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Executive Incentive Compensation and Economic Prosperity

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Keywords

Executive compensation, economic growth, investment ratio, long term incentive

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1. Introduction

The search for the optimal corporate level compensation contract between the owner (the principal) and the CEO (the agent) has been on the agenda for centuries. However, during the last decade politicians have also shown great interest in this issue. The U.S. president and several European prime ministers have expressed concern about the development of opaque compensation schemes and the amount paid. Implicitly this concern signals a belief in a causal link between these corporate compensation schemes and the economic performance of a country.

The literature is flooded with studies of different country characteristics that try to explain the relative economic prosperity of a country. These characteristics are classified in numerous ways from political freedom to conscript labor. Using an extreme bound analysis of the many variables claimed to explain economic prosperity, Levine and Renelt (1992) reaches the pessimistic outcome of almost no robust relation in addition to the one between average growth rates and the average share of investment in GDP. However, the prevalence of executive long term incentives was not included among the variables. Sala-i-Martin (1997) and Sala-i-Martin, Doppelhofer and Miller (2004) criticize the extreme bound analysis as too strong a test and make room for more robust relations. We hypothesize that one of these may be the relation between the degree to which long term incentive compensation is used in a country and the economic prosperity of that country.

Executive long term incentive compensation is commonly in the form of restricted stock or stock options. What we argue is that long term employee incentives, particularly executive long term incentive compensation, acts as a catalyst to increase the average economic performance of companies within an economy and thereby benefits the country's overall value creation. Based on agency theory, we argue that without incentives to take on risk, decision makers in any organization, such as executives, will prefer the status quo. Any positive executive action with risk associated with it is unlikely to be taken without a potential reward for a positive outcome. Further, we argue that the importance of these incentives may differ depending on which development phase a country is in. The impact of an incentive or the marginal utility of the potential amount paid out to the executive are probably stronger in developing countries than in developed ones.

To date there are no studies relating the use of incentive compensation to the economic prosperity at the national level. Murphy (1999) points out that prior to 1985 very few academic articles address executive pay. He writes that since then "CEO pay research has grown even faster than CEO paychecks." Subsequently numerous studies, too many to mention, on executive compensation appear in the accounting, economics, finance, industrial relations, law, organizational behavior, and strategy literature. Accountants typically focus on the interaction between pay and earnings management such as controlling earnings growth and the use of accruals. Financial economists focus on incentives and corporate decisions affecting shareholder value defined in terms of stock price performance. Economists examine the effects of regulation and interaction of strategy and compensation.

The focus of all areas of research has been primarily on executive incentives and some other aspect of the firm, whether it is, for example, organizational structure or firm performance, within a given country. Due to data availability, much of the early research

focuses on U.S. and U.K. firms. More recently, many international studies have looked at incentives and firm performance or other aspects of firms within various countries, but still commonly on an individual country basis. In this study we examine across countries the relation between incentives provided to executives and the growth of real GDP, arguing that managers will not take on risky investments without the benefits of a reward system providing remuneration when good outcomes to these investments occur.

The chapter is organized as follows. The next section elaborates on the link between incentive compensation and economic prosperity and presents our hypothesis. Section three describes our data and methodology and in section four we present and discuss the results. The final section summarizes our findings and provides some policy prescriptions.

2. Incentive Performance Plans and Economic Prosperity

Literature Review

Long term incentive programs have been used in the U.S. for the past several decades. However, they are a more recent phenomenon worldwide, both in developed and developing markets. During the last decade, the extreme enhancement of top executive compensation in the U.S. has caught the attention of a myriad of stakeholders concomitantly in the U.S. and worldwide. Not only are stakeholders such as shareholders, lenders, employees and customers attentive to CEO compensation in the U.S., but worldwide interest in this phenomenon has brought forth discussion and analyses from governmental officials, journalists and academics around the globe (Gabaix and Landier, 2007). Global attention to the U.S. CEO compensation phenomenon has not escaped the notice of top executives of non-U.S. firms, nor has the issue gone unnoticed in boardrooms in Europe and Asia.

