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How Economic Incentives May Destroy Social, Ecological and Existential Values: The Case of Executive Compensation

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Abstract Executive compensation has long been a prominent topic in the management literature. A main question that is also given substantial attention in the business ethics literature—even more so in the wake of the recent financial crisis—is whether increasing levels of executive compensation can be justified from an ethical point of view. Also, the relationship of executive compensation to instances of unethical behavior or outcomes has received considerable attention. The purpose of this paper is to explore the social, ecological, and existential costs of economic incentives, by discussing how relying on increasing levels of executive compensation may have an adverse effect on managerial performance in a broad sense. Specifically, we argue that one-dimensional economic incentives may destroy existential, social, and systemic values that influence the manager's commitment to ensure responsible business conduct, and have negative spillover effects that may reduce the manager's performance. There are well-documented findings that demonstrate that reliance on sources of extrinsic motivation (such as economic incentives) may displace intrinsic motivation. Our perspective is a holistic one, in the sense that we will explore the influence of sources of extrinsic motivation on the manager's intrinsic commitment to different types of values. We will in particular investigate how it may influence the manager's ethical reflection and behavior or lack thereof.

Keywords Executive compensation · Holistic perspective · Incentives · Motivation · Value-dimensions of managerial performance

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Introduction

This paper explores the social, ecological, and existential costs of economic incentives. The paper builds on the case of executive compensation like wages, bonuses, and stock options. We argue that relying on ever-increasing levels of such incentives may have an adverse effect on managerial performance in a broad sense. Specifically, we argue that one-dimensional economic incentives (i) may crowd out existential, social, and ecological values that influence the manager's commitment to ensure responsible business conduct (cf. Frey 1997; Mitroff 1998; Bouckaert 2006), and (ii) have negative spillover effects that reduces the manager's performance (cf. Ims and Zsolnai 2009).

The case of executive compensation has long been a prominent topic in the management literature. A main question that is also given substantial attention in the business ethics literature—even more so in the wake of the

recent financial crisis—is whether increasing levels of executive compensation can be justified from an ethical point of view (e.g., Carr and Valinezhad 1994; Walters et al. 1995; Nichols and Subramaniam 2001; Rodgers and Gago 2003; Chan 2008). Also, the relationship of executive compensation to instances of unethical behavior or outcomes has received considerable attention (e.g., Dalton and Daily 2001; McCall 2004; Harris and Bromiley 2007).

More generally, there is a substantial literature on the relationship between compensation or remuneration and motivation, and, ultimately, performance. In the psychology literature, Deci and Ryan (2000) have illuminated the relationship between intrinsic and extrinsic motivations, i.e., motivation that is inherent in the task itself, and motivation that relies on external rewards or sanctions, respectively. In the economic literature, the crowding-out effect, i.e., instances where external rewards in fact *reduce* the motivation of the actor, have been explored both conceptually and through a number of experimental studies (e.g., Frey 1997).

Our contribution is positioned in the extension of these findings. While we build on the distinction between intrinsic and extrinsic motivations and base our discussion on the crowding-out effect, our conception of performance differs from the traditional view. While the existing literature on compensation and performance assumes a one-dimensional conception of performance, i.e., performance implies efficient economic goal attainment; we broaden the conception of performance by viewing it in multiple dimensions. Thus, we will explore the relationship between compensation and performance, and the emergence of the crowding-out effect, with respect to performance wherein different types of values are at stake. We aim to illuminate how compensation may not only crowd-out intrinsic motivation, but also crowd out existential, social, and ecological values that influence the manager's commitment to responsible business conduct. As such, we will argue that excessive compensation schemes may in effect be detrimental to the inclinations of managers and their organizations to act responsibly. The crowding-out effect is often referred to as "the hidden cost of reward" (see, Deci 1976). Our paper further explores what we might call *the hidden existential, social, and ecological costs of one-dimensionality*.

