by the market. Of course, CEO pay, although large, is nonetheless finite, so there must be some constraints that impose limits on its size. Bebchuk and Fried refer to these constraints as "outrage" constraints, as they stem from the public reaction to extremely high CEO pay.

In *Pay without Performance,* Bebchuk and Fried develop both the principal–agent and the managerial power hypotheses nontechnically in a way that a general audience can understand. They then do an extensive review of the empirical evidence that, in their opinion, distinguishes these two views. Their conclusion is that the evidence overwhelmingly supports the notion that CEOs have great sway over their own pay, and that executive compensation is best understood through this lens, rather than through an optimal principal–agent contract in which the shareholders capture all the rents. They also provide some suggestions for reform, which they believe will ultimately improve corporate governance.

In this review, I first discuss the principal–agent and the power-based views of executive compensation as developed by Bebchuk and Fried. I then summarize the empirical evidence they present. Finally, I present my own reactions to the book.

2. *The Principal–Agent View of Executive Compensation*

In the classical principal–agent problem, a principal must delegate a task to an agent, whose incentives are not perfectly aligned with those of the principal. A partial solution to this problem is to utilize an incentive contract designed to pay the agent more when the task is performed better. Executive compensation is often cited as a real-world example of a principal–agent problem, since the shareholders, the principals, delegate virtually all decision rights to managers, their agents. A very large literature has emerged that characterizes executive compensation contracts as a solution to this agency problem both theoretically and empirically.[2]

Bebchuk and Fried start their book with a discussion of this literature. They argue that the dominant view of the finance/economics profession is that current executive compensation practices can be well explained as optimal responses to principal–agent problems. As such, they refer to this view of executive compensation somewhat sarcastically as "the official story" throughout the book.

I think Bebchuk and Fried are correct that the finance/economics literature has focused on optimal contracting models more than perhaps is warranted. However, I would suggest an alternative explanation for this focus. Having been part of many seminars over the years in which these issues were discussed, my feeling is that many people believe that many observed contracts are indeed not optimal.[3] Despite this belief, literature in economics tend to focus on the kinds of models that are readily solvable, which for executive compensation have historically been based on the presumption of optimal contracting. In many ways it is similar to the situation in industrial organization prior to the advent of game theory; even though most economists recognized that many important markets were oligopolies of some sort, most of the formal modeling focused on perfectly competitive models, since they were the only ones that could be easily solved.

Nonetheless, Bebchuk and Fried are quite correct to challenge the presumption that the

[2]See Murphy 1999 for a detailed survey.

[3] Indeed, I personally have argued, as Bebchuk and Fried do, that the power struggle between managers and the board is an important determinant of CEO compensation (see Benjamin E. Hermalin and Michael S. Weisbach 1998).

arms-length optimal contracting model is the right way to describe executive compensation practices. The underlying assumption of the principal–agent model is that the principal, in this case the shareholders, can somehow agree to an optimal contract with the agent, the managers in the case of executive compensation. In fact, in a modern corporation, the shareholders do not contract directly with the managers. Instead, they do so indirectly through the board of directors, who act as an intermediary. Unless the board acts perfectly in the interests of shareholders, contracts will differ from those predicted by an optimal contracting model. In practice, in fact, a host of issues exist that potentially distort boards' preferences from coinciding with those of the shareholders.

Ultimately, the usefulness of any model depends on exactly how important the departures from the model assumptions are in practice. Bebchuk and Fried argue that, in the case of executive compensation, these departures are significant and that the typical economist discussion understates their importance. In particular, the board of directors, rather than acting solely in the shareholders' interests, becomes "captured" by the CEO. As such, the contracts that are negotiated between the CEO and the board are not likely to be those that maximize shareholders' profits subject to the usual constraints in prinicipal–agent problems. Rather, the contracts are likely to reflect optimal rent-grabbing by the CEO.

There are a number of reasons why the board is likely to consider the CEO's interests rather than the interests of the shareholders. First of all, directors have incentives to keep their jobs. Directors are well paid, and sometimes receive substantial perks.[4] Opposing a CEO's wishes substantially increases the likelihood that a director will not be renominated to the board and will lose these benefits. Second, a CEO can provide benefits to directors in a number of ways. Bebchuk and Fried document a number of cases in which a director's firm received substantial business from the CEO. In addition, CEOs can and do direct their firms' charitable contributions toward those favored by the directors they like. Finally, CEOs can use influence on the companies on whose boards they serve to help their companies' directors acquire additional lucrative directorships.

