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CEO compensation in EU telecom companies: Does the state design the right incentives?☆

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ABSTRACT

This paper analyzes the structure of CEO pay in European fixed telecommunication companies, focusing on the impact of state ownership. Results show that, under the (partial or total) control of the state, the level of CEO compensation is lower and pay-performance sensitivity is higher than in privately-controlled firms. This finding suggests the state provides an incentive as well as a monitoring effect. However, when the state holds the majority of the shares, the pay level is significantly affected by the CEO power, suggesting that in these firms, CEOs are more likely to be entrenched with boards and succeed in raising their pay.

1. Introduction

Executive pay has sparked an intense debate around the world. On the one hand, according to the *incentive theory*, or *optimal contracting theory,* executive compensations that are sensitive to changes in firm performance reduce the agency problem between managers and shareholders (Jensen & Meckling, 1976; Jensen & Murphy, 1990). On the other hand, excessive CEO pay and corporate scandals have shown an alternative perspective, the *managerial power theory* or *entrenchment view,* whereby the directors' board may be "captured" by the CEO, who then obtains favorable compensation packages regardless of firm performance (Bebchuk & Fried, 2004; Gompers, Ishii, & Metrick, 2003; Weisbach, 2007).

Another corporate governance mechanism is firm ownership, as different types of shareholders may exert different pressures on the CEO and have significantly different compensation policies. In particular, when the government is the "large shareholder", its monitoring role and its effect on CEO incentives is still a puzzle (Alchian, 1977; Young, Peng, Ahlstrom, Bruton, & Yi, 2008; Conelly, Hoskinsson, Tihany, & Certo, 2010). State-owned firms are "owned by the citizens", but they are run by political bureaucrats who

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have goals that are often dictated by political interests that may conflict with social welfare improvement and shareholders' value maximization (Shleifer & Vishny, 1997). This suggests that the state may have different corporate governance strategies compared to a private shareholder (Grosman, Okhmatovskiy, & Wright, 2016; Shleifer, 1998).

The goal of this paper is to study the impact of state ownership on the structure of CEO pay in fixed telecommunication companies, with mixed private-public ownership, testing whether it is consistent with optimal contracting or with managerial power and entrenchment. The telecommunication industry is an interesting setting to explore. First of all, in the latest years, CEO remunerations in telecommunications companies have attracted a lot of attention by the media and the public opinion both in the U.S. and in the EU, especially when fixed telecom operators were involved.[4] Second, the ownership structure of these companies, often a mix of state and private investors, allows the investigation of the effect that different controlling shareholders have on the design of the incentives assigned to the CEO via the compensation policy. Third, managers in the telecoms sector are subject to the pressure of a competitive, highly dynamic market, and this in turn raises the question of whether the state as the controlling shareholder can provide the proper incentives.

Starting from the '80s, many European governments have liberalized the telecom industry and privatized state-owned fixed telecommunications incumbents by taking them public. However, although liberalization reforms have increased the competitive pressure in the industry,[5] many fixed telecoms operators are still controlled by the state, albeit being publicly traded in the stock exchange. In terms of corporate governance, the most interesting issue about these "hybrid organizations" is about how the interests of private as well as public shareholders are catered for by managers. Indeed, EU companies, such as Orange/France Telecom and Deutsche Telekom or the Swedish Telia Sonera, are partially controlled by national governments, but they feature as market leaders in the EU telecoms industry.

The purpose of this analysis is to understand how the state, as a large shareholder, influences CEO incentives, i.e. whether it optimally exploits the incentive effect provided by the compensation package or it exacerbates the powers of managers. To this end, this paper estimates whether the level and the sensitivity to firm performance of CEO pay changes at various levels of state ownership, controlling for CEO-specific variables that the corporate governance literature uses to capture the probability of entrenchment as well as for the degree of market competition. Most of the studies on the impact of state control focus on privatizations (Megginson & Netter, 2001; Poczter, 2016), on firms in transition economies (Filatotchev, Wright, & Bleaney, 1999; Grosman et al., 2016) or in China (Chen, Firth, & Xu, 2009; Conyon & He, 2012). Differently from these papers, this study looks at the market economies of industrialized countries where, in spite of privatization waves in the 80s and 90s, (partial) state ownership of large companies is still widespread (The Economist, 2012, 2014).