There are a number of potential causes that have been put forth to explain the rapid acceleration of compensation paid to U.S. CEOs. A recent analysis (Gabaix and Landier, 2007) has suggested that the increase in CEO compensation is a consequence of the increase in firm size. Controlling for size and other relevant firm-specific variables, Oxelheim and Randøy (2005) claim it is the mere internationalization — the product and service market, the capital market, and the corporate control market — that explains the increase. Supply and demand of CEOs with required skill sets is also often used to explain the increase in CEO compensation (Agarwal, 1981; Harris and Helfat, 1997; Finklestein and Boyd, 1998; Sanders and Carpenter, 1998).

Traditional agency theory suggests CEOs should be paid a premium wage to compensate for the high risk of being fired given the statistically short job tenure of U.S. CEOs (Williamson, 1963). Agency theory also argues that firms should pay CEOs more than the CEO labor market would suggest, especially so in the form of performance-tied incentives (Jensen and Murphy, 1990). These performance-tied incentives motivate CEOs, it is argued, to take actions that will result in the creation of greater shareholder wealth (Hall and Liebmann, 1998). Empirical research on performance-contingent compensation has produced results demonstrating links, albeit weak links, between firm CEO compensation and firm performance in the U.S. (Jensen and Murphy, 1990; Sloan, 1993; Kaplan, 1994; Aggarwal and Samwick, 1999; Tosi, Werner, Katz and Gomez-Mejia, 2000; Bebchuk and Fried, 2003). Other studies have shown a negative or no relation between CEO pay and firm performance (Kerr and Bettis, 1987).

Another strand of research argues that the publicly perceived talent of the CEO explains a significant portion of incentives in CEO compensation in the U.S. (e.g., Oyer, 2004; Rajgopal, Shevlin and Zamora, 2006). As explanation of the phenomenal rate of increase in U.S., organization theorists argue that CEO power and entrenchment have allowed CEO domination of boards of directors to the extent that CEOs have great influence over their own compensation. A corollary of this view sees CEOs “stacking” their boards through the implementation of board interlocks (director membership on mutual boards) thereby promoting a reciprocal compensation rewarding phenomenon on the boards of U.S. firms (Fich and White, 2005).

Gabaix and Landier (2007), working with data from U.S. firms, observe that CEO pay increases as the aggregate of firm size and value increases. That is, as firms in general become larger and more valuable, CEO pay increases proportionally. This increase is not one to one with each CEO’s firm. Rather, it is a general increase in CEO pay: “CEO pay changes one for one with aggregate firm size, while changing much less with the size of his own firm” (Gabaix and Landier, 2007). The phenomenon of CEO pay increasing proportionally to the aggregate size of firms in the U.S. has been noted by CEOs around the world, and it is reasonable to assume that they have acted upon this fact by taking actions consistent with the precepts of agency theory.

Within a country, the cadre of top CEOs is such that they are not unknown to each other. They are usually well acquainted with one another, and if one does not directly know another, there is typically a common CEO friend. In each country there is, in effect, a small and exclusive CEO-club (for example one Scandinavian study highlights such an effect; Randøy and Nielsen, 2002). This is in line with Granovetter (2005) who emphasizes that social networks affect the flow of information and trust. As long term incentives appear in the contract of one CEO, soon they appear in the contracts of others. Shortly thereafter, all CEOs in the country, following the precepts of agency theory, are trying harder to increase the size and value of the firm they manage.

Hypothesis

As a point of departure our discussion focuses, as the research does, on the firm-level and provides some arguments as well as some empirical indications that incentive programs may be value enhancing at that level. Results from past research show incentive programs may be value enhancing at the firm level. We then focus on the extent to which this value creation may also be found as a country phenomenon and reveal itself as increased economic prosperity. While the volatility of equity markets may reduce a strong tie between the effect of the incentives in any one firm, and that particular firm’s performance, the overall aggregate effect is, nonetheless, present and observable. We therefore argue that overall, long term CEO incentives have a positive effect on national prosperity – as strong incentives push the firms to be more appropriate risk takers.