Overall, there are substantial reasons why a director has incentives to cater to the wishes of the CEO. There are some factors that go in the other direction and cause directors to favor the shareholders: Directors do typically own some shares, and care about their reputations as quality managers. However, Bebchuk and Fried argue, in my opinion persuasively, that these factors are likely to be substantially smaller than those that favor the CEO. Thus, it is unrealistic to expect the board to negotiate the best possible executive compensation contract from the shareholders' perspective.

Given that boards are not predisposed to act in the shareholders' interest, there are some actions shareholders can take directly that potentially affect directors' actions and align executive compensation with their interests. For example, shareholders can sue the board, vote down stock option plans, and put forward their own proposals. However, unless a shareholder holds a large stake in the company and/or has a seat on the board, these measures are unlikely to have a meaningful impact on executives' behavior.

In addition, there are market forces that limit the extent to which board actions can deviate from the shareholders' interests. Managers' incentives are affected by the managerial labor market, potential acquirers value the company in the market for corporate control, managers must make their firms sufficiently attractive so that potential future suppliers of finance are willing to invest, and

[4] Bebchuk and Fried cite studies indicating that, in 2002, directors of the largest 200 companies received an average of $152,000 annually and directors of the largest 1,000 companies received an average of $116,000. As examples of valuable perks, directors of UAL Corporation can fly free of charge on United Airlines while directors of Starwood Hotels receive complementary stays (p. 25).

firms compete in product markets. Each of these markets potentially limits the extent to which directors' interests can deviate from shareholders. The extent to which each is effective in practice is unclear and is an ongoing topic of research. Nonetheless, Bebchuk and Fried contend, and I tend to agree, that none of these market forces is sufficiently powerful to push boards toward the equilibrium described in the optimal contracting models of executive compensation in which the principal holds the bargaining power.

3. *The Managerial Power Approach*

Bebchuk and Fried present an alternative approach to optimal contracting based on the idea of managerial power inside the firm. The idea is that the CEO has a good deal of control over the board, and this control includes the power to set a large part of his own compensation. Of course, there must be some factors that limit executive compensation; in addition to market forces, Bebchuk and Fried introduce an additional type of cost that they refer to as "outrage costs." Outrage costs occur when there are costs to the executives and directors from a public reaction to executive compensation that is perceived as excessively high. The difference between the managerial-power and principal–agent explanations is stark: The level of pay in the principal–agent approach is set so that the CEO receives at least his reservation utility, so that he is paid just enough to keep him from leaving and going to another firm. In contrast, the level of pay in the managerial power approach is set as high as possible, with the upper bound on pay determined by public perceptions.

I find this alternative approach to executive compensation to be intriguing and believe that understanding and evaluating it will be an important topic of research in the near future.[5] Certainly, the logic of the Bebchuk and Fried approach is in line with popular views of executive compensation in which managers have a lot of control over their boards. It differs from the optimal contracting approach both methodologically, and in terms of its predictions.

The weakness of the managerial power approach is that the "outrage" constraint is not particularly well-specified. What exactly is public outrage and why should it be treated as a constraint? What factors cause outrage, and how does outrage feed back and hurt the firm? Murphy (2002), in his discussion of these arguments, concludes that it is "sufficiently vague as to be irrefutable." Nonetheless, public opinion is clearly something that does affect executive compensation. The mechanism by which it does is unclear. For example why does extremely high levels of compensation for CEOs lead to public outrage, while similarly high pay for other professions such as entertainers or athletes do not? How does public opinion affect firms' profitability? What is the role of the media in this process?[6] Clearly, these are all important questions that economists do not know much about. Research into the process by which public opinion affects executive compensation potentially will aid research into other consequences of public opinion on economic activities.

4. *Distinguishing between the Optimal Contracting and Managerial Power Explanations*

Much of Bebchuk and Fried's book consists of evidence purporting to distinguish between the two explanations for executive pay. The arms-length contracting view suggests that managers will have incentive contracts to encourage managers to maximize profits. A large literature has developed that characterizes the optimal way to provide these incentives. Bebchuk and Fried focus

[5] It has already been the subject of some debate; see for example the discussion in a recent issue of Chicago Law Review between Bebchuk, Fried, and David I. Walker (2002) and Murphy (2002).

