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INTRODUCTION

TRADITIONAL ECONOMIC ANALYSES of industrial behavior have as their foundation the proposition that the managers of an enterprise guide its activities in such a way as to maximize profits. The theory of the firm as developed in its conventional form depends heavily on the profit maximization presumption, and the alleged allocative efficiency of the private enterprise system is grounded on the market implications of that objective. If it should turn out, therefore, that profits are not pursued by firms very diligently in practice, the relevance of a substantial portion of our received economic and political doctrine would become suspect.

The possibility that in a complex and heavily industrialized society, certain other managerial goals may well take precedence has been raised in the literature with increasing frequency in recent years. This is especially true where the very large corporation is concerned. We are reminded at regular intervals, by both the popular and the scholarly press, that the era of the owner-executive has passed. The professional managers who nowadays run the several hundred major firms which set the pace in our contemporary economy are said to have become effectively insulated from the motivations provided by the monetary rewards—and stirrings of pride—characteristically attendant upon proprietorship. Instead, their circumstances are described in terms which suggest that such men might properly be viewed as the private sector's occupational counterparts of the apocryphal civil servant—secure employees of an immense organization who are apt to feel only an incidental identification with the interests and objectives of those whom the organization is, in principle, established to serve.

Whether one subscribes to this image or not, it is clear that the direct link between corporate performance and managerial rewards

which was an essential feature of a simpler commercial environment consisting of a multitude of small entrepreneurs is no longer automatically present. We must, therefore, carefully consider the extent to which it is logical to count on the personal goals of management in publicly held enterprises being in harmony with the profit-maximizing desires of shareholders. If, indeed, no meaningful mechanism exists for eliciting such a congruence, neither the political nor the economic primacy of the free-market system can be proclaimed with the traditional vigor—and our economy's long-run productive performance may well fall short of the potential offered by an efficient allocation of resources.

The task of the analysis that follows is to appraise the possibility that an appropriate mechanism *is* present; to determine whether that mechanism seems sufficiently viable to encourage the sort of managerial behavior we desire; and to document the empirical dimensions of its impact. The question, in short, is whether the corporate environment, as presently constituted, contains an executive pay-off function that should lead to profit-maximizing managerial decisions, thereby validating the basic tenets of our normative economic models. The conclusion here will be that it does, and that the observably high degree of separation of ownership and management *roles* in the modern corporation has not been accompanied by a significant separation of their respective *self-interests*.

The Behavioral Possibilities

It is important to make explicit at the outset that only the economic incentives available to and experienced by contemporary professional managers will be considered in the subsequent discussion. No attempt will be made to investigate, or to assess, the multiple nonpecuniary channels through which individuals may seek job satisfaction. While organization theorists have correctly pointed out that such considerations may not only be influential in determining behavior but may, in fact, predominate in many instances, an adequate treatment of that possibility is beyond the competence of the present analysis. The entire concern here will be an attempt to uncover the nature,

direction, and strength of the measurable *monetary* factors impinging upon the managers of the corporate enterprise. The conclusions drawn presuppose that additional personal income is, at least to some degree, relevant to and sought by business executives. Accordingly, the question is whether the source and form of that income should render an executive's attitudes toward his firm's market performance consistent with those of its shareholders. Since this contention is widely disputed, the issue involved appears of sufficient general concern to merit attention.¹ If, for example, it can be established that, in practice, professional managers maximize their own incomes when their firms have maximum profits, a powerful argument for anticipating the effective operation of the industrial system in this country will have been provided. The analysis of the nonpecuniary motivations of the same individuals can then proceed on substantially more solid ground and be framed with an appreciation of the strength of the underlying economic relationships which must be either supplemented or overcome. Indeed, unless and until we know more than we now do about those economic relationships, speculation as to *what else* executives might be influenced by in making their managerial decisions seems premature.

