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Executive compensation: Trends and policy issues

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**Executive compensation:
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International Institute for Labour Studies
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Preface

This paper has been prepared as background to the new Institute's publication entitled *World of Work Report*, which this year focuses on the issue of income inequality. The Report shows that, in the majority of countries, the incomes of richer households have increased relative to those of their middle- and low-income counterparts.

This can be good for the economy. Indeed, it is crucial to reward work effort, talent and innovation – key engines of economic growth and wealth creation.

However, there are instances where income inequality reaches excessive levels, in that it erodes social stability. Growing perceptions that income inequalities are too high may weaken political support for pro-growth policies. Too much income inequality can also be conducive to unstable economic growth.

The Report examines a number of factors which may be conducive to excessive income inequality, such as financial globalization and steep increases in executive pay, disconnected from firm performance. The role of domestic factors is also analyzed, including i) emerging patterns of employer-employee bargaining; ii) the trend increase in non-standard forms of employment; and iii) the ability of the tax and transfer systems to redistribute the gains from economic growth.

This paper reviews research on one of the key Report's topics, namely executive pay, its linkages with enterprise performance and related policy issues. It is one of the first cross-country analyses of what has become a controversial topic during the financial crisis.

Raymond Torres
Director
International Institute for Labour Studies

A. Introduction and main findings

The issue of executive pay has attracted considerable attention over the past few years. On the one hand, the job of executives –i.e. the top managers of firms—has become more difficult owing to the fact that market conditions under which firms operate have become more volatile. Enterprises are under increased pressure to seize the opportunities of globalisation and new technology. The gains from seizing those opportunities can be large indeed. But the losses from failing to adapt to the challenges of globalisation can also be significant. At the same time, new technology and new forms of work organisation are being introduced by firms, making the task of managers more complex. These trends explain why firms are increasingly focusing on performance in order to determine executive pay. On the other hand, the rise in managers' remuneration has been regarded as a source of concern and a driver of excessive income inequality, which is the focus of this report.¹

The issue needs to be discussed in a dispassionate manner, avoiding unfounded perceptions. This is the approach chosen by this paper. It is based on official statistics on executive pay, as well as available studies which have been published in refereed journals. Many of these studies have examined the link between corporate performance and executive pay. The research perspective has traditionally been limited to one or two countries. However, more recently, researchers have begun to review executive pay in a wider, cross-national context.

Cross-country studies in this area are difficult. This is partly due to methodological difficulties arising from cross-country differences in accounting and disclosure practices. In addition, in certain countries, it is not possible to obtain official information on executive pay. Moreover, comparisons through time are hampered by methodological changes in the way executive pay is calculated and/or disclosed.

With these caveats in mind, the purpose of this chapter is to i) examine the patterns of executive pay for some of the countries for which such data are available (Australia, Germany, Hong Kong (China), the Netherlands, South Africa, the United States); ii) analyse the extent to which executive pay is associated with firm performance. The chapter ends with some considerations for policy.

Throughout the chapter, the term “executive” refers to both the chief executive officer (CEO) and lower-level executives of the firm. The term “pay” refers to all the components of executive remuneration. These terms are defined in more detail in the next Section.

Main findings

- The chapter examines the extent to which executive compensation may have interacted with the trends observed in income inequality described in chapter 1. The chapter shows that executive compensation varies considerably across the six selected countries, in terms of both the size and the structure of the compensation packages.
- Executive pay, without shared-based compensation, represents 71 times to 183 times the wage of the average worker. When shared-based compensation is included, executive pay varies between 103 times and 521 times average wages.
- Executive pay, in particular CEO pay, has followed a steep upward trend since the early 2000s. In the United States, between 2003 and 2007, CEO pay grew in real terms by a total

¹ Shields (2007) provides an interesting analysis in this respect. He shows how the companies affiliated to Business Council of Australia are constantly criticizing the lack of competitiveness of the Australian workforce, while at the same time their executive management compensation is on the increase.

of 45 per cent, compared with a real pay increase of 15 per cent in the case of the average executive, and 2.7 per cent for the average American worker. In the Netherlands, real CEO pay grew by 192 per cent over the same period, compared with 146 per cent for the average executive and 2.4 for the average worker.

- Evidence on the extent to which executive pay reflects firm performance shows mixed results. In some countries, such as the Netherlands and Portugal, recent studies do not find any link between pay and performance at all. Evidence for other European countries and Australia is more mixed –with some studies showing a positive link and other no link between executive pay and firm performance. By contrast, the majority of the studies on Asian countries find a positive relationship between pay and performance, though they only refer to specific sectors and companies. In the case of the United States, only a minority of the studies reviewed find a strong link between executive pay and performance.
- The above finding is surprising, given the pronounced incentive-based nature of executive pay. However it can be explained by various market imperfections.
 - Many CEOs exercise a considerable influence on the board that is responsible for determining the amount and structure of executive compensation.
 - Share ownership is often dispersed, making it difficult for shareholders to effectively oppose themselves against unreasonable compensation packages. Even where there are large institutional shareholders, they do not necessarily have a limiting influence on executive compensation as they, in particular if they have other additional business relations with the company which the CEO works for.
 - Many consultancy firms which assist companies to determine compensation packages have an own interest in a positive relationship with the executive board. As a consequence, they frequently use their influence to provide the executives with more generous compensation packages.
 - Share-based compensation components are often inefficient, inasmuch as they frequently only refer to the performance of the firm as a whole but not to the individual performance of the specific executives. Therefore executives may benefit from the rise of the company stock even if their own performance was poor.
- Overall this suggests that there are cases where executive pay increases are both inequality-enhancing and inefficient from the economic point of view. This suggests that there may be a role for public policy in this area.

B. How does executive pay compare across countries and how has it changed?

1. What is executive pay, how is it measured?

Executive compensation packages consist normally of various components. In order to categorize executive compensation, several distinctions can be made. It is possible to distinguish between fixed and variable compensation, between compensation in cash and non-cash compensation and between deferred and immediate compensation. For purposes of clarity, it appears appropriate to distinguish between fixed compensation, non-share based variable compensation, share-based variable compensation and deferred compensation.

Fixed compensation comprises in the first place the salary of the executive which may be regarded as the basis of the compensation package. In addition, many companies grant their executives certain benefits and allowances in kind, including the private use of company cars, aircrafts, financial counselling and home security. Certain companies also provide for a

reimbursement for tax liabilities produced by other components and perquisites obtained by the CEO. The determination of fixed compensation is usually based on a “competitive benchmarking” which employs a general salary survey and detailed analysis of specific industries or market peers (Murphy, 1999, p. 9).²

Variable compensation can be structured in a variety of ways and may be granted on an annual or a long term basis.

Annual variable compensation is either accorded on a discretionary basis, or based on pre-defined performance criteria.³ Performance criteria can be based on individual, business unit or corporate performance and may include thresholds or ceilings limiting the amount of payment (Lynch and Perry, 2003). Criticism in some countries, for instance in the UK, has focused on the fact that the bonus targets remain frequently unpublished. Further, Bruce et al. (2007) find an increasingly complex structure of bonus targets which is linked to higher bonus pay but not to higher shareholder return.

Long-term compensation is typically based on certain performance criteria which are established in advance. While programmes focusing on long-term incentives or non-stock related goals exist, programmes based on share performance largely prevail. The form and conception of share-based compensation differs widely. Companies can grant company shares to executives. The grant of stock will be more profitable to the executive the more the share value increases which is considered as giving the executive an incentive to contribute to the rise of the share value. Normally, the granting of stock is subject to the fulfilment of additional requirements, e.g. that the stock is only acquired after a certain amount of time and therefore entails a retention incentive as the executive has to stay with the company for that period (Restricted Stock Units). Performance shares are a special type of restricted stock in that they are only awarded if the company/executive meets certain performance goals.