Internationally, as firms grow, both in developed and developing countries, the opportunities for further growth require capital. The national financial markets are often limited in their ability to provide attractively priced capital for new projects and opportunities (Stulz, 1996). Hence, these firms look for capital outside of the local capital markets (Oxelheim et al., 1998). However, the ability to raise capital requires outsiders confidence in the corporate governance of the firm and the right risk propensity of top management

(Oxelheim and Randøy, 2005). Further, for top management to risk entering into non-domestic capital and real markets requires the managers are rewarded for the risk taken and they have the skill sets necessary for success. As a consequence of long term CEO incentives, greater effort on the part of a large cadre of CEOs in a country will result not only in the average performance of firms being enhanced within that country, but may also result in increases in aggregate firm size and value within that country, all of which enhances the economic prosperity of that nation.

We argue for the existence of systemic forces acting upon the relation of CEO long term incentives and overall firm performance within countries. While the relation between CEO long term incentives and financial performance of that CEO's firm is found by past research to be a weak link at best, we hypothesize that aggregate firm performance within a *country* will be enhanced by the ubiquitous implementation of CEO pay incentives within that country.

Within a nation, in a dynamic and complex manner, long term incentives for some CEOs fosters greater CEO effort leading to improved firm performance, not necessarily of any particular firm, but rather of firms in general within the nation. This, in turn, may lead to more CEO contracts with provisions for long term incentives. A positive feedback loop is temporarily created. Add to this positive feedback loop efforts on the part of the CEOs to grow their organizations motivated by the knowledge that larger organizations often have larger net incentives for their CEOs. Upon seeking growth, the CEOs find the need to seek funding from international capital markets. In so doing, the influx of the international market capital brings with it disciplines intensifying competition within the nation (Oxelheim and Randøy, 2003). Taken together, all these factors will increase competition at the firm level, enhance market efficiency within the nation and will - while supporting accelerated growth of firm size and value - ultimately lead to enhanced economic prosperity within the nation.

Moreover, whereas firm level research only captures the economic benefit accruing to firms or investors – the country level findings will capture how executive incentives accrue to a full set of economic stakeholders; employees, shareholders, the government, etc. The economy as a whole will benefit as resources are used more efficiently. Employees and stockholders can benefit from firms with higher growth and the government benefits from higher taxable income. Hence we put forward the following hypothesis:

Hypothesis: There is a positive relation between the proportion of firms within a country where CEOs have long term incentives and the economic prosperity of that country.

However, the strength of the incentive package may differ among nations for many potential reasons depending, for instance, on the way they are taxed, the legitimacy of the contracts, etc. We assume that the marginal utility of the compensation is larger for CEOs of firms in developing countries than elsewhere and hence the incentives are hypothesized to have a stronger impact in developing countries.

3. Methodology and Data

Variables, Model, and Method

To test our hypothesis we use panel data and perform a cross-sectional, time series regression of individual countries' real GDP growth rates, the dependent variable, against the existence of

long term incentive remuneration for CEOs. The dependent variable is calculated from the percentage change in annual GDP in constant national currency. To reduce misspecification of our model we include two additional control variables. We use a “hard” economic control factor; the growth rate in new investment (Ross and Levine, 1992 and Sala-i-Martin, et al, 2004), and a “soft” control variable, the Fraser Institute’s labor freedom index (Karabegovic et. al., 2003). The freedom index labor regulation scale is our surrogate for a measure of labor's impact upon CEO freedom of action and discretion. The higher the index value, the less the regulatory constraints are upon CEOs and such discretion may be particularly important to economic growth. The model used is:

$$\text{GDPGR}_{it} = \gamma_0 + \gamma_1 \text{LTIREM}_{it} + \gamma_2 \text{INV}_{it} + \gamma_3 \text{LABOR}_{it} + \alpha_i + \varepsilon_{it} \quad (1)$$

where LTIREM is the percentage of firms in a country providing long term incentive remuneration to their CEOs, INV is the growth rate of newly invested capital, and LABOR is the labor freedom index measuring labor market regulation.² In the model, i represents the i -th country, t denotes years 2001 to 2005, and the α_i s are the fixed effects’ country dummies that allow different regression intercepts for each country. The regression intercept for the base country, γ_0 , is either the U.S. or the U.K.³

