

White collar incentives[☆]Bok Baik^a, John H. Evans III^b, Kyonghee Kim^{c,*}, Yoshio Yanadori^d^a Seoul National University, 599 Gwanak-ro, Gwanak-gu, Seoul 151-742, South Korea^b Katz Graduate School of Business, University of Pittsburgh, 238A Mervis Hall, Pittsburgh, PA 15260, USA^c Trulaske College of Business, University of Missouri at Columbia, 327 Cornell Hall, Columbia, MO 65211, USA^d School of Management, University of South Australia, EM5-18, City West Campus, Adelaide, SA 5001, Australia

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ABSTRACT

This study analyzes the incentive design structure for a sample of mid-level white collar managers (WCM) in large, technology-oriented U.S. firms whose knowledge-based outputs are difficult to measure objectively. Consistent with the limited availability of objective outcome measures for WCM, we find that the sample firms make significant use of tournament-like implicit promotion incentives to motivate WCM, in addition to using explicit financial incentives. We also find that implicit and explicit incentives are complements rather than substitutes in our setting in which sample firms are generally not constrained in their ability to adjust implicit and explicit incentives. Finally, while both implicit and explicit incentives increase in job level, explicit incentives increase more rapidly than implicit incentives, resulting in an increase in the intensity of explicit incentives relative to implicit incentives. We attribute this finding to WCM at higher job levels exercising greater influence on organization performance, making organization-level performance measures more informative. Overall, the results are consistent with the availability of objective performance measures for WCM influencing the structure of their implicit promotion and explicit financial incentives.

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1. Introduction

The recent growth in research on organizational incentive systems has emphasized a mix of economics and behavioral concerns (Merchant, Van der Stede, & Zheng, 2003), identifying a variety of obstacles to providing efficient incentives for managers in large organizations. These obstacles include attracting employees with the appropriate mix of skills, generating contractible signals that are sufficiently informative about managers' actions, information asymmetry that prevents superiors from specifying the desired mix of actions for subordinate managers to take, and the counterproductive strategic behavior that subjective performance evaluations can engender (e.g., Golman & Bhatia, 2012). Among the most

challenging incentive design settings in large organizations are those involving mid-level white collar managers (WCM).¹ We define WCM as non-executive employees with significant managerial or professional expertise who serve in functions without specific responsibility for either generating sales or the overall performance of a major organizational unit, such as a division or the entire firm. The absence of responsibility for either sales or broad organizational performance limits the availability of appropriate performance measures sufficient to support exclusive reliance on explicit financial incentives. At the same time, the presence of numerous job levels in large hierarchical organizations provides the potential for implicit promotion-based incentives. However, this potential is itself constrained by the absence of a mechanism to guarantee that firms will not renege on such implicit incentives. Therefore, our research question is how firms in the face of these constraints design efficient incentives for their WCM.

Limitations inherent to both explicit and implicit incentives suggest that large, hierarchical organizations will often rely on second-best designs that combine some mix of explicit and implicit

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* Corresponding author.

E-mail addresses: bbaik@snu.ac.kr (B. Baik), jhe@katz.pitt.edu (J.H. Evans), kimkyo@missouri.edu (K. Kim), yoshio.yanadori@unisa.edu.au (Y. Yanadori).

¹ We use WCM to refer to either one or more white collar managers, depending on the context.

incentives for WCM.² In a general review of incentives in organizations, Prendergast (1999, p.11 and p.57) attributes the fundamental limitations of explicit financial incentives for many employees, including WCM, to the fact that their output is typically very difficult to measure, and therefore not contractible. He emphasizes that “a critical avenue for future research should be to better understand the evaluation and compensation of those with noncontracted output” (1999, p.11). In that spirit, this study seeks to provide insight into the design of incentives for WCM along three dimensions. First, we provide evidence to confirm our initial suggestion that WCM typically face a mix of both significant explicit incentives and significant implicit incentives, and further that the implicit incentives reflect tournament theory features. Second, we examine whether firms generally design explicit and implicit incentives as substitutes versus complements. Third, we analyze how firms’ relative reliance on explicit versus implicit incentives varies across white collar job levels within the firm.

