Executives Career Concerns and Compensation

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Why executives' incentive pay increases with firm size? Solely based on the explicit incentive scheme (e.g. bonus, stocks and options), the current studies usually imply that bigger firms have more severe incentive problems. However, once we take into account the implicit incentives from the executives labor market, the view would change.

In a dynamic contract framework, I model the implicit incentives by on-the-job search with sequential auctions (Cahuc, Postel-Vinay, and Robin, 2006). How large the implicit incentive is depends on the chance that executives can successfully climb the job ladder to a larger/more productive firm. For executives in very small firms, almost any job offer is given by a firm that is bigger, thus the on-the-job transition chance is high. For executives in very big firms, the chance to get offers from even larger firms is almost zero. Hence, small firm executives have larger implicit incentives compared to big firm executives. This brings my answer to the question: the (explicit) incentive pay increases with firm size, not (only) because bigger firms face more conflicts of interests with mangers, but because the implicit incentive decreases with firm size.

Do bigger firms indeed suffermore from incentive conflicts? I can estimate the total incentives by adding up the explicit incentives and the implicit incentives identified by on-the-job search behaviors. Deep parameters of incentive problems such as monitoring costs and effort costs can be recovered. These results will help to understand the relationship between corporate governance quality and firm size, and contribute to the debate of executives compensation.