We obtain information on the existence of CEO long term incentive plans from Towers Perrin, a consulting firm known for its expertise in the area of executive compensation. The firm has surveyed their clients in 22 countries for the years 2001, 2004, and 2005 and measures the percentage of firms providing CEOs with long term incentive remuneration. Their clients are likely to be large firms. Hence, our sample has a potential bias toward large firms. Since the Towers Perrin data on long term incentive plans is missing for the years 2002 and 2003, we observe the country by country trends and approximate the missing values by interpolation.⁴ The Fraser Institute produces extensive measures of economic freedom for 142 countries. Using the 2007 report written by Gwartney, Lawson, Sobel, and Leeson, we use the Fraser Institute index for Labor Market Regulations for the five years of 2001 to 2005 to match the years of the Towers Perrin data on long term executive incentives. The Fraser Institute ratings range from one to ten with ten denoting the highest level of economic freedom. The annual real gross domestic product (GDP) growth rate, GDPGR, is from the International Monetary Fund (IMF) Economic Outlook and is in constant (i.e., real) national currency. The annual growth rate in newly invested capital is calculated from figures obtained from Thomson-Reuter’s DataStream.

Descriptive Statistics

Table 1 reports descriptive statistics on the variables we examine on a country by country basis, as well as distinguishing the sub-samples of nine European countries vs. 13 non-European countries. The reported means are the five year averages of the variable. Of the 22 countries Towers Perrin tracks, Canada has the highest mean percentage usage of long term incentive programs with all the firms in the survey employing long term incentives programs, while India has the lowest with only 16% of the surveyed companies having incentive programs. The average annual real GDP growth rate ranges from less than 1% for Italy and Germany to 9.6% for China. The mean annual growth rate of newly invested capital ranges from -3.2% for Hong Kong to 19.4% for Argentina over the five-year sample period. The average labor market

regulation index from the Fraser Institute ranges from a low of 3.1 for Germany to a high of 8.6 for Hong Kong.

Table 1 Descriptive Statistics on Long Term Incentive Remuneration and Economic Statistics (2001-2005)

