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Determinants of Executive Incentive Pay in Europe

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Abstract

In this paper we study possible determinants of the use of incentive pay for managers in European companies. Data from 5,000 firms in 15 countries are used to analyze the degree to which incentive pay is associated with national embeddedness, local labour market institutions, ownership, and internationalization of markets. We find that companies in countries with high scores on power distance and individualism tend to use incentive schemes for managers more frequently than companies with lower scores on these cultural dimensions. Centralized wage bargaining and unionization at the firm level tend to reduce the prevalence of such schemes. Incentive pay is less common in state-owned companies than in privately owned firms. The findings also reveal that the more global the market in which a firm operates, the greater the probability that it will implement incentive pay elements for its managers. Our results suggest that unions, national labour market institutions and social and cultural norms serve as buffers against the introduction of US-style compensation systems.

Introduction

Performance-related pay such as bonuses, profit sharing and stock options constitutes an important element in incentive systems for US managers, and such systems have become more common throughout many European countries. Compensation tied to performance is assumed to give managers incentives to act in line with the interests of the owners. Growth in the use of incentive schemes may thus indicate a departure from «managerial» or «stakeholder» capitalism characteristic of corporate life in many European countries and a convergence towards US «shareholder value capitalism» (Buck and Shahrim, 2005).

Increased international competition, cross-border mergers and acquisitions, proliferation of multinational enterprises, internationalisation of financial markets, growing competition for executive talent, as well as spread of «best practice» have been emphasized as major sources of these changes. Such trends should be particularly clear in Europe where the European Union (EU) represents not only a common market for goods, services and labour, but also a common institutional environment where rules and standards are harmonized. The European business venue is thus affected by several parallel forces that might eventually lead to a convergence of business practices (Gooderham et al., 2004; Mayrhofer et al., 2011; Stavrou et al., 2010).

Yet there are considerable variations in the use of these incentive pay schemes between firms across European countries. Profit sharing, for instance, is commonplace in France but rare in Scandinavia. According to previous research the Scandinavia countries in general appear to have the least «Americanized» corporations in Europe, while the United Kingdom appears to be on the opposite extreme (Gooderham, Nordhaug, and Ringdal, 1999) suggesting that there are major obstacles to changes in favour of a US model. One reason may be that US style executive compensation is incompatible with prevailing norms in many European countries, such as the strong egalitarian tradition in Scandinavia. Others would emphasize institutional factors such as the role of trade unions and national wage settlements in Europe compared to the USA.

Rather than focusing on the merit or legal aspects of incentive schemes (e.g., Ferrarini, Moloney, and Vespro, 2004) in this paper we focus on the actual use of performance-related incentive schemes and its underlying determinants. The aim is to investigate how cultural and institutional factors affect firms' propensity to adopt incentive pay for managers. Based on data from 5,000 firms in 15 countries, we analyze the degree to which the use of such pay elements can be accounted for by nationality and local labour market institutions (wage bargaining centralization, unionization). Within this sample, about 70 per cent of the firms use some form of incentive pay for their managers, whereas 20 per cent offer managers stocks or stock options. Our analysis of nationality includes two of Hofstede's (1980) indicators of national, cultural embeddedness, that is, individualism and power distance. In addition we apply indicators of the nationality of corporate headquarters and measures of the degree to which the company operates in a domestic, regional (European) or global environment.

Background

Executive pay has during the last decade been subject to intense scrutiny and even public outcry in many European countries as well as in the U.S.A. (Bebchuk et al., 2010). Public concern and criticism are related to total or base compensation, but even more so to fringe benefits, performance-related incentive pay and golden parachutes. In the USA such schemes are extensive and widespread, and from an American perspective Norway's domestic controversies may seem like a storm in a teacup (Dale-Olsen, 2003). In large US companies, less than one third of total executive compensation comes in the form of base salary, whereas more than 40 per cent comprise stocks, stock options and bonuses (Goergen and Renneboog, 2011). Base salary for American executives is somewhat higher than for their European counterparts, but the striking difference across the Atlantic is related to the variable component of pay. Incentive pay, particularly stocks and options, has been the most rapidly increasing component of total compensation for American top managers (Core, Guay, and Larcker, 2003). American executives' total compensation is in addition high relative to their own subordinates.