The paper is structured as follows. First, we discuss the economic conception of incentives and performance. We outline the perspective of agency theory, and the criticism thereof. We moreover explore various perspectives on work motivation, and explicitly discuss the crowding-out and crowding-in effects. Second, we discuss potential adverse effects of excessive executive compensation. Third, we propose a holistic framework for understanding performance, motivation, and the effects of economic incentives. Finally, we outline alternative solutions and summarize our perspective.

The Economic Conception of Incentives and Performance

What is the relationship between the willingness to make an effort and productivity? In principal–agent models, we assume that the agent has to be compensated to act as desired by the principal (e.g., Eisenhardt 1989). It is well documented that external rewards influence performance (e.g., Luthans 1985; Lawler 1990). Furthermore, linking the compensation scheme to the share price makes the compensation scheme understandable and "logical" in the sense that payment follows performance. It is easy to administer, and objective criteria make the compensation scheme transparent and to a lesser degree marked by misunderstandings and conflict. As such, the fundamental insights from agency theory underpin the use of variable monetary compensation as incentives for performance.

Moreover, in western culture, *norms of rationality* are strong, which means that behavior is expected to be utility-oriented and instrumental (e.g., Elster 1986). This implies an expectation that the individual collects information about different alternatives and finally decides on the alternative that maximizes his or her goal function. The norm of rationality also implies that people experience a need for being perceived as being rational. The expectation of human rationality, and specifically of economic rationality, is an important assumption that justifies the use of external rewards as motivational sources.

However, the principal–agent model has been met with fundamental criticism. For one thing, human beings have *bounded rationality* (March and Simon 1958). This makes the incentive mechanism unpredictable, which may undermine its effectiveness. Another problem is that human behavior is social, and has to be understood in interaction with other people. As a consequence, it is not easy to predict or control behavior (Weick and Bougon 1986; Axelrod and Cohen 2000). In relation to this, it is argued that since performance is a collective phenomenon, performance should be compensated collectively, e.g., through collective bonuses that do not distinguish between the different members of a team or organization (e.g., Bogsnes 2009).

Moreover, it has been argued that the assumption of opportunism inherent in principal–agent models, as well as the assumption that opportunism can be managed by monitoring and incentives, in fact, *creates more* opportunism. In an attempt to tamper opportunism, organizations design elaborate monitoring systems, thereby implicitly communicating to employees that they are not trusted. The

net effect is a self-fulfilling prophecy—the creation of the types of behavior the system was intended to counteract (Ferraro et al. 2005; see also Ghoshal 2005; Ghoshal and Moran 1996).

The various criticisms directed at traditional agency theory justify an exploration of performance that goes beyond the purely rational and instrumental understanding of human behavior. In the following section, we explore theories of motivation that attempt to account for this.

Theories on Work Motivation

The principal's problem is to get the agent to perform at his or her maximum level. However, we cannot assume that an agent does this, in particular over time. What makes human beings perform over time is a key issue in motivation theory. There are a number of theories on worker motivation, and they differ in their assumptions about what triggers human motivation. For instance, one stream of theory conceives of motivated behavior as the consequence of unsatisfied needs (e.g., Maslow 1943; McClelland 1987). Behavior thus aims to fulfill such needs. An alternative conception is based upon the notion that human beings work toward a goal, and that this motivates some agents more than others (Locke and Latham 1990). An entirely different conception of motivation is captured in theories that assume unconscious motivation, which implies that individuals are unaware of the drives that make them act (e.g., Opdal 2011).

Haukedal (2008, p. 258) maintains that a problem with most motivation theories in the context of working life is that they largely, and often completely, presume instrumentality. An instrumental understanding of behavior implies that performance is regarded as a means to achieve something else. Thereby, for example, working overtime can be explained as a wish to earn more money or obtain other advantages. However, this is a too narrow conceptualization of *work performance*, which can be explained in other ways, for example, as a desire to continue with an activity because of enjoyment or because one relishes the challenge. This is the case for instance when we are engaged in actions that have no purpose beyond themselves, i.e., the so-called *autotelic* action (Csikszentmihalyi 1975).