Country	Percent of Firms with Long-term Incentive Remuneration (LTIREM)		Annual Real GDP Growth (%) (GDPGR)		Annual Growth of New Invested Capital (%) (INV)		Freedom Index – Labor Market Regulations (LABOR)	
	Mean	Standard Deviation	Mean	Standard Deviation	Mean	Standard Deviation	Mean	Standard Deviation
	PANEL A: European Countries (N=9)							
Belgium	87.0	8.7	1.5	0.8	7.8	11.5	4.8	0.2
France	93.0	2.2	1.6	0.6	9.3	11.2	5.2	0.3
Germany	73.0	10.0	0.6	0.7	2.8	11.4	3.1	0.7
Italy	69.0	14.3	0.7	0.8	9.4	12.5	4.1	0.8
Netherlands	96.0	4.3	1.2	1.0	6.3	10.0	5.3	0.4
Spain	62.0	8.7	3.3	0.4	16.3	13.2	5.3	0.5
Sweden	66.0	3.8	2.4	1.2	6.7	14.5	3.6	0.5
Switzerland	79.0	14.3	1.3	1.2	5.9	11.3	6.8	1.0
U.K.	97.0	2.2	2.5	0.6	8.8	9.3	6.9	0.3
PANEL B: Non-European Countries (N=13)								
Argentina	52.0	8.7	2.3	9.4	19.4	69.1	4.8	0.8
Australia	88.0	2.2	3.2	0.8	16.0	19.6	6.3	0.3
Brazil	53.0	10.0	2.8	1.8	8.1	24.0	4.5	0.5
Canada	100.0	0.0	2.5	0.7	11.3	8.5	6.7	0.3
China	25.0	5.9	9.6	0.9	18.0	4.6	4.5	0.1
China (Hong Kong)	62.0	11.5	4.4	3.5	-3.2	8.6	8.6	0.1
India	16.0	4.3	6.4	2.2	17.6	18.5	5.7	0.5
Japan	27.0	8.7	1.3	1.1	-2.2	10.4	6.5	0.4
Mexico	37.0	16.5	1.8	1.7	4.9	7.0	5.0	0.6
Singapore	78.0	7.7	4.1	4.2	-1.1	8.9	6.5	1.2
South Africa	64.0	6.5	3.9	1.0	16.5	29.1	5.4	0.2
South Korea	66.0	3.8	4.6	1.5	7.9	11.8	4.6	0.8
U.S.	97.0	2.2	2.3	1.2	4.2	7.3	7.5	0.5
Whole Sample	67.6	25.5	2.9	3.1	8.7	19.1	5.5	1.4
European Countries	80.2	15.1	1.7	1.1	8.1	11.2	5.0	1.3
Non-European	58.8	27.5	3.8	3.6	9.0	23.1	5.9	1.3
t-Statistics	4.74***		-3.79***		-0.24		-3.38***	

Descriptive statistics of the dependent and independent variables used in the fixed firm effects analysis are presented. The dependent variable is the annual real GDP growth obtained from the IMF. The independent variables are the percent of firms with long-term incentive remuneration from Towers Perrin, the annual growth of new invested capital from Datastream, and the labor market regulations freedom index from the Fraser Institute. The five year sample period is 2001 to 2005. Reported t-statistics are for the difference of means for European less non-European countries. *, **, and *** indicates significance at the 10%, 5% and 1% level, respectively.

We test for differences in the means of the dependent and independent variables between the nine European and thirteen non-European countries. The t-statistic for the dependent variable, annual real growth in GDP, is -3.79 and significant at the 1% level indicating European countries grow more slowly than non-European countries. In terms of the use of long term incentive remuneration, with a significant t-statistic at the 1% level of 4.74, the percentage of firms in European countries is greater than non-European countries. Regarding the Fraser Institute's economic freedom index for labor market regulation measuring the extent to which labor markets are regulated, the significant (1% level) t-statistic of -3.38 indicates European countries are more highly regulated with respect to labor than non-European countries. The only insignificant difference in means is for the growth rate of newly invested capital. Thus, the statistical test results reported in Table 1 indicate significant differences between European and non-European countries covered in our sample.

4. Empirical Results and Discussion

Key Empirical Results

In Table 2 we report the fixed effects regression results for the whole sample and sub-samples of nine European and 13 non-European countries.⁵ The 13 non-European countries are further divided into seven developed economies (Australia, Canada, China (Hong Kong), Japan, Singapore, South Korea, and U.S.) and six developing countries (Argentina, Brazil, China, India, Mexico, and South Africa). The results support the concept that long term incentives for higher level executives enhance national economic prosperity. Specifically, the results support the hypothesis in the whole sample, as well as all sub-samples except for the nine European countries. In our 22 nation sample we find a positive and statistically significant (p -value = 0.016) relation between the prevalence of long term incentives for high level executives and national economic prosperity. The regression coefficient of 0.0695 on LTIREM also indicates economic significance; if the proportion of firms in a country using long term incentives for CEOs increases from 50% to 60%, we expect to see an average increase of 0.695% in the annual growth rate of GDP. We argue that this incentive effect drives the economy by making executives take on a more appropriate level of risk (typically higher than without incentives) – in line with agency theory arguments. These firm level effects are then aggregated to the national level – as indicated by the higher GDP growth rates. Notably, the effect on the country level is much stronger than typically seen by past firm level research.