Another concept, which is generally referred to as stock options, gives the executive a right to purchase a certain number of shares at a pre-determined price (exercise price) for a specified period of time (option period). Often, the exercise price is set at the level of the market price at the date the stock options are granted. The vesting period (i.e. the period before the options may be exercised) amounts to several years. After the expiry of the vesting period executives may usually exercise the stock options within a certain time framework. The profit of stock options for executives lies in the difference between the exercise price of the option and the actual market price at the time the options are exercised (on the calculation of stock options, see Part III).

A rather recent development is the introduction of stock appreciation rights (SAR) which confer the right to receive payment in cash determined according to the appreciation of a stock price. The effect is therefore comparable to that of stock options. SAR are, however, easier to manage as they do not require the company to provide stock or executives to buy and to sell the shares in order to benefit from the increase of the share price. Compensation packages may also combine share-related goals with supplementary objectives.

Apart from this companies often have a pension programme in place, either specifically designed for executives or open to a wider scope of employees. In addition, companies in the United States often defer a certain part of the compensation to the retirement age of the executive.

Finally, numerous companies provide termination benefits to the executives, either as a lump sum (golden parachute) or as continued payment of compensation after the expiry of the contract. The termination clauses may preclude payment unless the reason for the termination of

² See Murphy (1999) for criticism and further comments.

³ The term bonus is misleading in this respect which is demonstrated by the disclosure practice in the United States. While the term bonus referred before 2007 to payment on pre-determined targets the term now means discretionary payment of the board.

the contract is caused by the executive, i.e. in case of unilateral termination of the contract or in the event of a serious fault of the executive.

The measurement of executive pay is complex, reflecting disclosure practices as well as methodological problems (see Box).

Box – Measurement of executive pay: methodological issues

Disclosure practices

Disclosure practices differ widely across countries. While some countries, as the United States, the United Kingdom, France and the Netherlands, require their companies to report detailed compensation data in a remuneration report, other countries do not have any specific requirements (for example Greece). In various countries disclosure was initially recommended in Codes of best practices which were eventually transformed into legal provisions as compliance by the companies concerned was considered to be unsatisfactory (for example the Netherlands, France (see EGCI (2003)) and Germany (Rang (2006))).

Many regulatory provisions are relatively vague and as a result, companies frequently only report aggregate data on executive compensation while giving no information on individual executive compensation (for example Brazil, Mexico and Japan). In some countries executives seem to consider the disclosure of the precise amount of remuneration as a risk to their personal safety (Ricardo and Carvalhal-da-Silva 2005).

A specific phenomenon is to be noted with regard to German law where companies are since 2006 required to provide detailed individual data on executive compensation. These requirements do not, however, apply if the shareholders assembly decides on the basis of a two-thirds majority to deviate from these provisions. Several companies have made use of this possibility.

Stock options and share-based compensation

Despite the recent progress regarding disclosure, comparing executive compensation remains a highly complex undertaking. The main difficulty in this field stem from the difficulty in calculating of the actual (or prospected) value of the share based compensation. Even in countries where disclosure of stock options is generally prescribed by national regulation, the latter rarely prescribes a specific methodology for calculating the value of stock awards and stock options. As a result, in South Africa, the UK or in France companies often provide the number of the shares or options granted, without however calculating a value of these compensation components. In addition, companies have various possibilities for calculating the value of share-based compensation: while companies in many countries calculate the value of the share-based compensation at the time when they were granted, companies in other countries provide the value of the stock awards and options that have actually been exercised.

The situation is further complicated by the fact that there are also different methodologies for calculating the value of share-based compensation at the date they were granted. The most widespread method for calculating the cost to the company of the stock options is the "Black-Schole Model" which aims at calculating the estimated value of the stock option upon exercise. Other models such as the "Binomial Model", allows for calculation of the grant date value of share-based compensation. Independently of the model used by individual companies, it should be noted that in the majority of the countries reviewed for the purposes of this study (mainly Netherlands, UK, France, Germany Australia, Honk Kong and South Africa), regulation rarely prescribed a specific method of calculation. This leads to a different calculation of the value of share-based compensation not only across countries but also across companies within the same country. For example, in Australia, it was observed that companies used both the "Monte-Carlo" or "Binomial" models; in Hong Kong (China) the method of calculation was often not disclosed which made comparison impossible.

In addition, it would appear that no model of calculation of the stock value at the grant date is exempt from certain limitations. Among other things, such models do not take into account the fact that stock options might be cancelled if the executive leaves the company –which leads to an overstate of the cost of the stock options for the company. Furthermore, the Black-Schole model assumes that the stock options will be exercised at the end of their life –and therefore does not consider that executives may also be free to exercise their options during the whole period –between the vesting and the expiry of the options (see Hall and Murphy 2000, Murphy 1999, p. 19). Moreover, a recent study on stock options in Australia estimates that the average fair value at grant date given to stock options constituted only 26 percent of the value of stock options actually exercised (ISS, 2006). Furthermore, in some countries the way of calculating stock awards and

options has also changed across the years rendering cross time comparisons even more difficult. For instance, until 2007 companies in the US were able to choose between a calculation fair market value or the estimated realizable value under assumptions regarding stock price appreciation. From 2007 on companies have to report the accounting charge the company took for that year and an aggregate fair market value of stock options and stock awards.

In order to be able to compare executive pay with precision it would be necessary to develop a uniform way of calculating the value of the different components of share based compensation. This goes, however, beyond the scope of this chapter.

2. How does executive pay compare across countries

This section looks at executive pay in six countries where disclosure practices permit comparisons. The six countries in question cover a wide geographical scope. They are Australia; Germany; Hong-Kong, China; the Netherlands; South Africa; and the United States.

For each of these countries, executive pay in the 15 largest companies is examined. The companies are selected on the basis of the “Forbes’ “Global 2000” ranking of 2008”.⁴ This helps to identify companies according to the same uniform for all the countries. As suggested by theory (Murphy (1999)) and established by empirical research in various countries, including in the US (Tosi et al 1998), Australia (Merhebi et al (2006)), Portugal (Fernandez 2008) France (Dardour 2008) and Germany (albeit with mixed results according to Haid and Yurtoglu (2006); Rang 2006), executive pay increases with company size. This implies that the level of executive pay in the 15 largest companies is likely to be higher than average executive pay for the economy as a whole. The purpose of the data provided here is not to furnish an all-embracing account of compensation practices but rather to provide a snapshot of developments in the countries concerned in order to show structural similarities, differences and common trends.⁵

Because of the above-mentioned methodological difficulties concerning the calculation of share-based remuneration, the comparisons are confined to pay components which do not depend directly on share values (i.e. salary and perquisites, bonuses and deferred compensation).

On average, CEOs earn between \$ 1.4 million and nearly \$ 10.3 million per year (plus stock options), that is between 71 and 183 times the wage of the average worker⁶

Executive pay in 2007 for the 15 largest companies in the six selected countries is shown in Table 1. The best paid executives are in the United States. In that country, average CEO pay exceeds \$ 10 million per year, that is about 183 times the wage of the average American worker. Executives in Hong-Kong, China and South Africa are paid much less than their US counterparts. However, even there, CEO pay represents between 54 and 148 times the wage of the average worker in the two countries.

⁴ Available under: http://www.forbes.com/2008/04/02/worlds-largest-companies-biz-2000global08-cx_sd_0402global_land.html.

⁵ Companies that did not provide necessary compensation data were excluded from the sample and the next largest one was added to replace it.

⁶ The figures on average workers salaries for 2007 are estimations based on 2006 data using the annual growth in hourly earnings of the OECD for 2007.