[6] See Alexander Dyck and Luigi Zingales (2002) for more on the role of the media in corporate governance.

on a number of predictions coming from this type of analysis: First, incentive pay should depend on variables under the manager's control and not those that the manager has no control over. Second, the manager should not be able to unwind these incentives; that is, make trades in the securities markets that somehow offset their effect. Third, the incentives should be clear to everyone; there is no reason under principal–agent theory why the nature of these contracts should be kept secret or disguised in any way.

Bebchuk and Fried's managerial power based explanation differs substantially in these predictions. Its main premise is that executive compensation is controlled primarily by the executives themselves. Stock options and other "incentive" pay are used as a way of justifying high compensation at a minimum of public outrage, the supposed incentives providing boards a rationalization for extremely high executive pay. Bebchuk and Fried argue that a closer examination of executive pay practices indicates that their structure is more consistent with executives maximizing their pay subject to an outrage constraint than with the contracts that would be the outcome of arms-length negotiations.

4.1 *Filtering Out Factors beyond the Executive's Control*

One puzzle for the optimal contracting approach is that observed incentive packages do not "filter out" factors that affect performance that are beyond the manager's control. For example, options are always in practice a function of raw (unadjusted) stock returns, so that during a rising market, executives generally receive large returns from their options from the marketwide component of stock prices. Optimal contracting would suggest that options be written as a function of excess returns relative to the market or even a potentially more sophisticated approach designed to filter out all factors that affect firm performance that are out of the manager's control. However, executive options are almost always written as a function of raw returns, never filtering out factors unrelated to executive effort. Consequently, during the bull market of the 1990s, almost all executives did remarkably well from their option plans, even if their firms had average, or even below average performance.

But what about when the market declines, as it did in the early 2000s? Then, options are commonly "repriced," lowering the exercise price to adjust for overall marketwide movements. To provide incentives, firms lower the exercise prices on executive stock options when they are substantially "out of the money" due to no fault of the executives.[7] If, alternatively, the options had been written as a function of excess rather than raw returns, this practice would be unnecessary. The net effect is that, by using options on raw rather than adjusted returns, executives reap benefits when the market rises but insulate themselves from market declines by repricings. As a result, the executives are better off with unadjusted options that can be subsequently repriced than they would be with options on excess returns.

Bebchuk and Fried argue that the fact that they utilize unadjusted options so commonly is evidence consistent with the managerial power explanation rather than the optimal contracting one. By using a seemingly simplistic, inefficient compensation system that does not filter out irrelevant factors, executives can justify repricing their own options following market declines. Given future repricings in bad states of the world, executives make themselves better-off ex ante than they would be using a seemingly more efficient compensation system that filters out factors beyond their control.

4.2 *Unwinding Incentives*

A second issue Bebchuk and Fried focus on that potentially distinguishes the optimal

[7] Of course, boards never raise exercise prices on executive stock options in a parallel manner when the firm's stock price increases due to overall market movements rather than any action of the executives themselves.

contracting and managerial power views is executives' ability to unwind their incentives. The optimal contracting view presumes that options and restricted stock are provided to executives as a way of giving them incentives to solve an underlying agency problem. These options and restricted shares provide incentives, however, only if executives are unable to sell them during the period in which the incentives are relevant, or to engage in other hedging transactions that effectively undo the effects of the incentives the options provide. In contrast, the managerial power view suggests that options and restricted shares are simply another way to transfer rents to managers, without providing meaningful incentives. This view implies that "incentive" packages should be structured so that in practice managers have substantial freedom to unwind the incentives in these plans.

Bebchuk and Fried provide an interesting survey of empirical evidence relating to this topic in chapter 14 of their book. Most options are exercised and then sold as soon as they are vested, which is generally well before the executive leaves office. "Restricted" shares are also sold relatively quickly. While it makes sense to allow executives some leeway to gain liquidity on some of their options, Bebchuk and Fried argue that the quantity sold suggest that much "incentive" pay does not provide nearly as many incentives as one might suppose. In addition, many executives have been able to hedge their options using "collars," which are combinations of derivatives that, when purchased by an executive, have the effect of locking in today's stock price and offsetting the incentives in option plans. Overall, Bebchuk and Fried argue that the freedom to unwind incentives is very large, and likely reflects the fact that "incentive plans" are actually set up to transfer rents rather than to provide incentives.