Table 2 Panel Least Squares Regression Results on GDP Growth

	All Countries (N=22)	European Countries (N=9)	Non-European Countries		
			All (N=13)	Other Developed Economies (N=7)	Developing Countries (N=6)
Intercept	-0.0282 (-1.2498)	-0.0047 (-0.3590)	-0.0510 (-1.4239)	-0.1357 (-2.8808)***	0.0305 (0.5250)
LTIREM	0.0695 (2.4384)**	-0.0169 (-0.8249)	0.1337 (3.2782)***	0.1682 (3.1602)***	0.1137 (1.8286)*
INV	0.0710 (6.3975)***	-0.0051 (-0.4257)	0.0784 (5.8428)***	0.0579 (1.9003)*	0.0778 (4.2430)***
LABOR	0.0008 (0.1929)	0.0070 (2.3304)**	0.0005 (0.0959)	0.0061 (1.0727)	-0.0087 (-0.7942)
# of Panel Observations	110	45	65	35	30
Adjusted R ²	0.5977	0.5116	0.6511	0.5005	0.6810
F-Statistic	7.7470***	5.1903***	8.9632***	4.7856***	8.7378***
Durbin-Watson Statistic	1.7148	2.4679	1.8333	2.3171	1.9036

This table presents the panel least squares regression results for all countries (22 cross-sections); European countries (nine cross-sections); and non-European countries (13 cross-sections). For the non-European countries, the data is further divided into seven developed countries (Australia, Canada, China (Hong Kong), Japan, Singapore, South Korea, and U.S.) and six developing countries (Argentina, Brazil, China, India, Mexico, and South Africa). All regressions are run with five years of data, 2001 – 2005. The dependent variable is the annual growth rate in real GDP. LTIREM is the annual percent of firms with long term incentive remuneration, INV is the annual growth of new invested capital, and LABOR is the average labor regulation index. The coefficients are time-series means of cross-sectional regression estimates with cross-section fixed dummy variables on 22, 9, 13, 7, and 6 countries, respectively. Numbers in parentheses are t-statistics. *, **, and *** indicates significance at the 10%, 5% and 1% level, respectively. The coefficients for the fixed effects dummy variables are not reported since they sum to one and are not relevant to the discussions.

When we then focus on the nine European nations within our 22 nation sample, we find a statistically insignificant relation between the prevalence of long term incentives for high level executives and national economic prosperity. These European findings lead us to investigate the relation between long term incentives and economic prosperity for the entire sample minus the European contingent. In this analysis we find a positive and highly significant (p -value = 0.002) relation between the prevalence of long term incentives for executives and national economic prosperity for this sample of 13 nations.

We consider the possibility that these findings might be a consequence of the higher level of wealth in the nine nation European sample as compared to the average wealth of the 13 non-European national sample. Therefore, we separately investigate the relationship between long term incentives and economic prosperity for the seven developed nations and for the six developing nations within our 13 nation non-European sample. In the case of the seven developed non-European nations we find a positive and statistically significant (p -value = 0.004) relation between the prevalence of long term incentives for executives and national economic prosperity. In the case of the developing nations, we find a similar positive relationship, but this finding is only significant at the 10% level (p -value = 0.08). For this small sample of six developing nations, we see that the importance of long term incentives for CEOs is skewed downward due to China and India - which both have the two highest mean rates of GDP growth coupled with the two lowest mean percentages of firms providing long term incentive pay to their higher level executives. It may be that an increased proportion of firms providing long term incentive remuneration to their CEOs is necessary in developing countries in order to overcome the inefficient manner in which such countries allocate their resources.