Although American-style incentive pay has been copied by corporations in other countries, there are still considerable differences with regard to the use of these pay strategies even within Western Europe. According to the Hay Group bonuses for Norwegian executives are on average 15 per cent of base salary, whereas in Germany bonus are on average the same amount as base salary. Stock options are widespread in France and the UK compared to Scandinavia. The UK and Norway, despite proximity across the North Sea, appears to be European extremes with regard to corporate governance, British business in general tend to be more «Americanized» than Norway (Gooderham et al., 1999).

These striking differences can only to a limited extent be accounted for by differences in industry structure and other business conditions, and may instead be related to differences in cultural or institutional environment. For instance, Rehu and associates (2005) concluded that there is a notable difference in incentive preferences between US and German employees, suggesting that compensation systems are related to cultural differences. This suggests that there are factors beyond agency and corporate governance considerations affecting the choice of compensation schemes for executives.

Compensation Schemes

Compensation schemes are key components of a firm's personnel policy because it affects to what degree the firm is able to attract, motivate and retain key employees. We focus on compensation in straight cash or compensation that is at least readily negotiable, but does not include additional compensation (such as pension schemes and fringe benefits) or golden parachutes for top managers in larger companies. For the sake of simplicity we further assume that compensation schemes include one or more of the following components: Base salary, stocks/stock options, merit pay, bonus, and profit sharing.

Base salary includes a bundle of closely related compensation schemes, and usually refers to a system of positions where each position is assigned tasks, responsibility, subordinates, decision making authority as well as monthly payment attached. In some cases base salary is also determined by the employee's qualifications, in addition to characteristics of the position. Although base salary does not vary with individual or firm performance, base salary still provides incentives for employee to get promoted or to improve skills. Performance-related pay typically supplements base salary. Although base salary also provides incentives, in this article incentive pay refers to pay that varies with performance (including bonuses for reaching specified objectives).

Contrary to base salary, merit pay aims at influencing work performance directly. Piece rate, one of the most popular forms of merit pay, implies that parts or all pay is determined by output quantity, for example sales agent commission. Bonus pay resembles merit pay in that it is calculated on the basis of actual performance or is contingent on the attainment of a pre-specified goal. Bonus may for example be granted to employees if the company achieves a certain level of productivity improvements. Profit-related bonuses also resemble merit pay in that they are directly linked to results. Profit sharing, however, implies that some or all employees share a percentage of company profits.

In most large corporations, ownership and management is separated (Berle and Means, 1932). Stocks and stock options, particularly for top managers, are thus compensation schemes that seek to align the interests of owners and employees. The current value of stocks/stock options are of course related to the value of profit sharing schemes, but depends on company prospects and on general fluctuations in the stock market, in addition to company profits. Incentive schemes are often alternative ways of obtaining the same outcome. Stock options, for example, will be an available alternative only for listed companies, and stock market listing is less common in for example Germany and Italy where pyramidal and cross-ownership structures are more common. Alternative incentive schemes can be considered functional substitutes.

Empirical research on compensation schemes has generally been preoccupied with two issues. The first line of research has dealt with compensation schemes as outcomes, and has sought to explain why firms use incentive pay. This research has in particular focused on explanatory variables and hypotheses derived from agency theory (e.g., Kang and Yanadori, 2011; Roth and O'Donnell, 1996). In addition, empirical research has focused on the influence of institutional forces on administrative practices in general (Gooderham et al., 1999) and compensation schemes in particular (Eisenhardt, 1988). The second line of research has focused on the relation between incentive pay and performance, notably studies of the relationship between executive compensation and performance (e.g., Carpenter and Sanders, 2002; Zajac and Westphal, 1994).