Haukedal (2008, p. 258) also emphasizes different problems with traditional motivational theories, which mainly build upon a cognitivist foundation, meaning that work is seen as the result of a decision-making process. In such a view, habits and feelings are not relevant, even if such psychological variables play a central role in all other types of behavior (Langer 1979). This critique is akin to the approach to motivation proposed by Deci and Ryan (2000), whose self-determination theory maintains that an understanding of human motivation requires a consideration of innate psychological needs for *competence*, *autonomy*, *and relatedness*. Thwarted satisfaction of these needs results "invariantly in negative functional consequences for mental health and often for ongoing persistence and performance" (Deci and Ryan 2000, p. 262). Deci and Ryan further distinguish between instrumental (extrinsic) and non-instrumental (intrinsic) motivation. Intrinsically motivated activities are those activities that individuals find interesting and would do in the absence of operationally separable consequences (Deci and Ryan 2000, p. 233), while extrinsically motivated activities require such consequences to motivate and reward the actor. Intrinsic motivation is a powerful determinant of performance, and its presence in employees is naturally valuable to organizations, since it produces performance without a need for external reward. Regardless, organizations tend to use external rewards and incentives, also in instances where it is likely that intrinsic motivation exists. As we will see in the following, this has destructive implications.

Crowding Effects

Empirical evidence shows that there in fact exists an effect that countervails the standard relative price effect on behavior (Frey 1997). This effect can be explained on the basis of the distinction between intrinsic and extrinsic motivation. The standard assumption is that an increase in pay (i.e., external incentives) will increase the agent's effort. This may well be illustrated with the supply curve of work effort. However, empirical studies have demonstrated that when external incentives are introduced when intrinsic motivation is present, a so-called *crowding-out effect* comes into play. The result is that an increase in pay in fact reduces the agent's effort, because the reward crowds out the actor's intrinsic motivation. The reason for this is that the actor's self-determination, self-esteem, and possibility of expressing altruism are all impaired (Frey 1997, pp. 16–17).

The crowding-out effect may be stronger than the pure relative price effect, so that the net outcome is that the supply curve shifts to a lower level than the initial effort. However, the crowding-out effect is not always strong, since it is conditioned by several identifiable factors, such as whether the external reward is seen as controlling or supportive (ibid.: 18).

Conversely, the *crowding–in effect* is a positive effect on intrinsic motivation of an institutional factor (Deci and Ryan 2000). This effect is less investigated than the crowding-out effect, but some findings suggest that, e.g., procedural fairness, avoiding the self-serving bias, instructions, framing of socially appropriate behavior,

personal contacts, and incomplete contracts, can have an important impact on performance (see, Frey and Osterloh 2005). In the case of complex interdependencies between actors, it is important to take crowding-in effects into account.

In cases where intrinsic motivation exist, variable pay for performance may undermine the willingness to contribute voluntarily to the common good—given that it is perceived by the agents as an effort to control. According to Tyler and Blader (2000), monetary incentives explain only 10 % of the variance in performance, while obligations based on intrinsic norms explain 30 %. Bucklin and Dickinson (2001) find that the amount of incentive pay as proportion of fixed pay can be relatively small but, nevertheless, be effective. Hence, in compensation schemes, it is important to recognize the relevant characteristics of the situation that determine whether added external incentives will crowd in or crowd out employees' intrinsic motivation.

Adverse Effects of Excessive Executive Compensation

High compensation of managers entails a distribution of wealth that provokes society. The following question is unavoidably asked: What is the justification for high executive wages? Has the performance of firms improved proportionally with managerial compensation? And is it necessarily the case that executives should be credited for the company's performance?

Based upon his authoritative survey, Murphy (1999, p. 2555) writes: "Although there is ample evidence that CEOs (and other employees) respond predictably to dysfunctional compensation arrangements, it is more difficult to document that the increase in stock-based incentives has led CEOs to work harder, smarter, and more in the interest of shareholders." Murphy also indicates that the way of payments also matters. It is not only a question of size—it is how the structure of the compensation scheme is designed. There are important findings that variable pay—and payment linked to performance—may have major dysfunctional impacts. Frey and Osterloh (2005) argue that payment linked to performance might in some cases explain some of the scandals in business—like the Enron and WorldCom collapses. The main argument is that pay for performance reinforces extrinsic motivation, which entails that individuals shift their "locus of causality" from inside to outside, from the activity itself to the reward. Thus, the content of the activity loses its importance, and intrinsic motivation can be undermined.