The Prevailing Economic View

Previous investigations of the character of executives' personal income links to their employer companies' success or failure² have arrived at conclusions which seem to fall consistently into two categories. On the one hand, the assertion is that those links are *too weak* to provide much impetus to efficient and diligent administration of the firm's affairs by its top management. The professional manager is depicted as being largely insulated from a meaningful regular job-performance

¹ Perhaps the most eloquent—and certainly the best-known—discussion of this broad area is contained in J. K. Galbraith, *The New Industrial State*, Boston, Houghton Mifflin, 1967.

² More precisely, it is *relative* success or failure which is at issue. Few sizeable corporations literally fail in the sense that they end up going out of business, but there are clearly a broad range of comparative profit results observable in the community each year.

review by shareholders and therefore able to protect his annual compensation from exposure to the sort of rigorous market test that the firm must confront externally. Among the studies which may be listed as adhering generally to this interpretation are the classic works of Berle and Means,³ and of Gordon,⁴ and the more recent analyses by Mason,⁵ Williamson,⁶ Larner,⁷ and by Monsen, Chiu, and Cooley.⁸ In particular, Berle and Means alerted us to the tendency for effective voting control of a large enterprise having a wide public stock distribution to pass into the hands of management—through mastery of the proxy voting mechanism. Larner confirmed their predictions and concluded that only about thirty of the two hundred largest non-financial corporations in the United States can still be classified as truly “owner-controlled.” This being so, there might well be reason to wonder whether professional managers will be impelled to concentrate on traditional entrepreneurial profit objectives in formulating the operating policies for their firms.

The second—but complementary—view maintains that even insofar as a corporation’s performance and its executives’ incomes are linked, the extant relationship is perverse. Specifically, it is contended that interfirm differences in top executive remuneration are more closely associated with differences in total annual sales volumes than with differences in profit levels. As a consequence, professional managers are characterized as being interested primarily in pursuing additional sales—subject perhaps to some implicit requirement that the corresponding profit rates be “reasonable”—rather than as

³ A. A. Berle and G. C. Means, *The Modern Corporation and Private Property*, New York, Macmillan, 1934.

⁴ R. A. Gordon, “Ownership and Compensation as Incentives to Corporate Executives,” *Quarterly Journal of Economics*, Vol. LIV, No. 2 (May 1940), pp. 455–473.

⁵ E. S. Mason, “The Apologetics of Managerialism,” *Journal of Business*, Vol. XXXI, No. 1 (January 1958), pp. 1–11.

⁶ O. E. Williamson, *The Economics of Discretionary Behavior*, Englewood Cliffs, N.J., Prentice-Hall, 1964.

⁷ R. J. Larner, “Ownership and Control in the 200 Largest Nonfinancial Corporations, 1929 and 1963,” *American Economic Review*, Vol. LVI, No. 4 (September 1966), pp. 777–787.

⁸ R. J. Monsen, J. S. Chiu, and D. E. Cooley, “The Effect of Separation of Ownership and Control on the Performance of the Large Firm,” *Quarterly Journal of Economics*, Vol. LXXXII, No. 3 (August 1968), pp. 435–457.

attempting to increase profits per se. By adopting this strategy, they are presumably following a course which will most effectively augment their own incomes. The rationale for such a position has been developed by Baumol,⁹ Marris,¹⁰ and Williamson,¹¹ and a certain amount of allegedly corroborative evidence has been offered by Roberts,¹² and by McGuire, Chiu, and Elbing.¹³ Not surprisingly, their analyses suggest that the pattern of industrial behavior and the nature of the process of resource allocation in the community will differ in several important respects from the classical result if higher sales, instead of higher profits, are the main economic concern of corporate management.¹⁴

Rebuttal

The intention in these pages is not to deny the facts of ownership-management separation and the emergence of professional administrators, nor to dispute the ability of executives to exercise practical voting control of their firms through proxy solicitations. Rather, the

⁹ W. J. Baumol: "On the Theory of Oligopoly," *Economica*, Vol. XXV, No. 99 (August 1958), pp. 187-198; "On the Theory of Expansion of the Firm," *American Economic Review*, Vol. LII, No. 5 (December 1962), pp. 1078-1087; *Business Behavior, Value, and Growth*, New York, Macmillan, 1967.

