Executive pay: where is the stick?

Yasmine Chahed and Hans-Erich Müller

Transfer: European Review of Labour and Research 2008; 14; 158
DOI: 10.1177/102425890801400118

Executive pay: where is the stick?[1]

The tremendous rise in executive pay, mostly in large multinational corporations, has sparked off a debate on what society can do in the face of managers' greed. This is considered an injustice by most people in formerly affluent societies, especially in a situation in which new forms of poverty are emerging. Some politicians are seeking laws to cap directors' remuneration; supervisory boards – including workers' representatives – are under increasing pressure on this issue. Defenders of the situation declare that such concerns are motivated solely by envy: for example, soccer players and investment bankers get even more; it is best to leave it to the invisible hand of the market. But should not company success be seen to be the result of responsiveness to a 'visible hand', as not only famous management gurus such as Porter and Kramer (2006) argue? The *Financial Times* (16 June 2006) expressed the point well with its headline: 'Executive pay is the new front in the battle for better governance.'

Do managers deserve what they earn? In the current debate on corporate success and manager remuneration it is becoming clear that variable performance-based remuneration elements may contribute to both good and bad governance. Negative examples include corporate scandals (such as Enron), severance pay scandals (up to US$200m for executives who have performed badly), stock option scandals (backdating or paying for failure, as in the case of former DaimlerChrysler head Schrempp) and others. Not only distributive justice and ethical appropriateness are at issue in relation to directors' pay, but also its effectiveness as a corporate governance mechanism.

Executive pay for performance is regarded as a governance tool similar to, say, supervisory boards; but it has become highly questioned (Hitt *et al.* 2007). The idea is based on the carrot and stick principle, aligning managers' (agents) and shareholders' (principals) interests by coupling shareholder value (performance) with executive pay. But this represents an enormous incentive to manage earnings. The result is that pay is excessive in countries in which other governance instruments, such as ownership concentration and employee participation in supervisory boards, are weak. Even Rappaport, an academic leader in the shareholder value movement, has had to admit the dark side of pay for performance as a governance tool (2006). The principle that bad management theories can destroy good management practice (Ghoshal 2005) also applies to the performance-based remuneration of top managers. The predominance of shareholder value and principal/agent models seems to have poisoned rather than to have cured corporate governance, and has contributed to remunerative excesses and corporate scandals, mostly in the USA. The stewardship model, which encourages trust, coalitions between stakeholders and voluntary compliance might be more appropriate (Davis *et al.* 1997; Frey and Osterloh 2005).

1 This thesis-paper is based on our book *Management Pay and Corporate Success – An International Comparison*.

Complex and dynamic business environments make it difficult both to measure corporate performance and to describe its drivers. By way of analogy, while it is not easy to assess a soccer player's performance, it is even more difficult to assess that of the team coach. And soccer is a much simpler affair than the business dynamics of a large multinational. Thus, the question arises whether, for instance, non-financial and ethical values are as relevant to corporate success as financial value enhancement. Holistic value-based performance management systems could – contrary to traditional expectations – capture non-financial factors, such as employees, customers and other operational drivers of business strategy. This is particularly desirable with regard to performance-based managers' pay. The debate on Balanced Scorecard (BSC) Systems (Kaplan and Norton 2005) encourages hopes of a stronger orientation towards wider corporate economic and social responsibility. Some firms already use non-financial reference figures, such as health and safety targets – for instance in the UK, where they have been awarded 'Business in the Community Awards for Excellence' (Chahed and Müller 2006: 114). But business practice reveals that problems with defining and implementing non-financial performance measures could nullify the theoretical superiority of BSC systems, and that a lack of transparency may open up such systems to manipulation.

International comparison of corporate governance systems in Germany, Sweden and the UK indicates that traditional shareholder or stakeholder approaches cannot explain the recent dynamics in corporate governance regulation. The detailed UK reporting requirements on individual directors' pay and on remuneration policy have been at the forefront in the thinking behind EU recommendations and legal reforms in Germany and Sweden.

But an emphasis on *ex post* control mechanisms is not enough. Good corporate governance still requires some degree of 'voice' for stakeholders to establish trust in internal decision making. Hence, holistic concepts of strategic management and performance measurement seem to provide a better basis for corporate governance and control, and could promote fair performance review and remuneration systems for managers.

Increased transparency in relation to management remuneration packages has developed into an instrument for improved internal performance orientation and external legitimation. Top management remuneration is no longer a 'private issue', as the world's largest enterprises are also political actors whose activities have far-reaching effects on society. Thus, business success also requires public legitimacy, and increased transparency provides a control mechanism for external stakeholders. The fact that corporate wealth and the wealth of nations have been decoupled to some extent due to access to cheap labour by global relocation and increasing concentration of capital in the 'happy few' Fortune 500 companies should not be an excuse for managers and those supervising them to neglect their social responsibilities. Multinationals remain rooted in their home base (Rugman and Collison 2006). As Paul Krugman (2002) has said, income inequality in the US has returned to the levels of the 1920s. This creates a situation in which the new elite, like its predecessors, has enormous political power. This jeopardises social cohesion and democracy. Corporate governance institutions – managers, shareholders and labour representatives – must take their share of the responsibility, but they will be overstrained if society is not also involved.

References

Chahed, Y. and H.-E. Mueller (2006) *Unternehmenserfolg und Managervergütung*, München/Mehring.

Davis, J. H., F. D. Schoorman and L. Donaldson (1997) 'Toward a Stewardship Theory of Management', *Academy of Management Review*, 22 (1), 20-47.

Frey, B. S. and M. Osterloh (2005) 'Yes, Managers Should Be Paid like Bureaucrats', *Journal of Management Inquiry*, 14 (1), 96-111.

Goshal, S. (2005) 'Bad Management Theories Are Destroying Good Management Practices', *Academy of Management Learning & Education*, 4 (1), 75-91.

Hitt, M. A., R. Ireland and R. E. Hoskisson (2007) *Strategic Management*, Mason, Ohio: Thomson Southwestern.

Kaplan, R. S. and D. P. Norton (2005) 'The Balanced Scorecard: Measures That Drive Performance', *Harvard Business Review* (July/August), 172-182.

Krugman, P (2002) 'For Richer', *The New York Times*, 20 October.

Porter, M. E. and M. R. Kramer (2006) 'Strategy and Society', *Harvard Business Review* (December), 77-92.

Rappaport, A. (2006) 'Ten Ways to Create Shareholder Value', *Harvard Business Review* (September), 66-77.

Rugmann, A. M. and S. Collison (2006) *International Business* (4th edition), Essex.

Yasmine Chahed
Doctoral student
at London School of Economics

Hans-Erich Müller
Professor for management
and organization at Berlin School
of Economics

Collective action vs free movement
The *Laval* and the *Viking* cases

Can an enlarged Europe tolerate equality of arms for trade unions seeking to combat wage shopping on the part of employers? This is in essence the question put before the European Court of Justice (ECJ) in the *Viking* and *Laval* cases in which judgments were delivered on 11 and 18 December 2007.[1] In both cases, trade

1 Judgment of 11.12.2007, *The International Transport Workers' Federation and The Finnish Seamen's Union v Viking Line Abp OU Viking Line Eesti?* Case C-438/05.
Judgment of 18.12.2007, *Laval un Partneri v Svenska Byggnadsarbetareforbundet, Svenska Byggnadsarbetareforbundet, Avdelning 1, Svenska Elektrikerforbundet* Case C-341/05.
The judgments can be viewed on the Court's website: http://curia.europa.eu/jurisp/cgi-bin/form.pl?lang=en