The empirical analysis uses a panel from 1999 to 2013 of 15 European publicly listed telecom companies. The sample is small, because there is typically one fixed line operator in each country,[6] but consistent, because it includes firms with similar characteristics and historical evolution, not only from state monopoly to privatized or privately controlled status, but also from homogeneous (fixed-line) to multi-product business (mobile as well as fixed telephony). In order to keep this set of firms homogeneous, "pure" mobile operators, such as Vodafone, and alternative fixed operators (such as cable firms) are not included since they are not subject to the same regulatory pressure as fixed operators. This set of firms allows us to study the potential impact of private vs. state ownership on CEO incentives in the light of the empirical predictions of either the incentive or the entrenchment theories, while the intra-industry analysis helps to isolate the influence of other industry-specific factors that may affect CEO compensation packages. Finally, the telecom industry plays a leading role in technological diffusion (Bouckaert, van Dijk, & Verboven, 2010; Briglauer, 2015; Vogelsang, 2015) due to the adoption of more technology-advanced networks, such as fast broadband connection and Next Generation Access (NGA) networks, that positively affects social welfare and a country's growth.[7] Therefore, it is crucial that these firms implement performance-enhancing mechanisms of corporate governance that not only align managers' and (all) shareholders' interests, but also incentivize the managers to invest in new and riskier technologies.

Results reveal that the effectiveness of corporate governance mechanisms differs depending on the identity of the controlling shareholder and varies with the size of the stake. In particular, under the (partial or total) control of the state, the level of CEO compensation is lower and pay-performance sensitivity is higher than in privately-controlled firms. This suggests an "incentive effect" provided by the state as controlling shareholder. However, when differences in the impact at different cutoffs of the state control (i.e.,

[4] "Telecoms operators are cash rich and seem not to worry about the amounts they pay top executives. There are no formulas and companies have to ensure they don't annoy their customers" (GTB-Global Telecoms Business, 16 February 2014). See also in the *Wall Street Journal* (3 October 2002): "As the stock prices of European phone companies sink ever lower, chief executives' compensation is *increasing*. That is because troubled telecommunications operators are finding that they need to pay more to attract fresh talent willing to parachute into some of the biggest messes in the corporate world. The latest example is France Telecom SA. The French operator, with debts […] that are seven times the company's stock-market value, Wednesday named Thierry Breton chief executive officer. His pay will be several times that of his predecessor, Michel Bon, ousted last month for failing to move aggressively enough to reduce that debt load after a series of acquisitions. The richer pay package partly reflects a realization of how hard it will be to turn around the likes of France Telecom and how risky it is to jump into such a situation".

[5] As reported in the EU Commission' scoreboard report (2014), the market shares of incumbent operators have steadily declined, from 98% in January 1998 to around 40% by the end of 2013, the last year of our sample period. This trend in the market also reflects the changes in the regulatory framework. For example, as a consequence of the Framework Directive and Access Directives (2002/21/EC and 2002/19/EC, respectively), the number of markets which require an *ex-ante market review* to assess the market power hypothesis, has fallen (since 2003) from 18 to only 4, excluding any retail market.

[6] A similar sample has been used in Cambini and Rondi (2012) to study the relationship between capital structure, investment and regulated prices in the EU telecom industry.

[7] Roller and Waverman (2001) show that an increase of 10% in the adoption of faster broadband connection leads to an increase of 2.8% GDP growth, on average. More recently, Czernich, Falck, Kretschmer, and Woessmann (2011) find that investing in new broadband infrastructures leads to an increase in GDP per capita ranging from 2.7 to 3.9 percent. Moreover, Gruber, Hatonen, and Koutroumpis (2014) show that the overall future benefits of new broadband investments outweigh their costs for the European Union and infer that the use of the network contributed annually 1.36% GDP of EU countries.