HOW INTERNAL TRANSACTION COSTS DRIVE COMPENSATION SCHEMES

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Abstract

The literature on chief executive officers (CEOs) establishes that economic and sociological rationales arc both essential to understand the level and structure of CEOs' compensation. Our thesis is that internal "transaction costs" or frictions override strictly economic criteria to determine pay levels and pay structures. We study mid-level jobs that have features strikingly similar to the CEO. We show that pay checks and their underlying structure follow counterintuitive patterns, as if the employer resorts to a third party (i.e. the customer base) to reduce employee discontent over pay. We also find that firms reward managers as if they have considerable value added.