Although deliberate design and market forces may influence the use of incentive pay, there can at the same time be powerful (non-market) institutional and cultural factors at play. Many of these make compensation practices that are effective in one country inappropriate or even unworkable in another context (Giardini, Kabst, and Müller-Camen, 2005; Gooderham et al., 2004; Gooderham et al., 1999). This can be the case with regard to systems developed and applied in the USA, but it can also be true across borders in Europe.

National Culture

Culture refers to the systems of meaning, values, beliefs, expectations and goals that are shared by members of a particular group of people and that distinguish them from members of other groups. Hofstede describes culture as a collective phenomenon within a country, a «collective programming of the mind» for a group of people (Hofstede, 1980, 1991). However, what we observe are the artefacts of cultural dissimilarity – the numerous and often pronounced differences in practices such as greeting rituals or dress codes. Hofstede assumes that manifest culture builds on fundamental values and that these values are essentially about what people regard as good and right. This mental programming is assumed to be stable and resistant to change. Cultural differences can be found at many different levels, professional, class and regional, but it is particularly potent at the national level due to the socialization of generations.

As an alternative to in-depth single-country studies scholars have attempted to classify cultures in relation to one another by using a few, relatively broad fundamental dimensions that are particularly relevant to corporate governance. Based on a survey among more than 100,000 IBM employees in 50 countries Hofstede identified four basic dimensions of national culture: Power distance, uncertainty avoidance, individualism/collectivism, and masculinity/femininity. These are not intended to describe individuals but are descriptions of national norms or values. Our basic proposition is that management practices, in the same way as greeting rituals and dress codes, are cultural artefacts and thus expressions of the underlying system of values (see also Oudenhoven, 2001). We believe that power distance and individualism are particularly influential with regard to how easily executive incentive pay is culturally accepted.

Power distance indicates the extent to which a society expects and accepts a high degree of inequality in institutions and organisations. In a country with a large power distance, organisations are characterised by formal hierarchies and by subordinates who are reluctant to challenge their superiors. In a country with a small power distance, subordinates expect to be consulted and the ideal boss is a resourceful democrat rather than a benevolent autocrat. Because incentive pay to top managers typically involves considerable handouts, such incentive schemes may imply greater income inequality across the ranks. Incentive pay should thus be less acceptable in countries with a small power distance. We accordingly expect that incentive pay for managers will be more frequent in countries with high scores on power distance.

The individualism-collectivism variable relates to the extent to which people prefer to take care of themselves and their immediate families rather than being bound to some wider collectivity such as the extended family or clan. Typical individualists will tend to prefer work settings in which they can make their own decisions, autonomy, variety and pleasure are sought in the system. Executive incentive pay implies that compensation tends to be awarded on a more individual basis. In collectivist countries this type of incentive pays would accordingly conflict with salient social norms. We expect that incentive pay such as stock options and bonuses for managers will be more frequent in individualist countries.

Institutional Constraints and Pressures

Although cross-national management research has been heavily influenced by Hofstede, cross-national differences are probably more fully understood by considering both national culture and social institutions. However, the controversy regarding the relative importance of culture and institutions persists (Buck and Shahrim, 2005). Differences in compensation systems across countries can be analyzed with regard to other differences such as national institutions (Gooderham et al., 2004). At the same time there are organizational characteristics, such as labour relations, that may affect the choice of incentive systems along with country-level variables (van Oudenhoven, 2001). In Scandinavia as well as in most other Western European countries, base salaries are determined through bargaining between labour unions and the employer (or employers' association). Wage bargaining is done on behalf of unionized employees, but the results are frequently implemented for many other employees (Stokke, 1998). Moreover, there may be local (company-level) or individual bargaining in addition to or within the frames of a national or industry-wide wage settlement.

Countries with a centralized wage bargaining system tend to have smaller wage differences than countries with only local bargaining. Companies not covered by a national settlement will also tend to have the major national settlements as anchors or reference points when negotiating with their employees. This may be done in order to make settlements legitimate internally as well as externally (Scott and Meyer, 1994). We accordingly assume that there can be a spillover into decisions regarding executive incentive pay – even if exectuive incentives are not covered by the wage settlement.