Such a view stands in sharp contrast to the position of Jensen and Murphy (1990, p. 139), who assert that "so many CEOs act like bureaucrats rather than the value-maximizing entrepreneurs companies need to enhance their standing in world markets." Jensen and Murphy moreover assert that "It's Not How Much You Pay, But How." They argue that, if possible, CEOs should own substantial amounts of company stock. However, in the case of giant companies like IBM, General Motors, or General Electric, CEOs should have substantial cash compensation that should be structured to "*provide big rewards for outstanding performance and meaningful penalties for poor performance.*" (Jensen and Murphy 1990, p. 141). Jensen and Murphy assert that monetary compensation and stock ownership remain the most effective tools for aligning executive and shareholder interests. Moreover, they strongly support the link between pay and performance. In fact, they warn that non-monetary rewards "typically motivate top managers to take actions that reduce productivity and harm shareholders … As prominent members of their community, CEOs face pressures to keep open uneconomic factories, to keep peace with labor unions despite the impact on competitiveness and to satisfy intense special-interest pressures" (Jensen and Murphy 1990, p. 149). Thus, CEOs should not act like good citizens but regard Corporate Social Responsibility as a strategic act, in the spirit of Milton Friedman and Michael Porter (e.g., Porter and Kramer 2006).

A second problem with individual economic incentives for executives is that managers will be too concerned about achieving what they are measured on. This may lead to suboptimal behavior as a result of goal displacement, since it becomes tempting to aim for high performance in the areas—and within the time frame—that determines bonuses (cf. Kerr 1975). Seen in a holistic perspective, this may imply serious dysfunctions. For one thing, it may lead the organizational focus away from important issues. Moreover, it may lead the organization into emphasizing technical efficiency at the expense of responsible behavior and sustainable business practices.

The challenge is to find a way to measure and remunerate managerial performance that facilitates a holistic long run view of the company (cf. Jensen 2002). In this regard, performance on the stock market gives a biased focus. The strategy for compensating the manager could alternatively be developed to be contingent on the satisfaction of employees, the environmental performance of the firm, etc. An example of this is the American company Allied Electronics, which has tied its incentive system to the sustainability performance of the company (Eccles et al. 2012). Empirical studies demonstrate that procedural justice is a key component to foster group engagement and cooperation (Tyler and Blader 2003). This implies that executive compensation that is seen as procedurally unfair—since compensation is determined by factors outside the locus of control of managers—may undermine employees' engagement and, ultimately, performance. The

group engagement model suggests that the identity is more important that resources in predicting engagement and cooperation (Tyler and Blader 2003, p. 355).” Identification reflects the extent to which people “cognitively merge their sense of self and their evaluations of self-worth with their judgments of the characteristics and status of their groups” (Tyler and Blader 2003, p. 354). Hence, compensation schemes that are perceived as unfair effectively destruct the social and cooperative fabric of the organization.

Thus far, we have explored some pitfalls associated with relying on economic incentives that, respectively, indicate adverse economic (efficiency) outcomes (e.g., reduced work effort), systemic outcomes (e.g., suboptimal behavior due to goal displacement), existential outcomes (e.g., reduced self-worth), and social outcomes (e.g., reduced employee engagement and cooperation).

A Holistic Framework

Mitroff (1998) proposed a holistic framework, wherein it is distinguished among four dimensions of problem-solving: the scientific–technical, the interpersonal–social, the systemic–ecological, and the existential–spiritual. Without any doubt, the scientific–technical way of thinking is the dominant perspective in our western culture. For work-motivation purposes, it entails a simple logic: if someone expresses frustration in his or her job, compensate him or her with more money. The assumption is that money is an efficient means to increase the effort and well-being of employees in an organization. In the following, we problematize the dominance of this perspective, which easily leads decision makers into a fallacy of misplaced techno-centrism (Ims and Zsolnai 2006). We will focus on the hidden costs of using a scientific–technical mindset in situations in which alternative perspectives might be more fruitful.