¹⁰ R. Marris, *The Economic Theory of Managerial Capitalism*, New York, Free Press, 1964.

¹¹ J. Williamson, "Growth, Sales, and Profit Maximization," *Economica*, Vol. XXXIII, No. 129 (February 1966), pp. 1-16.

¹² D. R. Roberts, *Executive Compensation*, New York, Free Press, 1959.

¹³ J. W. McGuire, J. S. Chiu, and A. O. Elbing, "Executive Incomes, Sales, and Profits," *American Economic Review*, Vol. LII, No. 4 (September 1962), pp. 753-761.

¹⁴ Given the likelihood that nonpecuniary job goals are also relevant to executives, it should of course be stressed that "sales maximization" is not necessarily quite an appropriate description of the hypothesis advanced by the writers cited. Thus, management may well be thought of as seeking increased sales in preference to all other measurable indices of company performance—but may not address even that result with full vigor if it interferes substantially with the realization of various subjective job satisfactions. The same comment applies to the use herein of the term "profit maximization." The latter should be interpreted simply as denoting the *primacy* of profits among the operating economic goals of management, if not literally the squeezing out of the last possible profit dollar regardless of the noneconomic personal sacrifices perceived by executives.

objective will be to present some new empirical evidence about the economic circumstances of senior corporate officials which argues strongly that the phenomena indicated have not been sufficient to create a real difference between the pecuniary interests of management and stockholders. The claim will be that the relevant executive pay-off functions still have the right form to encourage profit-seeking behavior as the dominant pattern, despite the pervasive separation of ownership and control. Put differently, to the degree that increments to their personal income are of interest to professional managers, higher corporate profits can be shown to produce those increments more directly and more consistently than any other vehicle under executive jurisdiction.

The basis for these assertions is found in two key features of the contemporary corporate executive's relationship to his company which have, to date, been given insufficient attention in the literature. First, his compensation for services rendered does not consist merely of those stable direct annual cash payments called salary and bonus, which are invariably used as measures of his earnings. In fact, the senior executive compensation package turns out to have been weighted quite heavily in recent years toward what may be classed as contingent "ownership" items of one kind or another—arrangements which utilize shares of the employer corporation's common stock as the compensation medium, and whose ultimate value necessarily depends on the securities market's response to the firm's achievements. Second, while it is true that nowadays there are very few large, publicly held companies in which the top management group holds a majority or even a substantial minority of the outstanding stock, it is nonetheless also true that the stockholdings which executives *do* have are sufficiently large that the economic impact of those holdings is highly important in the context of executives' *personal* wealth positions. Thus, we shall see that the income which the typical upper-level professional manager enjoys each year from the combination of such items of remuneration as stock bonuses, stock options, and profit-sharing plans, plus the dividends and capital gains occasioned by his holdings of his company's shares, bulks large in comparison with—indeed, dominates—receipts from salaries, cash

bonuses, pension promises, and other traditional "fixed-dollar" rewards. Consequently, we find that the ownership-management earnings link is not so tenuous after all. The possibility—or, more precisely, the likelihood—of a continuing close identification by executives with the profit objectives of shareholders thereupon seems more plausible than the conventional view suggests.

Profits and Stock Prices

Before proceeding, however, one important—if not very original—point should be emphasized. Implicit in the following discussion is the proposition that, as managerial goals, "profit maximization" and "share price maximization" for a firm are equivalent concepts. When properly defined, the latter is simply a more rigorous and more comprehensive restatement of the former in situations where it is necessary to deal not only with the anticipated *size* of the elements in a stream of corporate earnings, but with their *futurity* and *uncertainty* as well. In the last decade or so, the theoretical literature concerned with corporate investment and financing decisions has, of course, established this principle as the core of the normative decision-making framework.¹⁵ Hence, in addressing the relevant issues, the position throughout will be that shareholders and management can be considered to share a common economic goal whenever management's personal income depends significantly on either the firm's profits or the market-price behavior of its common stock.