Tab. 1: Average Compensation by employee category, 2007

| | CEO | | Average Executive | |
|-------------------|------------|------------------------------------|-------------------|------------------------------------|
| | USD | Ratio of compensation per employee | USD | Ratio of compensation per employee |
| Australia | 6,001,060 | 135.3 | 2,415,012 | 54.5 |
| Germany | 6,796,643 | 147.8 | 3,767,554 | 81.9 |
| Hong Kong (China) | 2,723,425 | 160.2 | 1,075,757 | 63.3 |
| Netherlands | 3,578,286 | 71.4 | 2,171,016 | 43.3 |
| South Africa | 1,370,824 | 104.4 | 934,378 | 71.1 |
| United States | 10,309,701 | 182.6 | 6,297,870 | 111.5 |

Source: Own calculation based on the annual reports of 15 of the biggest companies in the respective countries, see Annex.

It is important to note that these data provide an underestimate of the total remuneration of executives. Indeed share-based compensation is not taken into account. A rough estimate based on available information suggests that the represent between 25 percent (in Germany) and 60 percent (in the United States). This rough appreciation illustrates that the total amount of executive compensation would be considerably higher if share-based compensation were taken into consideration.

A significant proportion of executive pay depends, in principle, on performance

To a significant extent, executive pay depends, in principle, on individual and firm performance. In Australia, German, Hong-Kong, China and the United States, the variable component exceeds the fixed component. But even in the other two countries (the Netherlands and South Africa) the variable component is significant.⁷

3. How has executive pay evolved?

There are only few studies on the evolution of executive pay on a global level. However, for the purposes of this chapter, an attempt has been made to obtain data on changes in executive pay between 2003 and 2007 in the 15 largest companies in two countries, namely the Netherlands and the United States.⁸

The choice of countries was mainly determined by the objective of comparing developments in two countries with different corporate governance traditions and a different institutional framework. The contrast between compensation practices in the United States and the Netherlands seemed to be instructive. Unlike the United States, the Netherlands is a relatively small country whose companies employ a two-tier governance system. Elements that have for a long time been inherent in executive compensation in the United States, such as comprehensive disclosure of compensation and the frequent use of share-based compensation, have emerged only relatively recently in the Netherlands (see De Jong et al (2005), Dufhues (2007)). The findings may therefore be regarded as representative of two different frameworks of corporate governance.

In both cases, it was possible to obtain data on share-based compensation. In this context, one methodological particularity regarding the calculation of the value of share-based compensation should be noted. Unlike the companies in the United States, various Dutch

⁷ In addition, the differences between CEO compensation and remuneration of average executives varied significantly across countries. In Australia and Hong Kong (China) CEO earned twice as much as non-share based compensation as the average executive in their boards. In Germany, the Netherlands and the United States CEO compensation exceeded average executive compensation by more than 60 percent while CEO in South Africa earned slightly more than 50 percent than the average executive.

⁸ Companies which were not listed at the national stock exchange or did not provide comparable data were excluded from the analysis. In this case we shifted further to the next biggest company.

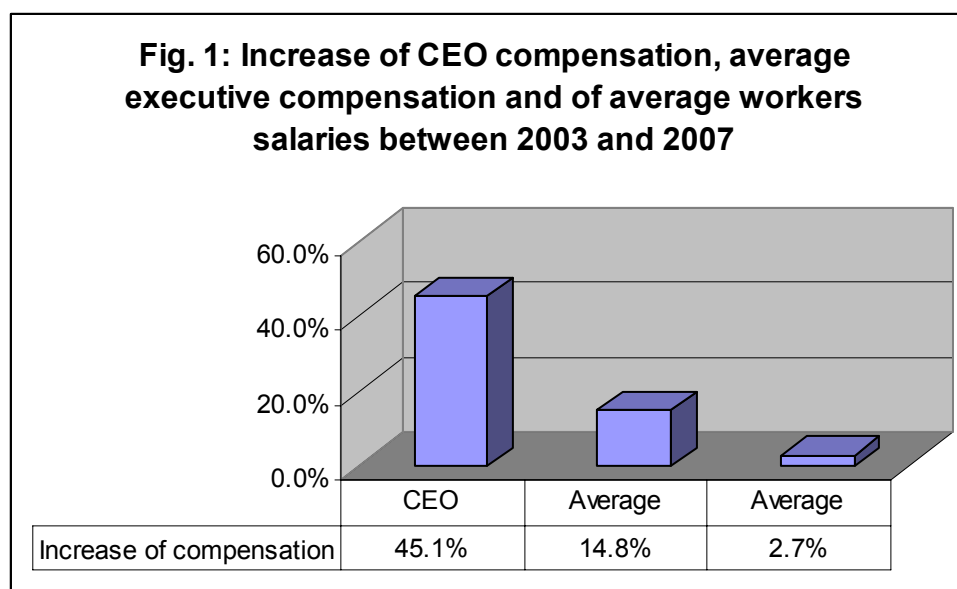
companies did not provide the information necessary for the application of calculations based on the Black-Scholes Model. The value of stock awards and stock options was therefore determined by calculating the value of the stock awards vested in the year of the annual report and the stock options actually exercised in that year. We nevertheless referred to the Black-Scholes Model for United States companies as the generally used method. While this methodology renders rather difficult a meticulous cross-country comparison of the results of the calculation, it allows for a comprehensive analysis of developments across time. We therefore refrain in this chapter from directly comparing the data of the two countries and focus instead on the analysis of the developments within the two countries from 2003 to 2007.

Between 2003 and 2007, average pay of American executives rose by 45 percent and by 15 percent in the case of CEOs and average executives respectively, compared with 2.7 percent [RT guess] for the average American worker

Executive compensation is generally known as having significantly risen in the last decades. As illustrated in the chart, average executive compensation of the top 15 United States companies increased from \$11.1 million in 2003 to \$12.5 million in 2005 and \$12.7 million in 2007. CEO Compensation rose from \$16.9 million in 2003 to \$20.4 million in 2005 and to \$24.4 million in 2007.

Drawing on available data for the years 2003, 2005 and 2007, it would appear that CEO compensation is on the increase also when compared to average executive compensation. While the ratio CEO/executive in 2003 was 1.53 the same ratio increased in 2005 to 1.63 and to 1.93 in 2007 –indicating that CEOs have earned in 2007 almost twice as much as their colleagues, simple executive members of boards.

Furthermore, the strong increase in compensation is remarkable. During the 2003-2007 period, CEO compensation rose by more than 45 percent from 2003 to 2007. The increase of average executive compensation was slightly more moderate but still amounted to almost 15 percent during the four years. This was contrasted by the very modest increase of workers salaries during the same period of not even three percent (see charts and tables below).⁹

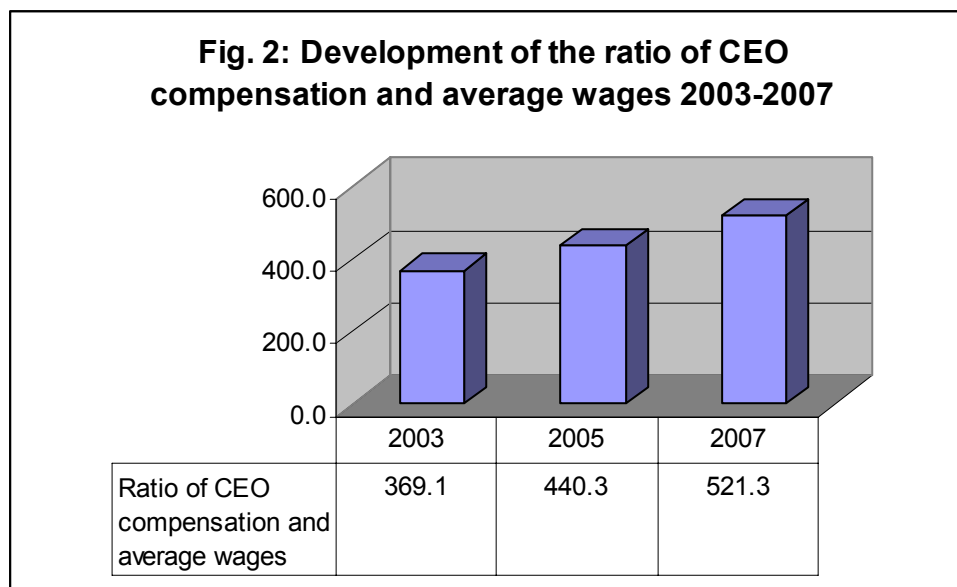


Source: Own calculation based on the annual reports of 15 of the biggest companies in the United States, see Annex.