Because the benefits of union membership vary across countries, there is considerable variation in the correlation between unionization and wage settlement coverage (Stokke, 1998). Unionization may accordingly operate independently of wage bargaining. Strong unions tend to moderate managerial power and autonomy (Gooderham et al., 1999), and therefore also tend to reduce compensation differences within the company. Unions also tend to favour collective wages and oppose individualized wage bargaining (as this would undermine unions). Unionization should therefore be negatively associated with executive compensation level in general and incentive pay in particular.

MNCs and Diffusion of Corporate Governance

Multinational corporations (MNCs) can be effective vehicles for the diffusion of HRM practices for several reasons (Fenton-O'Creevy, Gooderham, and Nordhaug, 2005). They are generally large and prone to adopt elaborate HRM practices, and their size and visibility in the host countries context often make them likely role models for local companies (Mayrhofer & Brewster, 2005). MNCs' border spanning nature also increases their salience in the local context. US companies are frequently regarded as such role models, and others that want to «catch up» will accordingly be inclined to adopt US-style corporate governance (Brewster, 2004). Although evidence indicates that practices originating in the USA are in fact widely disseminated, less research has investigated to what degree such practices are compatible with local norms and institutions or if practices are culturally specific and non-transferable to other contexts (Newman and Nollen, 1996; Liberman and Torbiörn, 2000).

A basic challenge for MNCs is integrating HRM across dispersed units while at the same time adapting to the institutional and cultural requirements of host communities (Bloom et al., 2003; Giardini et al., 2005). Hence there are two basic mechanisms at work: a country-of-origin effect (the MNC imposes policies on subsidiaries; or subsidiaries adopt country of origin practices in order to look good in the eyes of the mother company) and a host-country effect (subsidiary is imprinted with host-country context or the MNC tries to adapt to local practices) (Giardini et al., 2005; Liberman and Torbiörn, 2000). We expect the country-of-origin effect to be notable with regard to US MNCs such that subsidiaries of US MNCs more often than others tend to have incentive pay for their managers.

Exposure to International Competition

Although benefits of improved corporate governance may be considerable, the motivation to pursue those benefits may be less so. Prior success may make actors so self-complacent that they will not feel the need to implement any changes (Miller and Chen, 1994; Greve, 2003). Firms operating with a comfortable profit may not be motivated to exert the extra effort required to implement novel practices to marginally increase their returns (Mayrhofer and Brewster, 2005). Such «lazy» firms can typically be found in protected environments insulated from international competition. State-owned companies in addition tend to be protected by politicians. Competing internationally accentuates the need for a more intense husbandry of resources which in turn ought to accentuate the need to install stronger incentives for management. It may therefore be surmised that firms that are exposed to international competition are more inclined to use elaborate compensation methods than firms which operate exclusively within domestic markets. Another reason is that operating on the international venue widens the scope of managerial tasks and increases the demands on managerial efforts. In other words we expect that companies with exports are characterized by a stronger performance focus than non-exporters.

Methods and Data

The analysis is based on data collected in a multinational survey organized by the Cranfield-network for human resource management. The questionnaire was translated to the language of each participating country and distributed to companies with 100 employees or more. Informants answered questions regarding four types of incentive pay for managers: stocks/stock options, merit pay, bonus, and profit sharing. Responses were coded as yes or no for each type of incentive pay. Table 1 shows the number of firms by country along with the percentage of firms using incentive pay for managers. We measured variables indicating centralization of wage bargaining in a similar way. Informants indicated if bargaining takes place at national level (industry-wide), at company level, or individually for each employee. Because national wage settlements may leave scope for further bargaining at the company as well as the individual level, responses are not mutually exclusive. Respondents were also asked to estimate the percentage of trade union member among company employees.

Informants were further asked to describe the main geographical market for the company's products or services. Ordered response alternatives were: local, regional, national, European, and global. By coding these responses from 1 to 5 this variable measures increasing exposure to international competition. In order to capture the hypothesized influence of US multinationals we coded one dummy for US corporate headquarters location. We further included one dummy to indicate whether the company is owned by the state or not. In order to capture the hypothesized impact of national culture, we assigned values for Hofstede's (1980) individualism/collectivism and power distance dimensions to each company according to the country in which it is situated (values included in Table 1).

