

# **Executive Pay, Hidden Compensation and Managerial Entrenchment**

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## **Abstract:**

We consider a managerial optimal framework for top executive compensation, where top management sets their own compensation subject to limited entrenchment, instead of the conventional setting where such compensation is set by a board that maximizes firm value. Top management would like to pay themselves as much as possible, but are constrained by the need to ensure sufficient efficiency to avoid a replacement. Shareholders can remove a manager, but only at a cost, and will therefore only do so if the anticipated future value of the manager (given by anticipated future performance net of future compensation) falls short of that of a replacement by this replacement cost. In this setting, observable compensation (salary) and hidden compensation (perks, pet projects, pensions, etc.) serve different roles for management and have different costs, and both are used in equilibrium. We examine the relationship between observable and hidden compensation and other variables in a dynamic model, and derive a number of unique predictions regarding these two types of pay. We then test these implications and find results that generally support the predictions of our model.

Keywords: executive compensation, perks, hidden pay, entrenchment, corporate governance

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