The stark difference between compensations received by CEOs, on the one hand, and salaries received by average workers on the other hand, has also accentuated the actual gap

⁹ The data concerning the increase of executive compensation refers to the inflation-adjusted compensation and wage data.

between CEO compensation and average salaries (as exemplified by the ratio increase from 369.1 in 2003 to 440.3 in 2005 and to 521.3 in 2007; see chart and table below).



Source: Own calculation based on the annual reports of 15 of the biggest companies in the United States, see Annex.

Moreover, the disparities among the selected group of CEOs and executives from the same companies increased considerably, as is indicated by the evolution of the coefficient of variation, illustrated by the tables and charter below.¹⁰

Tab. 2: Disparities among CEOs and average executives between 2003 and 2007

| | 2003 | 2005 | 2007 |
|------------------------------------|------|------|------|
| CEO Coefficient of variation | 0.51 | 0.54 | 0.65 |
| Executive Coefficient of variation | 0.47 | 0.52 | 0.70 |

Source: Own calculation based on the annual reports of 15 of the biggest companies in the United States, see Annex.

To better illustrate the main trends in executive and CEO compensation in the US, the following charts provide an overview of compensation broken down in four specific components: (a) salary and perquisites; (b) variable compensation in cash; (c) share-based compensation; and (d) deferred compensation (such as pension payments). It is conspicuous that variable compensation constitutes more than 90 per cent of total compensation of CEOs in all years examined and more than 88 per cent of total average executive compensation.

Furthermore, share-based compensation is the dominant component of total compensation for both CEO compensation and average executive compensation. In all the years under examination (2003, 2005 and 2007), share-based compensation constituted more than half of total compensation of CEOs (ranging between 60 and 70) percent and slightly less for executive board members (between 50 and 60 percent).

A quantitative analysis of the compensation components provides additional interesting insights. From 2003 to 2007, the salary of CEOs and executive managers in the companies examined rose by approximately 20 percent (see, table below). An asymmetric trend can be observed with regard to the evolution of variable compensation in cash, which increased by roughly 45.5 percent in the case of CEOs, but declined slightly in the case of executive board members. The proportion of share-based compensation rose strongly in both cases – by 70.32 percent for CEOs and by 48.29 percent for executive board members. Finally, deferred

¹⁰ The co-efficient of variation is computed by dividing the standard deviation of a given data set by its mean.

compensation increased spectacularly by more than 200 percent for both CEOs and executive members of the board. In sum, with the exception of salary and perquisites, the compensation increase was much more significant for CEOs than for simple executive board members. This development may among other things be linked to a change in reporting practices. The rise in share-based compensation component seems to be more important than the rise of the deferred compensation component (because of the overall higher importance of share-based compensation).

Tab.3: Proportionate increase of the compensation components 2003-2007

| | Salary and Perquisites | Variable Compensation in Cash | Share-based Compensation | Deferred Payment |
|------------------------------------|---------------------------|----------------------------------|-----------------------------|---------------------|
| CEO Compensation Increase | 19.75% | 45.50% | 70.32% | 294.40% |
| Executive Compensation Increase | 18.29% | -0.93% | 48.29% | 227.45% |

Source: Own calculation based on the annual reports of 15 of the biggest companies in the United States, see Annex.

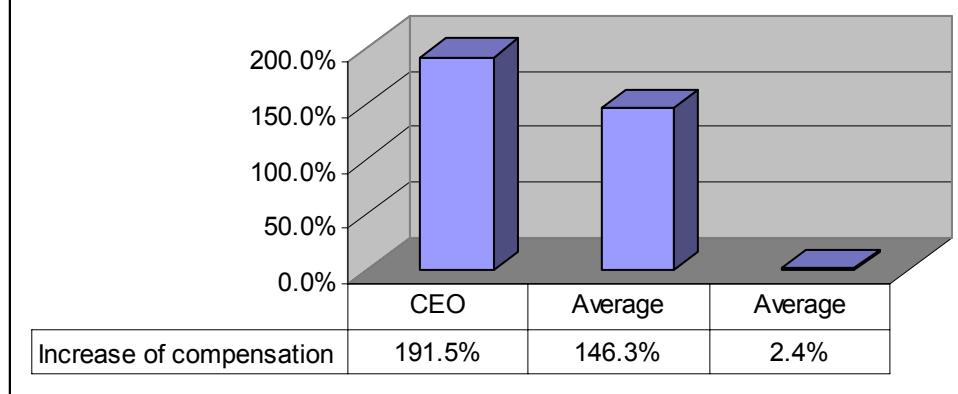
It is interesting to note that the increase of indirect remuneration components, i.e. share-based and deferred compensation, was considerably stronger than that of salary, perquisites and variable compensation, showing a trend for more sophisticated compensation packages.

Between 2003 and 2007, average pay of Dutch executives rose by 191 percent and by 146 percent in the case of CEOs and average executives respectively, compared with 2.4 percent [RT guess] for the average Dutch worker

In the Netherlands, CEO and executive compensation have undergone considerable developments in the period examined. First of all, the strong increase of compensation of both CEOs and average executives, is observed.

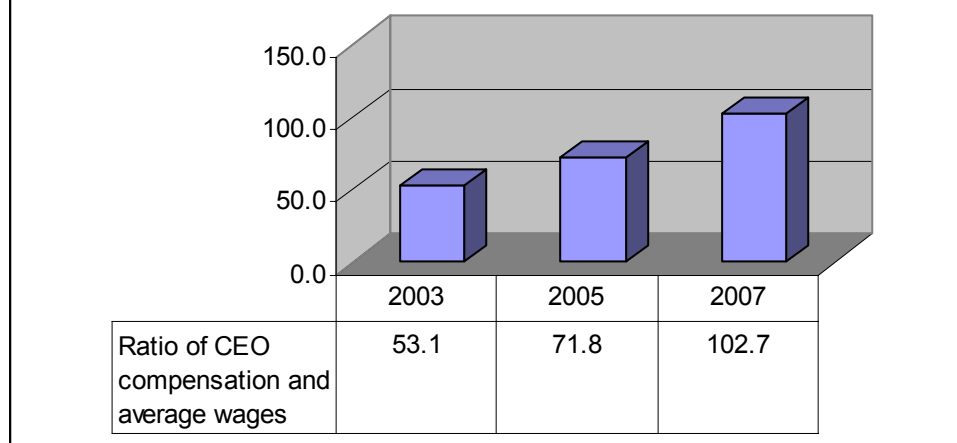
The evolution of CEO and executive compensation was monotonously positive. Moreover, during the period 2003 - 2007, compensation increased dramatically, in particular if compared to average wages. Relying again on OECD data regarding annual labour compensation per employee the above charts and diagrams make apparent that CEO and average executive compensation rose disproportionately compared to the wages of average employees. While CEO compensation of almost doubled, the compensation of average executives increased by 146 percent. This development contrasts with the small increase of average workers salary of about 2.4 percent.

Fig. 3: Increase of CEO compensation, average executive compensation and of average workers salaries between 2003 and 2007



Source: Own calculation based on the annual reports of 15 of the biggest companies in the Netherlands, see Annex.

Fig. 4: Development of the ratio of CEO compensation and average wages 2003-2007



Source: Own calculation based on the annual reports of 15 of the biggest companies in the Netherlands, see Annex.

The gap between Dutch CEO compensation and average wages also increased. While CEOs earned about 50 times more than the average employee, their compensation exceeded the average salary by almost 72 times in 2005 and by more than 100 times in 2007.