Analysis and Results

Table 1 shows the percentage of firms using incentive pay in the form of shares/options, bonuses or any type (including merit pay and profit sharing). These are the dependent variables in the logistic regression analyses reported in Table 2. As expected the companies in the Scandinavian countries demonstrate low scores, whereas French firms exhibit the highest rate of incentive pay. The table also includes scores for Hofstede's individualism and power distance dimensions. Analysis at the country level reveals Pearson correlations at about 0.5 between power distance and «any incentive» as well as bonus. The per cent stocks/stock options correlates at 0.5 and 0.3 with individualism and power distance. These correlations indicate there is in fact an association between culture and the use of incentive pay for managers, and constitutes a preliminary support for the hypothesis that culture does influence the adoption of incentive schemes.

Table 1. Sample, per cent firms with incentive pay for managers and Hofstede cultural dimensions by country.

Country	Sample	Incentive pay, % of firms			Hofstede scores	
		Stocks/ options	Bonus	Any incentive	Individualism	Powerdistance
Austria	230	7	2	70	55	11
Belgium	282	24	24	73	75	65
Denmark	515	11	11	42	74	18
France	400	34	31	94	71	68
Germany	503	18	1	82	67	35
Greece	136	18	38	83	35	60
Ireland	446	22	24	43	70	28
Israel	194	18	20	56	54	13
Italy	79	13	11	81	76	50
the Netherlands	234	15	9	59	80	40
Norway	391	12	15	42	69	31
Portugal	169	4	14	56	27	63
Spain	294	18	18	75	51	57
Switzerland	168	17	15	87	68	34
UK	1091	30	31	71	89	35
Total	5132	20	19	66	70	38

Table 2 shows the result of logistic regression analyses with regard to two types (stocks/options and bonuses) as well as total incentive pay for managers. «Any incentive» is coded 0 (zero) if the firm does not report any form of incentive pay for its managers, and 1 (one) if any of four types of pay is reported. Models are identical except for the dependent variable. Models are more successful predicting stocks/options and total incentive pay for managers (pseudo R^2 around 20%) than predicting bonuses (pseudo R^2 around 10%). We included company size (logarithm of number of employees) as a control variable, and note that the larger companies tend to offer managers incentive pay more often.

Table 2. Incentive pay for managers. Logistic regression.

	Stocks/ options		Bonus		Any incentive	
Power distance	0.013	***	0.014	***	0.022	***
Individualism	0.027	***	0.018	***	0.004	
US multinational[d]	1.386	***	0.523	***	0.853	***
Wage bargaining:						
Individual[d]	0.003		–0.011		0.174	***
Company[d]	–0.029		0.088	***	0.111	***
National[d]	–0.122	***	–0.116	***	–0.143	***
Unionization	–0.083	***	–0.071	***	–0.088	***
Global market	0.263	***	0.165	***	0.313	***
State owned[d]	–2.908	***	–0.855	***	–1.012	***
1000 employees (log)	0.299	***	0.059	*	0.317	***
Model chi-sq	745.80	***	319.34	***	943.84	***
–2 log likelihood	3778.14		4062.19		4384.61	
McFadden pseudo R^2	0.16		0.07		0.18	
Nagelkerke pseudo R^2	0.24		0.11		0.28	

*p<0.05 **p<0.01 ***p<0.001

[d]Dummy variables (if true = 1, if not = 0)

N=4321

According to these analyses high individualism and high power distance increase the probability of implementing incentive pay. The results also indicate that US multinationals tend to export incentive schemes for managers to their subsidiaries in Europe; this influence appears to be particularly strong with regard to stocks or stock options (as expected). We further note that internationalization appears to trigger the use of incentives: The more global the company's market, the greater the probability that some type of incentive pay for managers is applied. State owned companies clearly have a lower probability of implementing such compensation elements.

As hypothesized, the institutional context clearly has an impact on the use of incentive pay (in particular the combined dependent variable). The more centralized the wage bargaining, the less probable that the company will use incentive pay for managers. Moreover, the greater the presence of trade unions in the company, the less likely it is that the managers of the company will receive such pay in addition to the base salary.