4.3 *Camouflaging Compensation*

Finally, and most persuasive in my opinion, is the fact that many executive compensation practices are hidden, a practice Bebchuk and Fried refer to as "camouflage." Such camouflage is relevant to this discussion because there is no reason why, according to optimal contracting theory, that firms should hide features of executive compensation systems. In contrast, if managers are setting their own compensation subject to an outrage constraint, then compensation should be structured so as to minimize outrage. In particular, if rents can be transferred to executives in ways that do not attract public attention, then it is possible to pay executives more total compensation for given amount of public outrage.

Executive compensation is often camouflaged by having it take forms that are typically not discussed in the press. For example, executives typically receive supplemental retirement plans (SERPs) that go well beyond the retirement plans that are given to most employees. In contrast to the tax-advantaged retirement plans offered to most employees, companies cannot deduct the funds they use to fund SERPs from corporate income tax, so SERPs are not a tax-efficient way to pay executives. These retirement plans are, however, a good way to camouflage payments to executives, since they typically do not show up in press reports of executive compensation. In addition to retirement plans, firms sometimes allow executives (but not other employees) to defer compensation until retirement, and typically guarantee a rate of return well in excess of market rates. As an example, Bebchuk and Fried point out that in 2001, when one-year Treasury bills were yielding around 4 percent, both GE and Enron guaranteed their executives a 12 percent annual return on their deferred compensation (p. 102). The present value of this extra guaranteed return is substantial, but sufficiently hidden that it almost never makes it into press reports of executive compensation.

Executives increasingly are provided in-kind benefits in retirement that substantially exceed those given to other employees, even adjusting for the differing levels of compensation. In addition to lifetime health benefits, executives can receive free use of company planes, cars, apartments, security systems, and many other benefits. While it is unlikely that these perks are the most efficient way to provide compensation to the executives, their cost is not reflected in that levels of executive compensation that are publicly disclosed. A valuable benefit retired executives sometimes receive is lifetime "consulting" contracts that guarantee retired executives large sums in exchange for consulting work that may or may not ever occur. Finally, executives often receive large loans from their companies at interest rates well below market. Again, it is not clear why such loans are part of an optimal compensation contract, but their present value is a form of compensation that is well-camouflaged from the press.

5. *Positive and Normative Interpretations: A Market Equilibrium in Governance*

There are two different ways in which one can evaluate this book. One can consider the book from a positive perspective and consider whether the managerial power perspective is consistent with the available evidence. An important question is whether theories of compensation based on managerial power should supplement or even replace the optimal contracting view. A second way to evaluate the book consists of a more normative perspective. The tone of the book conveys that there is a major problem with executive compensation systems and with corporate governance more generally. More importantly, it suggests that this problem can and should be fixed. One comes away from reading the book thinking that, somehow, the system could be set up in a way that would substantially improve executive incentives and, consequently, corporate performance as well.

5.1 *Positive Implications*

From a positive perspective, I find the Bebchuk and Fried arguments fairly persuasive. Although a number of explanations for the lack of filtering of market or industry performance in executive compensation have been proposed in the literature, I find the most plausible explanation for this seemingly simplistic practice is that executives prefer this type of compensation to its alternatives.[8] I also find it hard to reconcile optimal incentive contracting with the fact that "incentives" provided by executive compensation contracts are effectively undone by other actions on the part of the executive. If the contracts really were optimal and included incentives for top management, they undoubtedly would have some way of prohibiting executives from unwinding the incentives. Finally, the high level of camouflage observed in executive compensation is clearly evidence that boards and managers wish to hide true compensation from the public. Optimal contracting theory provides no reason why firms would wish to hide compensation, but Bebchuk and Fried's explanations do provide such a reason.

Going forward, the book suggests a number of directions that are potentially fruitful directions to explore. Optimal incentive contracting and managerial rents are not mutually incompatible. Developing models of optimal contracting with management rent-seeking along the lines suggested by Bebchuk and Fried would be a useful addition to the executive compensation literature.[9] Understanding the nature of the outrage constraint on managers and the way it relates to public opinion would be an important element of this type of work. Another approach would be to presume that some firms approximate arms-length contracts with their executives, while others follow the Bebchuk and Fried model. Is it possible to estimate approximately how many firms fall into each category? What factors lead to firms following each model?