Also, we see significant effects from our control variables on economic growth in some of our samples. In line with past research, we see a positive relation between GDP and investment as purported by Ross and Levine (1992) and Sala-i-Martin et al (2004). The annual growth rate of newly invested capital has a positive and significant relation with GDP growth in all samples except for the nine European countries, in which it has an insignificant (negative) relation. For the whole sample, 13 non-European countries, and six non-European developing countries the relation is highly significant (p -value = 0.000); for the sample of seven non-European developed countries the relation is significant only at the 10%-level. However, we find that our economic freedom index for labor market regulations is a positive and statistically significant (p -value = 0.026) predictor of national economic prosperity only for the nine nation European sample. Since this index represents the freedom of a firm's management to hire, discipline and reallocate employees into positions of responsibility to which they are best suited, the significance of the coefficient indicates this is an important component of national prosperity.

Europe's Different Dynamic

From our finding of a positive and significant relation between the freedom index for labor market regulations and GDP growth in Europe and our other findings, we speculate that a different dynamic between long term incentives for higher level executives and national economic prosperity may exist in Europe as opposed to the rest of the nations in our sample. In Europe, we commonly find labor participation in corporate governance through regulated labor membership on boards of directors. This governance by labor is not the general case outside of Europe. It may be that labor participation on corporate boards allows for less labor flexibility and less managerial risk taking – such that the benefits of expensive long term executive incentives are greatly reduced.

We speculate that the level of “savoir-vivre” found among the European business and labor elite (there is always an exception to every rule) serves to create a more collaborative climate with emphasis on a balance between prosperity and equality. This collaboration may mean that the enhanced motivation of long term incentives to encourage high level executives to behave more competitively may be counterbalanced in Europe. The counterbalancing motive operating upon European executives may be the social expectation that they must behave in a more civil manner regarding the executive incentives and the compensation of the firms’ employees. This motive is reinforced by the fact that if European executives violate these codes of behavior, it is likely they will lose status and with the loss of status, the legitimacy enabling them to secure and retain their high level executive position. Thus, there are unique cultural and culturally engendered regulatory labor provisions in Europe that mediate against the more ruthless competitive rivalry that the enhanced long term incentives for executives tries to encourage.

The insignificance of long term incentive remuneration on economic growth is the unexpected and (from a purely capitalist growth prospective) dysfunctional result. Our results imply that in Europe, the greater intensity of labor regulations results in lower national productivity. We speculate that these regulations act as a counterbalancing force to the motivation to increase competitive rivalry achieved by incentive compensation of high level executives. High levels of labor regulation act to tie the hands of high level executives, and limit their freedom to act in a manner that may increase competitive rivalry. As such, these higher levels of labor regulation dampen the executive's drive to enhance competitive rivalry and thus counterbalance the motivating effect of incentive compensation.

Robustness of Our Results

As noted in Section 3, our fixed effects model is robust to including different economic freedom indices instead of or in addition to the freedom index for labor market regulation. Our key result of a positive and significant relation between long term incentive remuneration for CEOs and GDP growth for a country remains for our total sample of 22 countries, our sub-sample of 13 non-European countries, our sub-sample of seven developed non-European countries, and our sub-sample of six developing non-European countries. Also, our regressions of GDPGR on LTIREM, INV, and LABOR for five years are robust to including or excluding the interpolated data for long term incentive remuneration for 2002 and 2003; the coefficient signs and magnitudes are qualitatively the same, but the standard errors for our coefficient estimates increase if we omit 2002 and 2003 due to the reduced efficiency caused by the loss of information on the covariance between GDPGR with INV and LABOR for the two omitted years. In Table 2, our Durbin-Watson statistics are close to 2.0 for all five regressions, indicating that autocorrelation is not a problem causing us to underestimate the standard errors of our estimated regression coefficients. Specifically, at the 5% level of significance, none of our Durbin-Watson statistics cause us to reject the null hypothesis of no positive or negative autocorrelation. Unreported analysis of our regression residuals indicates our fixed effects model does not suffer from heteroskedasticity, which also indicates we are not overstating the statistical significance of our estimated regression coefficients.⁶

Unreported regressions satisfy our concern about the possibility of reversed causality when examining the relation between GDP growth and long term incentive remuneration. Can high economic growth cause more firms to use long term incentives? We emphasize that our LTIREM variable is simply the percentage of firms with long term incentive plans for CEOs, but is not total compensation and size or form of the long term incentives, which we expect to be affected by the past growth of the economy (as CEOs can capture part of the rent from economic growth).