Although there are some differences in coefficient estimates, the results are generally robust across types of incentive pay. The impact of individualism is the only notable exception from this pattern. In addition, individual bargaining appears to influence the use of other types of incentive pay (covered by the combined variable), but not stock options or bonuses. This corroborates the results above and lends support to our assumption that different types of incentive pay are functional substitutes.

Discussion and Conclusion

The results essentially support our basic proposition. Companies situated in countries that have high scores on power distance tend to use incentive compensation schemes for managers more frequently than do companies in other countries. European subsidiaries of US corporations tend to use such schemes more than subsidiaries of Asian or European corporations. Centralized wage bargaining and unionization (both measured at the firm level) tend to reduce the prevalence of such schemes for managers. The results also show that the more global the environment in which the firm operates, the greater the probability that it will install incentive pay for managers. Larger firms also tend to implement incentives more often than smaller firms. The analysis does not support our expectation that incentive pay would be more common in countries with high scores on Hofstede's individualism dimension. The results are robust across types of incentive pay.

Although Hofstede's theory has for decades been the benchmark in cross-cultural research and management, substantial criticisms have also accumulated. Some critics have pointed out that Hofstede's data, collected around 1967–73, are now getting old and that the world have changed both politically and economically (McSweeney, 2002; van Oudenhoven, 2001; Trompenaars and Hampden-Turner, 1998). Cultures change and globalization may lead to a convergence of culture in general and in organizational culture particular (Gooderham and Nordhaug, 2002; van Oudenhoven, 2001). It has for example been proposed that because of globalisation younger people in particular are converging around a common set of values. Critics have further contended that the research by Hofstede and his associates was culturally biased because Hofstede's team comprised Europeans and Americans whereas the studies include many countries from other parts of the world (Roberts and Boyacigiller, 1984). However, in the context of this article, where the aim is to apply Hofstede's findings on a European basis, this is a less relevant problem. A final criticism involves seeming anomalies in Hofstede's research. For example Trompenaars and Hampden-Turner's (1998) research suggests that German corporate culture is substantially more hierarchical than Hofstede's finding implies.

In this paper we have contrasted the impact of cultural and institutional factors. In a broader perspective it would also be relevant to consider whether and, eventually, to what extent these are causally related. Are, for example, egalitarian norms in Scandinavia a result of decades of government and trade union efforts to reduce inequalities or are they merely a manifestation of norms that already existed? In the first case, egalitarian norms are a great success for the trade unions and the social democrat parties, whereas in the latter case trade unions and social democrat succeeded because of these norms.

If cultures are indeed more malleable than frequently assumed, labour market institutions and their associated politics (rather than prevailing norms) will form the major obstacles to Americanization of European compensation practices. The United Kingdom experiences during the Thatcher period suggest that norms adjust to practices rather than the other way around: In the 1970s compensation practices in Britain did not differ much from those in Scandinavia. Wage differentials were small, and UK top managers were paid less than their colleagues in other large industrialized countries. During the 1980s executive pay changed dramatically along with labour market reforms implemented by the Thatcher government, and UK executives were now among the best paid (Cheffins, 2003). We might speculate if the Americanization of UK corporations occurred as result of politics rather than as a result of a common Anglo-American culture.

Our findings indicate that cultures with high power distance are more receptive to incentive pay for managers and that such compensation practices tend to be imported from the USA. The results further suggest that for companies involved in international competition there is more pressure or perhaps stronger needs to implement incentive pay for managers. At the same time unions and national labour market institutions seem to act as buffers against the introduction of US-style compensation schemes. Moreover, the analysis suggests that institutional conditions play a somewhat more active role in determining the use of incentive pay than do the companies' national, cultural embeddedness. Although internationalization of corporations and product markets are strong forces behind changes in managerial styles, the research reported in this study also suggests that politics and national institutions are major obstacles to Americanization or cross-European standardization of corporate governance, at least in regard to incentive systems.

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