Moreover, the disparities among CEOs and among average executives increased considerably from 2003 to 2007. For CEOs the coefficient of variation increased from 0.42 to 0.59. For average executives a similar tendency was noted, although on a lower level. Here, the coefficient of variation increased from 0.34 to 0.47.

Tab.4: Disparities among CEOs and average executives between 2003 and 2007

| | 2003 | 2005 | 2007 |
|------------------------------------|------|------|------|
| CEO Coefficient of variation | 0.42 | 0.47 | 0.59 |
| Executive Coefficient of variation | 0.34 | 0.38 | 0.47 |

Source: Own calculation based on the annual reports of 15 of the biggest companies in the Netherlands, see Annex.

Remarkable developments can also be identified regarding the evolution of the composition of compensation.

The relation between fixed and variable performance in Dutch compensation packages has traditionally been very different from similar packages in Anglo-American companies. As exemplified by the charts below, fixed compensation composed more than 70 per cent of both CEO and executive compensation packages in 2003. The relation between both elements however, changed considerably between 2003 and 2007 with the result that variable compensation constituted more than half of total compensation in 2007 (60.47 per cent for CEOs and 56.67 per cent for executives).

Basic salary constitutes the most important component of compensation in the Netherlands. Its significance has however declined significantly over the period examined. While basic salary constituted more than half the total compensation (57.53 per cent for CEOs and 57.65 per cent for executives), the share of salary and perquisites in the calculation of total compensation decreased in 2007 to 36.17 per cent (CEO) and 33.86 per cent (executives). The share in percentage of variable compensation in cash rose from 2003 to 2007 but declined in the period 2005-2007. Another striking development regards an observed increase in share-based compensation. While share-based compensation played only a marginal role in 2003, it constituted about one third of the compensation packages in 2007.¹¹ On the contrary, pension systems as a part of overall compensation slightly diminished from 2003 to 2007.

Tab.5: Proportionate increase of the compensation components 2003-2007

| | Salary and Perks | Bonus | Share-based Payment | Deferred Payment |
|-------------------|------------------|---------|---------------------|------------------|
| CEO | 49.69% | 174.39% | 5391.17% | 8.36% |
| Average executive | 34.83% | 163.02% | 3706.04% | -9.15% |

Source: Own calculation based on the annual reports of 15 of the biggest companies in the Netherlands, see Annex.

The same trends are exemplified by the charts and table above. Especially the share-based compensation increased extremely, by more than 5000 percent for CEOs and more than 3700 percent for average executives. It should be noted in this regard that executive compensation is a relatively recent phenomenon. Although various companies have introduced share-based incentive plans before 2003, most of these plans had not become effective by 2003 since the stock awards had not yet been vested. In addition, due to unfavourable developments in the stock market –making the value of various stock options relatively low- many of the options were only exercised after 2003. In addition, the annual bonuses increased remarkably by about 174 percent and 163 percent respectively. With about 50 percent for CEOs and about 35 percent for average executives, the rise in salary and perks was somewhat lower, but still remarkable. Deferred compensation remained roughly the same –increasing by about 8 percent for CEOs and even declining slightly in the case of executives (- 9.15 percent).

4. To what extent has executive pay responded to performance?

A key issue which arises from the above findings is the extent to which the level and growth of executive compensation corresponds to corporate performance.

Broadly speaking, empirical research regarding the relationship between pay-performance is usually based on econometric regression models which take into account a number of economic variables. The variables and methodologies employed by these studies often differ considerably. While some studies focus on cash-based compensation, other consider also share-

¹¹ It should be noted in this regard that even before 2005 many Dutch companies had share-based incentive programmes in place. However, as share-based compensation is a relative recent phenomenon in the Netherlands numerous stock awards and options had not yet vested in 2003 and 2005. In addition, various share-based compensation programmes only conferred a rather limited value as stock price was relatively low at that time.

based compensation. Similarly, indicators for corporate performance include shareholder value or annual stock return, but also indicators based on accounting figures such as return on assets (operating earnings over the book value of total assets) and return on sales (operating earnings on total sales). Moreover, the number of companies and executives examined and the period of examination varies. Therefore the results of those studies are not directly comparable.

It should be noted that research findings from consultancy firm surveys (e.g., Korn Ferry, Study Press Release 2008)¹² seem to suggest that when asked whether executive compensation reflects actual performance, directors and managers of the surveyed companies give usually an unambiguous answer to this question. (Consider removing)

The results whether executive compensation reflects economic performance is very controversial; these results partly depends on the geographical focus of the study. Due to its economic relevance and favourable disclosure conditions, research has originally concentrated on the US where the bulk of the studies reported a positive relation between pay and performance (Jensen and Murphy, 1990) (Joskow and Rose, 1994), (Kaplan, 1994), (Boschen and Smith, 1995), (Hallock, 1998) and (Hall and Liebman, 1998). Yet the findings regarding the relevance of such link has been questioned. Various studies find a statistically significant link which is, however, economically weak and therefore provides only a weak incentive for executives (Jensen and Murphy, 1990, Garen, (1994). Other studies find a stronger link between compensation and performance and document that the pay-performance sensitivity has increased over time (Hall and Liebman, 1998, Boschen and Smith, 1995). Several papers providing a meta-analysis of existing research work (Tosi et al, 2000, Dalton et al, 2003) suggest that a widespread, strong link between compensation and performance has not been established so far.

Based on these findings, Barkema and Gomez-Mejia (1998) argue that the concentration on the statistical relationship between executive compensation and corporate performance “leads researchers into a blind alley” (p.143). They therefore suggest to enhance research efforts to fathom the “relative importance of firm performance and other criteria such as the market, peer compensation and behavior” (ibid).

In the last few years researchers have increasingly explored the pay-performance relation also in companies outside the United States. A statistically significant pay-performance relation has been reported with regard to Canada (Zhou, 1999). Research focusing on Asia has come to more complex findings. Kato and Long (2005) document a positive relation between pay and performance regarding Chinese companies. According to Firth et al. (2006) the pay-performance link is however weak which -in their view- raises questions about the effectiveness of firms' incentive systems. Kato and Kubo (2006), Kato et al. (2006), and Unite et al. (2008), also identify a positive relationship with regard to Japanese, Korean, and Philippine firms, respectively.

However, it is remarkable that all the above mentioned studies underscore that the positive pay-performance relation holds only for a certain type of firms. No positive link between executive compensation and corporate performance could be identified concerning Chinese state-owned companies (Firth et al., 2006, Kato and Long, 2005). Likewise, according to Abe et al. (2005) pay-performance relation in Japan is significantly stronger for firms with a Main Bank relationship or a bank-appointed member of the board of directors. The same is true for Korean executives with regard to non-Chaebol companies (Kato et al., 2006). Similarly, Unite et al (2008) find that the positive relation between pay and performance does not hold for companies with an affiliation to a family group.

Evidence from European countries presents a mixed picture. Some studies covering the UK find a low pay-performance sensitivity (Gregg et al, 2005, Conyon and Murphy, 2000, and

¹² “When asked if they felt their CEOs compensation directly reflects company performance, more than half (55 percent) of respondents indicated that it does not reflect or is only “somewhat” reflective of the organization’ s results. Another forty-two percent said their CEOs compensation was in line with company performance.”

Ozkan, 2007). Bruce et al (2007) come to the same conclusion with regard to bonuses of UK companies.

Mixed findings are reported for Germany. Haid and Yurtoglu (2006) report a weak relation between compensation and performance. Conyon and Schwalbach (2000) confirm the positive relation for Germany (and the UK). By contrast recent studies on Portugal (Fernandes, 2008) and the Netherlands (Dufhues et al, 2007) do not find any connection between pay and performance.

In Australia, findings concerning the link between executive compensation and firm performance are heterogeneous. While Defina, et al. (1994) do not find a significant pay-performance relationship, Matolcsy (2000) reports a significant positive relationship during economic growth but no relationship during economic slowdown. Recently, Merhebi et al. (2006) document a statistically significant link between pay and performance. They concede, however, that the economic relevance of this link is rather low.