Unreported regressions test and satisfy our concern regarding reversed causality; we find an insignificant relation between LTIREM and lagged GDP growth.

5. Concluding Remarks on Executive Incentive Compensation and Economic Prosperity

In this paper we discuss the existence of a link between the prevalence of long term incentive compensation for executives and the economic prosperity of a country. The current debate reflects a belief in the existence of such a link. Unfortunately, existing theory provides no guidance. In fact this chapter is the first reported study on this relation. Considering that existing literature suggests a positive but only weak relation between CEO incentives and firm level performance, the sign of the link becomes an empirical question. Here, we argue there is a positive externality from executive long term incentives to stakeholders such as labor, suppliers, buyers etc. The broader economic benefit from this enhanced value creation of the firm is greater economic prosperity at the national level. Our empirical tests support such an argument, as we find a strong and significantly positive relation between the prevalence of long term incentive compensation and the economic prosperity of the 22 countries of our study.

When we analyze this relation between long term incentives for executives and GDP growth for non-European countries only we find an even stronger positive relation, whereas for the European countries in our study we find the relation to be insignificant. Within the non-European countries, the relation is stronger and more significant for the developed countries than the developing countries. This outcome is somewhat unexpected, but suggests some barriers or problems within the developing countries reduce the economic impact of the long term incentives. Hence, our policy prescription is that the political stimuli of an increasing use of incentive based compensation in non-European countries will foster economic prosperity, but such a policy of increasing the use of incentive based compensation in European countries may not be recommended due to the different labor dynamics.

We suggest further research on a broader data set. We are not able to decompose the relative economic rewards of various stakeholders, but suggest that this decomposition can be an interesting analysis for future research.

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² Other models incorporating other Fraser Institute economic freedom indices, individually and in combinations, including capital control, legal market regulations, monetary policy, openness to trade, and business regulations, as well as a composite economic freedom index based on 23 sub-indices were analyzed as alternates or additions to the economic freedom index for labor market regulation. The results are qualitatively the same regarding the coefficients and statistical significance for the LTIREM and INV variables. With our small total sample of 110 observations, from five annual observations for 22 countries surveyed by Towers Perrin, a model with fewer independent variables is preferable to enable us to have sufficient degrees of freedom to use the fixed effects model for smaller sub-samples including six, seven, nine, and 13 countries.

³ Unreported cross-sectional tests support our selection of the fixed effects model by indicating significant differences between the regression intercepts for the whole sample of 22 countries as well as the subsamples of nine European countries, 13 non-European countries, seven non-European developed countries, and six non-European developing countries.

⁴ In analyzing the Towers Perrin data for 2001, 2004, and 2005 it is clear that the percentage of firms providing long term incentive pay to their CEOs does not vary wildly from year to year, but changes slowly and gradually; clear trends are visible from 2001 to 2004 on a country by country basis. Using interpolation assumes a linear trend from 2001 to 2004 which keeps our errors of approximation small, since most countries experience only a five to 20% change from 2001 to 2004. Without interpolation, our estimators will be less efficient and the standard errors larger as the information from 2002 and 2003 regarding the covariance between our independent variables, the annual growth rate of newly invested capital and labor market regulation, and the dependent variable, real growth in gross domestic product, is lost.

⁵ Our regressions in Table 2 use fixed effects to control for the differences between countries by allowing each country to have a different regression intercept and so focus on the within country variability rather than the between country variability. Fixed effects regressions reduce the bias that would otherwise result in our coefficients' estimates from unmeasured variables that are correlated with GDP growth and distort the between country variability.

⁶ Our small sample precluded our use of robust standard error estimators like White's heteroskedasticity consistent estimator.

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