[8] See chapter 12 of Bebchuk and Fried for discussion of these explanations.

[9] One recent paper following this approach is Camelia M. Kuhnen and Jeffrey Zwiebel (2006).

How are these factors related to the CEO's degree of control over his board? How does the extent of the manager's influence over his compensation affect subsequent firm-level performance? Certainly, the Bebchuk and Fried analysis suggests that answers to these types of research questions would be potentially valuable.

5.2 *Normative Implications*

On a normative level, the book definitely takes the view that management's control of its own pay is "bad" and is a problem that somehow could be corrected. Starting with the subtitle, *The Unfulfilled Promise of Executive Compensation,* and throughout the remainder of the book, Bebchuk and Fried imply that something is *wrong* with the executive compensation system. What is not clear is what the alternative is. To be relevant, the compensation not only has to be inefficient and excessive relative to a theoretical benchmark, but also the problem should somehow be fixable. In other words, there should be a realistic set of reforms that will move us to a better equilibrium.

Let us presume that Bebchuk and Fried are correct and that their description of firms' governance is basically correct and managers effectively set their own pay subject to an outrage constraint. Then, of course, shareholders would be better-off if we could magically shift to a world in which they engage in arms-length bargaining with managers and achieve the contracts described in the principal–agent literature. The problem is that it is not clear how in practice we could shift to the theoretically better equilibrium; or if the practices Bebchuk and Fried describe are the best that can be achieved. The reason why CEOs are able to take rents from the shareholders is because of their bargaining power vis a vis the board. Yet, this bargaining power is itself endogenously determined inside the firm and is likely outside the realm of potential regulatory improvements.

In chapters 15 and 16 of their book, Bebchuk and Fried make some suggestions as to how executive compensation and corporate governance might be improved. First they encourage investors to become aware of and to discourage some of the practices they discuss in the book. For example, they encourage investors to pay executives options that filter out general market or industry movements, and to make it difficult for executives to unwind incentives. Second, they encourage both regulators and market participants to make the structure of executive compensation more transparent. Finally, they suggest some changes that potentially increase the power of the shareholders relative to the managers, such as improving the rights of shareholder-nominated candidates in corporate elections. The extent to which these types of reforms move the equilibrium closer to that of the arms-length contracting model is an open question.

The problems Bebchuk and Fried focus on are not new. Both Adam Smith (1776) and Adolph Berle and Gardiner Means (1932) characterize the corporate governance practices of their day in much the same way as Bebchuk and Fried's description of modern corporate governance. Perhaps the problem is fundamental to the nature of the corporation? Perhaps management's (partial) control over the board, and ultimately over their own compensation, is an inevitable consequence of dispersed ownership and the corporate form of organization. Certainly, despite these problems, corporations have achieved remarkable returns, and have been the organizational form responsible for most of the vast wealth creation that has occurred over the past century.

5.3 *A Market Equilibrium in Governance*

To evaluate corporate governance and whether it can be improved, I think that we must think about governance from the same equilibrium perspective as we do other economic institutions. The basic characteristics of corporate governance, including managers sometimes having control over the board, have remained unchanged for many years. Management's having control over the board is one element of the governance equilibrium that has appeared to prevail over time. Despite this "problem," the modern dispersed corporation has been responsible for the vast majority of economic progress in the last century.

Bebchuk and Fried imply that it is possible to improve on this equilibrium. My guess is that in practice this will be difficult. Hermalin and I have recently argued that the set of circumstances under which regulations on governance can improve welfare are indeed limited.[10] It is unclear how attempts to improve governance through regulations will make things better.

It is evident that different governance equilibria arise out of different economic institutions. For example, executive pay practices differ widely between the United States, Europe, and Japan. Nonetheless, given the large institutional differences economies in these regions, it is not clear exactly which factors lead to each governance equilibrium. Nor is it clear how one would distinguish which of these governance equilibria is socially most desirable.

Bebchuk and Fried have assembled a wealth of evidence suggesting that managers have control over their compensation systems. They argue that executive compensation should be thought of as a process through which executives take rents from their firms in an attention-minimizing fashion rather than an optimal incentive system through which shareholders motivate executives to choose value-maximizing actions. As a positive description of the way that corporations have operated historically, I tend to agree with this characterization. However, just because executives capture rents from this process, it is not clear that the process can be easily improved.

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[10] See Hermalin and Weisbach (2006).