The above brief survey indicates that a straightforward relation between pay and performance is difficult to establish and that such relation is country specific. It would seem that the question of pay performance link largely depends on economic, institutional and cultural peculiarities prevailing in the countries under examination.

C. What explains the development in executive compensation?

1. Theoretical framework

A number of theories have been put forward in order to explain the levels and composition of executive compensation (Gomez-Mejia (1994). In a recent study by Otten (2006) the author identifies no less than 16 theories explaining executive pay. According to Otten some of these theories draw on the assumption that executive compensation is mainly the outcome market forces, that is, a market for executives, while other view executive compensation “as a socially constructed symbol fitting the expectation, status or role that executives play in a society or firm” (Otten, 2006, p. 50). A third branch of theories considers compensation as a consequence of (potential) interest conflicts problems between shareholders (principals) and executives (agents), and problems of managerial discretion nature that researchers (since Jensen and Meckling, 1976)¹³ refer to as “agency problem”. This model would be based on three basic assumptions: (1) agents are risk-averse; (2) they follow primarily their self-interest; and (3) their interest does not necessarily correspond to the principal agent’s interest.¹⁴ As shareholders have only imperfect information about action developed by executives the abilities of the former to control their behaviour of the latter are limited. This restricts the possibility of the shareholders to enforce the agency contract significantly. There is therefore a risk that executives might follow their own goals rather than those of their principals, i.e., the shareholders (Tosi and Gomez-Mejia, 1989, Tosi et al, 1991).

Based on these assumptions, several sub-theories within agency-theory come to different estimations as to the role performed by executive compensation.

¹³ Jensen and Meckling “Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure”, *Journal of Financial Economics*. 3:5, pp. 305-60. See for a survey on agency theory: Hart, O. and B. Holmstrom (1987), “The Theory of Contracts.” In T. Bewley (ed.), *Advances in Economic Theory, Fifth World Congress*. Cambridge: University Press.

¹⁴ As executives do not bear all the consequences of their action it is necessary to bring into place mechanisms that managers interests with shareholders interests.

The so-called “optimal contract theory”,¹⁵ is up to now the most popular theory in the area of executive compensation. This theory views executive compensation as a means for enforcing the agency contract between and thereby solving agency problems between shareholders and executives, notably through a process of alignment managers’ interests with shareholders’ interests (Grabke-Rundell and Gomez-Mejia, 2002). In order to motivate executives to perform as effectively as possible and according to the interests of shareholders, risks are transferred to risk-averse executives through incentive-based compensation packages. Consequently, the optimal contract theory considers determination of compensation as a question of “pay design” which will, in the optimal case minimize agency costs (Core et al, 2003, Gomez-Mejia and Wiseman (1997)). Thereby, the optimal contracting theory implies that executive compensation contracts are usually bargained at arms’ length between the board of directors and the executives; compensation levels would be the output on market forces; and the structure of executive compensation would reflect the intention to provide executives an incentive to act as efficiently as possible from the perspective of the shareholders. In this context, the board of directors is of major importance as it is responsible for structuring the executive compensation packages in the interest of the shareholders and making sure that the executives serve shareholders’ interest. (Grabke-Rundell and Gomez-Mejia, 2002).

A second variant of agency theory that increasingly generates interest in academics and research cycles is referred to as “managerial power theory”. This theory argues that executive compensation is not only a way of addressing the “agency problem” but also part of the problem itself (Bebchuk and Fried, 2003, 2004 and 2006). According to this theory, the conditions under which executives actually obtain their compensation arrangements are rarely at arms’ length conditions (Bebchuk and Fried, 2003). As a consequence optimal contracting is practically impossible to achieve, and therefore rather weak in fully explaining compensation practices.

Managerial power theory suggests that executive compensation is a product of a variety of factors, in particular those related to the discretion and power of executive officers themselves. Apart from information asymmetry, the executive’s discretion results from the dispersion of shareholders which weakens their bargaining power and from the entrenchment of the CEO in the board which increase his/her bargaining power (Grabke-Rundell and Gomez-Mejia, 2002). In addition, the non-programmatic nature of executives’ positions makes it difficult for shareholders to establish straightforward performance criteria and to evaluate the effort made by the executive (Eisenhardt, 1988). Furthermore, managerial power theory contests that the board of directors, which is in charge of determining executive compensation packages, necessarily acts in the interest of shareholders, and that loyalty to shareholders depends on whether their interests are related more closely to the shareholders or to the executives (Conyon and He, 2004).

The theory makes a number of predictions on how the level and structure of compensation might change in the presence of certain institutional factors. Among other things, it is argued that the more “power and latitude” executives exercise, the more the “levels of compensation” will increase, and the more “pay performance sensitivity of compensation packages” will decrease.¹⁶ Such situation will be witnessed particularly when: (a) the board is relatively “weak and ineffectual” (see already Fama, 1980)); (b) there are no large outside shareholders; (c) there are fewer institutional shareholders; and (d) executives are protected by anti-takeover legislation conditions (in particular Bebchuk and Fried, 2002 and 2003).

Furthermore, managerial power theorists argued that, in order to prevent public opinion “outrage”, including among potential investors, executives have an incentive to use their influence in order to “obscure” and “legitimize” their rent extraction (Bebchuk and Fried, 2003, p. 75). The influence exercised by managers over their own pay –so the theory goes- produces costs to shareholders that go beyond the direct compensation costs, and is indeed damaging for

¹⁵ Research papers frequently refer to this theory as “agency theory”. This is, however, only partly correct since agency theory is a generic term comprising also other theories than optimal contracting theory.

¹⁶ “Sensitivity” refers here to the degree to which executive compensation corresponds to corporate performance.

managers' incentives and by the same token corporate performance (Bebchuk and Fried, 2002, 2003, 2004).

It is often suggested that the two above-mentioned theories - optimal contract and managerial power - are not mutually exclusive but rather complementary (Merhebi et al., 2006) and that they may be used in combination in to explain key aspects of executive compensation levels and structure. The remainder focuses on a number of practical and institutional aspects of the principal-agent problem.

2. Regulatory Framework of Executive Compensation

a) International regulation

Executive compensation as part of corporate governance has been addressed by a variety of international agencies and organisations under various codes or principles of good governance, which are non-binding vis-à-vis member states or the companies concerned, and are confined to providing guidance in the form of best practices.

The most conspicuous in this respect are the "Principles on Corporate Governance" (2004) of the OECD. These principles provide among other things that shareholders should have a possibility to express their views over the issue of remuneration policy for executives and (other) members of the board. In addition, according to these principles, share-based compensation should be made conditional on approval of the shareholders meeting. Further, the remuneration policy should be disclosed and the link between the design of the compensation packages and corporate performance disclosed. Also, non-executives should be included as members of the board so as to provide an independent opinion on issues that may be subject to a conflict of interest.

Within the framework of the European Union, the European Commission has adopted a comprehensive recommendation¹⁷ specifically dealing with compensation of directors of publicly listed companies. It contains, among other things, recommendations as to which information should be provided on directors' fixed and variable compensation as well as on the information to be provided on the performance criteria upon which variable compensation is based. It also recommends that shareholders should have either a binding or an advisory vote on directors' compensation and that share-based compensation should be conditional on a prior vote by the annual assembly. The Recommendation leaves the implementation to the member states either by legislation or by best practice rules. In a recent follow-up report on the Recommendation¹⁸ the Commission comes, however, to the conclusion that while a large majority of the member states either recommend or require comprehensive disclosure of directors' remuneration, "only a disappointingly low number of Member States considered it necessary to recommend that shareholders vote on the remuneration criteria of the board/management board" (European Commission, Recommendation, p.3.).

b) National regulation

Determination of executive compensation may in general be regulated in three different ways. First of all, the state may prescribe a certain procedure by binding laws. Otherwise, the procedure may be left to the autonomy of the company. Various countries employ a combined approach, ancillary provisions being applicable in case the statute does not provide for a procedure.¹⁹

¹⁷ European Commission, Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies (2004/913/EC).