¹⁵ See, for example: F. and V. Lutz, *The Theory of Investment of the Firm*, Princeton, Princeton University Press, 1951; D. Durand, "Costs of Debt and Equity Funds for Business: Trends and Problems of Measurement," *Conference on Research in Business Finance*, New York, National Bureau of Economic Research, 1952, pp. 215–247; F. Modigliani and M. H. Miller, "The Cost of Capital, Corporation Finance, and the Theory of Investment," *American Economic Review*, Vol. XLVIII, No. 3 (June 1958), pp. 261–297; M. J. Gordon, *The Investment, Financing, and Valuation of the Corporation*, Homewood, Illinois, Richard D. Irwin, 1962; J. Lintner, "Optimal Dividends and Corporate Growth Under Uncertainty," *Quarterly Journal of Economics*, Vol. LXXVIII, No. 1 (February 1964), pp. 49–95; J. Lintner, "The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets," *Review of Economics and Statistics*, Vol. XLVII, No. 1 (February 1965), pp. 13–37.

Background of the Study

The origins of the present investigation lie in a recently published empirical study of executive compensation policies in large, publicly held corporations, conducted by the author, also for the National Bureau of Economic Research.¹⁶ In that undertaking, a record was constructed of the value to a representative group of senior executives of all the major items in their compensation packages: pension benefits, stock options, stock bonuses, stock purchase plans, deferred-pay arrangements, and profit-sharing plans, as well as salaries and cash bonuses. The resultant figures were cast in the form of an annual measure of total after-tax remuneration for each executive in question for each relevant year of his employment experience. The output, therefore, provides both a comprehensive historical index of aggregate managerial reward and a profile of its constituents.¹⁷ Those analytical techniques and computational procedures developed that bear on the current effort will be summarized below, but the reader is, of course, referred to the original volume for a full description.

The data for the investigation were obtained from the proxy statements which corporations must submit in connection with their annual shareholders' meetings. The Securities and Exchange Commission requires that the main features of the compensation arrangements enjoyed by the senior officials of a firm be reported.¹⁸ In addition, holdings of the corporation's securities by individuals serving on its board of directors must be listed. Since, in practice, most top-level administrators are also members of the board, it became evident while gathering the data for the compensation study that sizeable ownership positions in their firms were not unusual among executives. In fact, the stock holdings observed, while invariably far from denoting significant voting interests, were sufficiently large in many instances

¹⁶ W. G. Lewellen, *Executive Compensation in Large Industrial Corporations*, New York, National Bureau of Economic Research, 1968.

¹⁷ See also: Leonard R. Burgess, *Top Executive Pay Package*, New York, Free Press, 1963.

¹⁸ Specifically, the requirement now is that information be presented for the three highest-paid officers and for any director who earns more than \$30,000 a year.

to suggest that the annual income accruing therefrom in the form of dividends and capital gains might be as, or more, important to the men involved as their reported remuneration as employees. This impression reinforced the finding in the compensation analysis that ownership-related instruments of remuneration have themselves come to comprise a significant percentage of total managerial pay. The possibility, then, that there existed a much stronger, more direct, and more rational ownership-management income link than was generally recognized prompted the current study.

Focus

When combined with the indicated data on compensation, and with information on corporations' stock prices and per-share dividend payments over time, the proxy statement reports of stockholdings permit a detailed reconstruction of top management's historical ownership experience in several dimensions. In terms of our interest here, the market value of the designated holdings and, as suggested, a comparison between the periodic dividends received and capital gains enjoyed by executives on the one hand, and their employee compensation on the other, seem the most pertinent aspects of that experience. The investigation will, therefore, concentrate on exploring these elements of the record.