“White collar employees” include salaried office workers and other employees not engaged in blue collar labor (Prandy, Steward, & Blackburn, 1982). With advances in technology, white collar employees constitute a large and growing proportion of the U.S. workforce, accounting for 61.5% of total employment in 2009 (Bureau of Labor Statistics, 2010).³ Professional and technical white collar workers alone grew from about 11% of all employees in 1960 to 23% in 2000 (Wyatt & Hecker, 2006, p.38). This study focuses specifically on a subset of all white collar employees whom we term “white collar managers”, operationalized by our including only employees with at least a bachelor’s degree and excluding the firm’s top five executives, division managers, managers of operational units and employees with sales responsibilities. We exclude the latter employees because the nature of their responsibilities generates relatively informative outcome measures with which to evaluate their performance, which we expect to significantly influence the resulting incentive structures.⁴

We analyze proprietary compensation data for a sample of WCM working in administrative, technical, and research and development functions in large U.S. technology-oriented firms during 1997–2002.⁵ Typical job titles within our sample are Financial Analyst, Legal Counsel, Application Programmer, System Analyst, Semiconductor Process Engineer and Mechanical Design Engineer. WCM in such large U.S. firms typically operate in a hierarchical organizational structure in which an individual’s advancement follows a relatively well defined path through specified job levels

(Gibbs, 1995, pp.247–248). Consistent with this observation, our sample firms have well-defined job levels for each job.

We document the following empirical results for WCM. First, we find that the magnitude of both explicit financial incentives and implicit promotion-based incentives for WCM are economically significant. Further, we document an increasing, convex functional relation between various compensation measures and job levels for WCM. This finding is consistent with the tournament theory prediction (Rosen, 1986) and suggests that our sample firms make significant use of implicit promotion-based incentives to motivate their WCM. Second, we find that our sample firms generally use implicit promotion-based incentives and explicit financial incentives as complements. In particular, at a given job level, there is a positive association between implicit and explicit incentives in a cross-section of firms. Third, at higher job levels, both implicit and explicit incentives become stronger. However, consistent with broad-based performance metrics becoming more informative for jobs with more decision rights, we find that the relative intensity of explicit incentives compared to implicit incentives increases at higher job levels. That is, although both implicit and explicit incentives become stronger at higher job levels, explicit incentives increase faster.

These findings contribute to the compensation literature by providing new insight concerning the design of incentives for white collar managers, a large and rapidly growing category of employees for whom previous literature is limited. Prendergast (1999, p.11) calls for research on [professional] employees with “noncontracted output”. To the extent that WCM in our sample represent the typical professional workers with noncontracted output in high technology industries, our findings provide insight on how firms design incentives for this group of employees. Further, because our sample consists of a broad cross-section of large, technology-oriented firms, our findings on WCM’s incentive design are more likely to generalize and extend prior research on incentive design when compared to more detailed studies of a single firm.

With respect to specific incentive design features, our study makes the following contributions. First, we offer an explanation that helps reconcile the two opposing views on the use of implicit and explicit incentives. While some prior studies find a substitutive relation between implicit and explicit incentives in settings in which firms’ ability to modify employees’ implicit incentives is limited, our results suggest that firms use the two types of incentives as complements when they are free of such constraints and can optimally adjust both explicit and implicit incentives. Second, while most firms face both the problem of inducing employees to provide unobservable efforts and the problem of motivating efficient decisions for improving firm value, prior research has typically examined each of these problems in isolation (Athey & Roberts, 2001, p.200). Using a setting in which both the difficulty in prescribing employee input and the breadth of employee decision rights increase at higher job levels, we provide empirical evidence on how firms design incentives for WCM. Our findings suggest that explicit financial incentives tied to aggregate performance become more important as employees gain additional decision rights and carry out more complex tasks. This generates a positive association between the relative intensity of explicit incentives and the impact of a WCM’s decisions on firm performance.

2. Literature review and hypothesis development

2.1. Promotion-based incentives for white collar managers

Lazear and Rosen (1981) demonstrate how tournaments in the form of internal competitions for promotions can be effective alternatives to output-contingent contracts when outcomes are

² Explicit incentive contracts link pay to individual or group performance. Examples include piece rates for production workers, commissions for sales persons, and performance bonuses and stock options for executives. Implicit incentives exist when the incentives are not contractible but are based on an implicit understanding between a worker and his supervisor. In this study, we define explicit incentives as any financial payments tied to performance, and implicit incentives as arising from promotion to the next higher job level.

³ The Bureau of Labor Statistics (2010) breaks down the 61.5% into 21.9% employed in professional and related fields; 15.4% in management, business and financial operations; 13.0% in office and administrative support; and 11.2% in sales and related occupations.

⁴ For example, top executives can be rewarded based on the firm’s accounting and/or stock price outcomes; sales managers can be rewarded based on sales results; managers of operational units such as hotels or retail stores can be compensated based on accounting measures of revenue, expense or profit or non-financial measures of customer satisfaction; and production managers can be rewarded based on measures of production volume, cost and quality.

⁵ The sample firms are generally comparable in size to S&P 500 firms during the same time period. The median market capitalization of the sample firms is \$4.8 billion, compared to \$5.7 billion for the median S&P 500 firm. Likewise, operating performance and growth opportunities of the sample firms are also comparable to those of S&P 500 firms. The median return on assets and market-to-book ratio are 6.8% and 3.95, respectively, for the sample firms versus 5.0% and 3.29 for the median S&P 500 firm.

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