¹⁸ See European Commission, Staff Working Document of 13 July 2007, Report on the application by Member States of the EU of the Commission Recommendation on directors' remuneration SEC (2007) 1022.

¹⁹ This is, for instance, the case in the Netherlands and in Greece (ECGI (2003)).

Procedures for the determination of executive compensation, where they are not fixed by shareholder meetings, differ among countries employing a one tier or a two tier corporate governance system. In a one tier system the board which typically consists of executive and non-executive directors is responsible for fixing the compensation packages of the officers. However, most procedures provide that only the non-executive members may vote and participate in the decision-making on executive pay determination. In various countries, companies are asked to create a special remuneration committee responsible for setting executive compensation.²⁰ Often the majority of those committees consist of executives that are formally independent of the company (independent non-executive directors). This applies for instance to the US (Murphy, 1999), the UK (Thompson, 2005) and Hong Kong (China).²¹

In companies with a two tier structure, i.e. a management board and a supervisory board, the latter normally determines the executive compensation. This applies to Germany, the Netherlands, Austria and partly to France, Finland and Portugal (ECGI, 2003). In countries where supervisory boards employ a system of co-determination, employee representatives may participate in setting the executive compensation (in particular Germany and the Netherlands).

The shareholders general assembly is in most cases not directly involved in setting executive compensation. In many (particularly European) countries legislation provides that executive compensation shall be fixed by the general assembly of shareholders unless otherwise stipulated by the statute of the company. This is among others the case in Greece and the Netherlands. However, de-facto the statute usually delegates this competence to another body. In Spain, the shareholder assembly determines the basic principles of the remuneration but leaves it to the board of directors to determine the concrete terms (ECGI, 2003).

Furthermore, legislation in some countries, such as the UK, provides that compensation must be approved by the general assembly of shareholders which provides shareholders with a certain influence on the determination of compensation (see Company Act 1985, as cited in ECGI, 2003).

3. The role of institutional factors in shaping executive compensation

The remainder examines a number of institutional factors associated with corporate governance that appear to shape executive compensation. These are notably: (a) the role of directors; (b) the role of other “power-pay relationships”; and (c) the role of consultancy firms. Finally, a brief reference to the special role played by share-based compensation is provided.

a) The role of directors in determining executive compensation

A number of studies, in particular those using the managerial power approach, have dedicated considerable attention to the link between levels of compensation and performance sensitivity and on the presence (or lack therefore) of institutional factors limiting (or increasing) executives’ managerial discretion. Among other things, these studies highlight the role of the composition of the directors’ board. Evidence covering US and Portuguese firms suggests that compensation is higher if the board is larger since this is rendering organised opposition of directors against executives more difficult (see Core et al, 1999, Fernandez, 2008)²². This finding has recently been confirmed in a cross-national study by Otten and Heugens (2007) covering executive salaries and bonuses for 17 countries. Similarly, compensation would be higher if the appointment of the majority of the executives has been influenced by the CEO.

²⁰ This is the case in the US, the UK, Japan, Hong Kong (China), South Africa and others. On the situation in Asia see in particular the comprehensive report of the OECD (2007).

²¹ This is also provided for by the Hong Kong (China) best practices which are followed by the majority of companies. According to a survey of the Hong Kong (China) Security and Exchange Commission, 23 percent of companies deviated from the provision on the establishment of a remuneration committee with a majority of independent, nonexecutive members (CFA Study: It pays to disclose (2008), p. 17).

²² Fernandez argues in this regard that the independence of non-executive directors should be strengthened.

Furthermore, relation between CEOs and other executives, and the bodies in charge of determining executive compensation, seems to be a relevant factor in the determination of executive compensation. As far as the US is concerned, it has been argued that directors' and executives' interests are considerably intertwined as directors have an interest in being reappointed to the boards (for financial and social reasons. Since the slate containing the list of candidates to be nominated in the management is normally the only slate for elections, CEOs in the US have a significant influence over re-appointment issues. For this reason directors may have an interest in maintaining a good relationship with the CEO. This may affect however their capacity to critically supervise the determination of the compensation of executives (Bebchuk and Fried, 2003)). Evidence confirming this assumption is provided by Core et al. (1999) who document that CEO compensation is higher when directors have been appointed by the CEO himself.

Another factor influencing executive compensation can be identified in the phenomenon of interlocking directorships. The latter refers to a situation where executives of one firm serve simultaneously as members in the board of another firm. Hallock (1997)²³ examined more than 9,800 directors' positions and found that in 1997, eight percent of the CEOs were reciprocally interlocked, and that 20 percent of the examined firms had current or former employees sitting on boards of other companies. Similarly, Core et al (1999b) find that executive compensation would be higher and corporate performance lower in companies where (among other things) the board of companies is interlocked. He also found that the fact that boards are reciprocally interlocked is positively correlated with higher managerial compensation. Given the fact that interlocking directorships are increasingly observed among trans-national company relationships (e.g., Van Veen 2006, Staples 2007) it would appear that this phenomenon has the potential to impact on executive compensation.

b) The role of institutional investors

Furthermore, the presence of institutional investors has been identified as having an influence on executive compensation. A study by Hartzell and Starks (2002) covering a large number of firms in the United States in the period 1991-1997 finds that the level of executive compensation decreases anti-proportionally to the concentration of institutional investors: the higher the number of institutional investors, the lower the compensation of executives, and *vice versa*. David, Kochar and Levitas (1998) distinguish between institutional investors with and without other business relationships with the firm. They find that the level of executive compensation is positively related with the former (***i.e., in the presence of additional relationships between the institutional investors and the firm***) and negatively with the latter (***in the absence of such relationships***). Comparable findings are reported in the case of the UK. By examining a large number of companies in the UK Dong/ and Ozkan (2007) document that the presence of institutional investors as such does not constrain the level of executive pay, and does not strengthen either the pay-performance relationship. This strengthens the thesis that ***investors in the UK*** are rather passive and rather ineffective in terms of monitoring. However, the authors argue that "dedicated investors with long term horizons" do have a positive influence on both of the factors (p. 28)

c) The role of consultancy firms

Another relevant institutional factor in the shaping of executive compensation is the role played by compensation consultancies, i.e., private firms providing companies with data and advice regarding compensation determination. Bebchuk and Fried (2003) argue with regard to the United States that since typically it is the human resources (HR) departments of companies that select these consultancy firms (which are in turn accountable to the executive board) a conflict of interest might be generated: consultants have an interest not only in providing the best

²³ Hallock, Kevin F., 1997, "Reciprocally Interlocking Boards of Directors and Executive Compensation," *Journal of Financial & Quantitative Analysis* 32 (3), 331-44.

advice regarding executive compensation, but also in being hired again by the company (or other companies). Crystal and Graef (1991) have also documented that the same consultants who provide CEO compensation advice, frequently conduct work in the same firms for other subject matters. This may create an incentive for the consultant to avoid giving advice which may be regarded as inconvenient by the executive board, in order not to lose additional contract opportunities (Crystal and Graef, 1991). Other studies explain how consultancy firms propose an increase of executive compensation even in times when the company performance is rather poor. According to Gillan and Stuart (2001) consultancies usually propose compensation packages that are either performance-driven or peer group-driven, i.e., based on a comparison of compensation packages in other firms. In that way, consultancies can shift from one method of calculation to another, depending on the circumstances but not necessarily based on corporate performance. Moreover, a recent memorandum of the House of Representatives of the United States from 6 March 2008 provides evidence that in cases where one consultancy firm had recommended a reduction in CEO pay another one was hired by the management of the company, i.e., one which was more favourable to the CEO's interests (House of Representatives, 2008).