The roster of firms whose executives' circumstances are examined consists of three different and distinct groups: fifty very large manufacturing corporations, fifteen companies engaged in retail trade, and fifteen small manufacturers. The large manufacturers comprise the sample which was analyzed in the original compensation study. They were drawn from the top of *Fortune* magazine's tabulation of the five hundred largest United States industrials for the year 1963.¹⁹ Some fifteen industry categories appear on the list, and the firms involved averaged \$1.9 billion in sales, \$1.6 billion in assets, and \$130 million in after-tax profits during 1963. Taken together, they accounted for roughly one-fourth of the total sales of the entire manu-

¹⁹ *Fortune*, Vol. 70, No. 1 (July 1964), pp. 179-198.

facturing sector. As such, their executives' experience may legitimately be considered representative of the situation in the large, publicly held enterprise in this country.

The retail trade and small manufacturing samples are completely new, and are offered here as a counterpoint to the findings for the large manufacturers. The former grouping includes what are, for all practical purposes, the fifteen largest retailers in the country and encompasses virtually every nationwide chain of stores currently operating. The small manufacturing sample was compiled from the companies ranked 350th and below on *Fortune's* list. On average, they had \$118 million of sales, \$85 million of assets, and \$5 million of after-tax profits in 1963. These figures suggest that, while some fairly decent-sized corporations are in fact counted within the group, they are clearly cut from a different cloth and function at a much smaller scale of operations than the corresponding large manufacturers. Useful comparisons among the findings for the three samples should, therefore, be possible.

The investigation will cover the period 1940 to 1963 in all three instances, this being the interval for which the underlying large manufacturing compensation data were generated. Nineteen-forty should constitute a sensible starting point in any case, since that year just precedes the current era of high progressive marginal personal tax rates and thus allows the historical record to reflect the important environmental changes which have occurred. Approximately 950 different individual executives and some 8700 man-years of earnings and ownership evidence are included in the computations.

Organization

In Chapter 2, the basis of selection—as well as the particular characteristics—of the three samples will be discussed, and the procedures employed in their analysis described. Chapter 3 presents the relevant data on executive compensation for all three groups, while Chapters 4 through 6 offer accounts of top management's ownership experience for each sample in turn. Chapter 7 summarizes the findings and outlines the conclusions which those results suggest.

The Findings

Among the major elements in the historical record which emerges are the following:

1. In recent years, the senior executives of the country's largest industrial corporations have owned an average of between \$1 million and \$2 million worth of their respective companies' common stock *per capita*.
2. In terms of market values, these figures represent a threefold to fourfold increase in ownership since the early 1940's.
3. The annual dividends and capital gains occasioned by the holdings are well in excess of the amounts the same individuals receive in the form of compensation as employees of the firms in question.
4. When those dividends and gains are added to the stock-related compensation of executives, the resulting totals run anywhere from three to five times the value of the corresponding fixed-dollar rewards from salary, cash bonuses, pensions, and similar items.
5. This degree of ownership involvement actually surpasses that observable among the executives of smaller firms, despite the prevailing view that large companies are the ones wherein the problem of the separation of management and ownership is most severe.
6. The annual income enjoyed by the senior officers of small industrial enterprises and of retailing organizations is, on the other hand, also highly dependent on the dividends and stock price performance of the various employer corporations. As such, it offers compelling evidence of a broad-based link in the economy between managerial wealth and shareholder returns.

The particulars of these findings are spelled out in subsequent chapters, and their relationship to the matter of likely executive decision rules is considered. It should be emphasized again, however, that only measurable economic phenomena are at issue. While it may be reasonable in places to draw some inferences about possible managerial responses to the evidence uncovered, it will in no sense be

legitimate to contend that a solid behavioral model has been provided. The more modest hope is that the data presented will enhance our understanding of the relevant environment, and will offer some improved documentation of the income consequences and opportunities confronting the professional manager.