Managerial compensation, strategy and firm performance: an introduction

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Managerial compensation is a rich subject, worthy of more attention than it has hitherto received. At a very practical and topical level, the last 5–10 years have seen an explosion in the level of managerial compensation at a time when many unskilled workers have suffered an erosion in real earnings (and often also lost their jobs) and other, more highly skilled workers have only just maintained their living standards. One does not need to have much of a social conscience to feel uneasy about these big shifts in the distribution of earnings, nor much curiosity to ask why they have occurred. At a somewhat less practical level, thinking about executive pay raises very interesting issues about motivation, and particularly about the extent to which purely pecuniary considerations affect the behavior of senior managers. Many of the individuals who rise to the top of corporate hierarchies are intensely ambitious and take great pride in their achievements, and they also enjoy other privileges such as status and the exercise of power. In these circumstances, it is not entirely obvious that their performance is determined by pecuniary incentives alone.

Most of the current interest by economists in the subject of managerial compensation arises from an interest in principal-agent problems. This theory emphasizes the shape rather than the level of pay as a source of incentives for senior managers; it is how you pay them that matters rather than how much. A key implication of this theory is that managerial pay is tied to performance through salaries and bonuses, shareholdings in the firm, stock options, or dismissal in the case of bad performance. Empirical evidence shows that there is indeed a statistically significant relationship between managerial pay and firm performance (see Larcker, 1983; Murphy, 1985; Coughlan and Schmidt, 1985 amongst others), but for the majority of top managers this relationship is quite weak (see Warner et al., 1988; Jensen and Murphy, 1990 and others). Jensen and Murphy even argue
that this relationship is too weak to be consistent with principal-agent theory. One interpretation of the evidence is that boards of directors fail since they are responsible for setting managerial pay and for ousting top managers that perform badly (Jensen, 1993). Another explanation is that managers are motivated by other factors than pecuniary incentives alone, and that principal-agent theorists can learn from other disciplines in this respect, for instance from psychologists and sociologists, and from practitioners (Baker et al., 1988).

Virtually all existing evidence on principal-agent theory is from US data sources, and it is not entirely obvious that these results can be uncritically generalized to other settings:

- Tax regimes differ across countries, in terms of absolute tax rates and in terms of the relative taxation of various pay elements, such as salary and bonuses, capital gains from shareholdings and stock options, and pension benefits.
- External control systems differ across countries. In most countries, takeover markets are less developed than in the US, implying less external discipline through hostile takeovers if boards of directors and top managers do not perform well. However, alternative external disciplinary mechanisms often exist, for instance, through affiliations with networks of firms or monitoring by the main bank (Moerland, 1995). International differences in external control systems may lead to differences in managerial pay systems across countries.
- In Europe and Asia, collective decision making is more common than in the US (Hofstede, 1980; Pennings, 1993), which makes it more difficult to assess individual effort. For instance, firms in Europe are often led by management teams (e.g. Germany: “Vorstand,” The Netherlands: “Raad van Bestuur”) with the chairman of the team acting as a primus inter paribus, rather than as the all-powerful CEO in the US setting.

The collection of papers in this special issue is a selection of the papers presented at a workshop on “Managerial Compensation, Strategy and Firm Performance” held at Humboldt-University Berlin on June 13–14, 1994.1 The main goals of the conference were: first, to build a link between the often rather narrow work done on managerial compensation by applied economists and related work done by theorists, practitioners and sociologists, and, second, to stimulate an international comparison of executive compensation schemes.

The first paper in the collection is by Kevin Murphy, and was specifically commissioned to help put the subsequent work on executive compensation

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reported at the conference into a wider perspective. Murphy offers a number of explanations for why the issue has surfaced in the public mind, and then concludes with a number of practical observations about how effective pay-for-performance systems might be implemented.

Bruno Frey's paper reflects some of the discussion about the wider issues associated with executive compensation systems which were discussed at the conference. He makes a useful distinction between intrinsic and extrinsic work motivation, and discusses when purely pecuniary motivations crowd out other (possibly more effective) forms of motivation. In his view, the tensions which are associated with this crowding out go quite some way in rationalizing the 'puzzle' identified earlier, namely that pay-performance relationships for top managers are too weak to be consistent with principal-agent theory.

The first of the country studies is by Dennis Mueller and S. Lawrence Yun and concentrates on the US. They use a well known model of bureaucracy as a benchmark against which to examine the extent that existing managerial salaries reflect the exercise of discretion by managers, and observe that compensation accelerates 'too fast' at higher levels of typical corporate bureaucracies to be consistent with this view. They also find that the compensation of managers of firms whose returns on investment are less then the cost of capital is rather higher than that of managers in firms which the return on investment is closer to the cost of capital, and they suggest that this reflects the exercise of managerial discretion.

The paper by Takao Kato examines compensation in Japan using microdata on a sample of 154 Japanese firms. Distinguishing between firms with and without a group affiliation, Kato finds that top managers in affiliated firms earn 20–30% less than top managers in non-affiliated firms. The evidence is consistent with the idea that group affiliation exerts external discipline on top management teams in Japan in the absence of external control by a takeover market.

There are two studies of the UK included in this volume. The first, by Andy Cosh and Alan Hughes examines the role of institutional shareholders. No support is found for the hypothesis that the presence of institutional shareholders leads to stronger pay-performance relationships for top managers. In fact, the evidence is consistent with evidence for the US showing that institutional shareholders, when compared to other external blockholders, often side with management, for instance, when voting on antitakeover amendments (Pound, 1988; Brickley et al., 1988), and that they stimulate growth rather than restructuring of firms (Bethel and Liebeskind, 1993). Martin Conyon also examines compensation in a complementary study, and finds that remuneration committees seem to have some dampening effect on remuneration, but that separating the roles of CEO and Chairman do not. Both UK studies find statistically significant relationships between firm performance and top management pay (through salary and bonuses, dismissals), consistent with previous studies using US data.

Finally, Pedro Ortin Angel and Vicente Salas Fumas examine executive compensation in Spain using Sherwin Rosen's famous model of superstars to help
interpret the data. They use human capital variables to help alleviate potential simultaneity problems which might arise between corporate size and compensation. Although the results are not completely unambiguous, their work seems to suggest that single equation models may exaggerate the extent to which compensation is linked with firm size.

References

Hofstede, G., 1980, Culture’s consequences: international differences in work-related values (Sage Publications, Beverly Hills, CA).