4. The role of share-based compensation

All performance-related remuneration components are subject to the problem that the goals set can usually be influenced by the executives only to a certain extent. Moreover, the degree of the influence of the executive is difficult to determine. Nevertheless, it is proposed to integrate these elements into compensation in order to motivate the executive. The motivation functions, however, only indirectly because the less the influence on the goal, the smaller will the motivation of the executive be (Eckardstein, 2001). A second risk is that the executive and other managers may be tempted to manipulate accounting numbers in order to meet the goals of the incentive programmes (Lynch and Perry, 2003).

The role of share-based compensation has been widely disputed in recent years. Criticism has in particular been uttered with regard to the traditional design of stock options. Stock options plans allow executives to benefit from increases of stock value regardless of whether the positive development of the stock price is linked to the performance of the firm or with growth the industry concerned or the country economy as a whole. As a consequence, executives may often benefit from stock option programmes although the performance of their firm – and thus their own performance – is poor which deprives the stock option plans of their incentive and reward effect (Bebchuk and Fried, 2004). Academics have therefore put forward more sophisticated stock option plans which include a comparison of firm performance with the average of a peer group or other additional performance criteria.

Another problem relates to the practice of stock options re-pricing. This repricing normally occurs if stock options turn out to not to be as lucrative for the holders (CEOs, executives) as expected because of an unfavourable evolution of shares value. In this regard Carter et al. (2003) highlighted that numerous companies decided to re-price their stock options, not only in the event of poor performance of the industry in which the company operates (let alone the economy of the country) but even –and indeed mainly- in the event of poor firm performance. These developments lead, among other things, to a clear distortion of the incentive effect of stock options.

Some academics go further, contesting the added-value of share-based compensation as a whole, arguing that monetary incentives are inefficient to stimulate executives' behaviour in the interest of shareholders as they would hamper or "crowd out" the intrinsic motivation of executives (see Frey and Osterloh, 2005).

Ongoing policy debates

In many countries proposals have been put forward with a view to mitigate the problems regarding executive compensation which have been illustrated by this study. Given the strong differences across countries regarding executive compensation, the proposals are highly country-specific.

A number of proposals deal with the institutional framework in which executive compensation is determined. Some of those proposals argue for an enhanced role of the shareholder meeting, usually referred to as “Say on Pay”. The focus of the debate in the United States is current on a non-binding vote of share-holders on executive compensation matters. While not providing shareholders with a veto on compensation packages, shareholders would have an institutionalized platform to express their disagreement with the remuneration policy of their company (Gopalan, 2007).²⁴ Similarly, a recent proposal of the Austrian trade unions argues for the strengthening of information rights of the shareholders on executive compensation matters (Arbeitnehmerkammer Wien, 2008). Other proposals favour an enhancement of the committee in charge of determination of compensation. For instance, German trade unions argue for a stronger role of the German supervisory board and in particular for a more intensive participation of the employee representatives in the compensation determination process (German Trade Union Federation 2008).

Certain proposals also deal with the amount and the criteria employed to fix executive compensation. Proposals from German and Austrian trade unions suggest that, when determining executive compensation, not only personal performance and firm performance but also other criteria such as social and environmental sustainability should be taken into account (German Trade Union Federation 2008 and Arbeitnehmerkammer Wien, 2008).

A third group of proposals deals with a more rigid taxation of executive compensation. It is suggested that companies should no longer be able to deduct executive compensation as a business expense. According to these proposals, this would set a negative incentive for excessively high executive compensation by increasing the compensation costs of the company. Proposals along those lines have been put forward, among other, in the US and in Austria (Anderson et al. 2007 and Arbeitnehmerkammer Wien, 2008).

Conclusion

The present paper has tried to highlight certain cross-national tendencies regarding the institutional framework, structure and recent major trends in the field of executive compensation. It has become obvious that executive compensation differs considerably across countries, from the viewpoint of determination, disclosure, constitutive elements, and levels. The literature review has shown that a clear and economically sound link between executive compensation and firm performance cannot be established, despite some evidence in this respect (in certain countries and particular types of firms, depending on the compensation packages on which one focuses). Finally, the paper has highlighted certain institutional factors affecting the structure, levels and performance sensitivity of executive compensation.

While this goes beyond the scope of this paper, it should be noted that a variety of suggestions have been put forward regarding ways to improve corporate governance as far as executive compensation is concerned. These suggestions might range from improved monitoring

²⁴ A legislative proposal providing for a “say on pay” was adopted by the House of Representatives in 2007. A similar proposal, sponsored by Barak Obama, is currently before the US Senate, USA Today 11 April 2008: Obama pushes bill for checks on executive pay. http://www.usatoday.com/news/politics/election2008/2008-04-11-obama-exec-pay_N.htm.

processes by shareholders on compensation issues,²⁵ to more vigorous taxation of certain components of executive compensation (Anderson et al, 2007). The nature of these changes would depend largely on national and political contexts and therefore cannot be one-size-fits-all.

It should be noted that executive compensation in publicly listed companies is only a part of the executive compensation narrative. Other categories of executive compensation such as those observed in the hedge fund and private equity industry have, up to now, received only sporadic attention from the research and policy community. This is a paradox to the extent that, it would appear that certain chief executives earn as much as a billion USD per year, thereby outpacing even the biggest earners among CEOs in publicly held companies (see annexed table by Anderson et al 2007). This seems to be due to a general lack of information regarding privately held companies. The levels of earnings observed in hedge funds and private equity companies merit further attention from the research community.

The research strand dealing with international executive compensation has emerged only recently and therefore requires further elaboration. A more systematic international comparison of share-based compensation and on the use of pension systems and termination benefits need to be further developed. Another field of research which merits more attention has to do with the redefinition of the very concept of CEO performance in a way that focuses not only on the economic dimensions of performance, but also on social and environmental ones. Last but not least, research regarding ways to improve executive compensation will remain an interesting topic and a cornerstone in the area of corporate governance as a whole.

²⁵ A “say on pay” of shareholders is for example contained in the reform programme of, among others, Senator Obama (see http://www.usatoday.com/news/politics/election2008/2008-04-11-obama-exec-pay_N.htm).

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Annex: List of companies referred to in the report

1. Australian companies

AMP
ANZ Banking
Commonwealth Bank
Macquarie Group
National Australia Bank
Qantas Airways
QBE Insurance Group
St. George Bank
Telstra
Suncorp-Metway
Wesfarmers
Westfield Group
Westpac Banking Group
Woodside Petroleum
Woolworths

2. German companies

Allianz
BASF
Bayer Group
BMW
Commerzbank
Daimler
Deutsche Bank
Deutsche Post
Deutsche Telekom
EON
Munich Re
RWE Group
Siemens
ThyssenKrupp Group
Volkswagen Group

3. Hong Kong (China) companies

Bank of East Asia
Cathay Pacific Airways
Cheung Kong
China Mobile
China Netcom Group
China Unicom
CLP Holdings
China Resources Enterprises
Henderson Land
Honk Kong Electrics
Hutchison Whampoa
MTR
Sun Hung Kai

Swire Pacific
Wharf Holdings

4. Dutch companies

Aegon
Ahold
Akzo Nobel
ASML Holding
Royal BAM Group
Royal DSM
Fortis
ING Group
Royal KPN
Royal Phillips Electronics
Ranstad Holding
SNS Reaal
TNT
Vedior
Wolter Kluwer

5. South African companies

AngloGold Ashanti
Barloworld
Bidvest Group
First Rand
Gold Fields
Impala Platinum Holdings
Imperial Holdings
Naspers
Remgro
RMB Holdings
Sanlam
Sasol
Standard Bank
Steinhoff Intl Holdings
Telkom

6. US American companies

Altria Group
AT&T
Bank of America
Berkshire Hathaway
Citigroup
ExxonMobil
General Electric
Goldman Sachs
JPMorgan Chase
Merrill Lynch
Morgan Stanley
Procter & Gamble
Verizon Communications
Wachovia
Wal Mart Stores