The interpersonal–social dimension of problem-solving is in line with the focus on the employee’s identification with his or her group or organization. (e.g., Tyler and Blader 2003). Trying to solve the problem of identification with more money would be solving the wrong problem precisely. The equality policy of American organic food retailer Whole Food Market instead plays on social dimensions (Mackey and Sisodia 2013). Its main characteristic is an “in-it-together” mindset where performance, and therefore compensation, is seen as a collective phenomenon. Also, such an approach plays down the differences between organizational members and emphasizes the similarities between employees in the same organization. If the problem is identification, engagement, and cooperation—which is distinct from performance, yet arguably influences performance—the objective can be reached by means of other approaches altogether. For instance, value-based leadership that aims to inspire employees to take part in a vision with the company positively influences the identification of employees (cf. Pruzan 2009).

Another important dimension of problem-solving in Mitroff’s framework is the systemic–ecological dimension, which highlights the fact that problems relate to a larger whole. The assumption is that everything is interconnected, which means that we must take into account how the problem is connected to the broader system. In this perspective, increasing executive compensation may generate systemic effects that exert a heavy toll on the organization in the long run. For one thing, it takes up resources that could have been used for other purposes, and perhaps serve the organization better. Secondly, it creates a precedent toward which executives—and employees more broadly—may use as a reference point when considering their own future compensation plans. Also, new conflicts may be created in the organization due to perceived unfairness, which has implications far beyond the compensation case itself. Conflicts are easy to create, but harder to manage, especially after they have mutated and spread in the organizational organism. Finally, the response from society at large may be negative, in effect causing serious damage for the reputation and the branding efforts of the company (e.g., van de Ven 2008). A contemporary example of the detrimental reputational effects of perceived unfair compensation is the case of Goldman Sachs, who paid their executives record bonuses following the turmoil of the financial crisis and the bailouts from the American government.

However, the most ignored problem dimension today is arguably the existential–spiritual dimension. Within the existential–spiritual dimension we open up for understanding the human being’s life-projects (Williams 1981), dignity, search for meaning (Frankl 1969), pride, and self-respect. When we look at man in such a frame, we see man not as a utility maximizer, but more in line with the conceptualizations in modern motivational theory, where the inherent pleasure of the task (Deci and Ryan 2000), or the experience of flow (Csikszentmihalyi 1975) are motivators of activities that are intrinsically valuable for the actor.

As discussed by Frey (1997), intrinsic motivation is undermined when the individual’s self-determination is impaired. When the individual senses an external intervention that aims to control his or her behavior, the individual’s deep-rooted responsibility for the task is also undermined. This implies that the individual externalizes the responsibility for the task or performance, effectively rendering him or her disengaged from the task and its consequences (e.g., Bandura et al. 2000). The net effect of this process is that the preexisting commitment of the

individual to the behavior is displaced, and the moral or social norms that incited him or her to act are substituted for transactional or purely rational norms. Thereby, the act itself is transformed from having existential relevance for the individual to an act that is carried out in a narrow transactional perspective.

Pruzan (2009) gives insightful observations and analyses of how spiritual perspectives emerge at the individual as well as corporate level throughout the world. He writes that "once leaders have developed their own spiritual self-awareness, they naturally exercise it in some form of service beyond self-interest. The dualistic distinction between one's self and others becomes replaced by a deeply felt connectivity, and the ordinary distinction between responsibility to one's self and to others attenuates." (Pruzan 2009, p. 252).

Focus on the existential–spiritual dimension indicates that we are oriented toward the person's self-concept. This means we see managers "that they are beings of the requisite depth and complexity to have an identity … (or to be struggling to find one)" (see, Taylor 1989, p. 14). The organization has to address and to deal with such questions, otherwise words like visions, values, goals and strategies will only have a shallow meaning. The answers to those questions cannot be announced via managerial decree but need to be part of the leaders and employees' identity and integrity. An "outside in" perspective is not satisfactory. What we need is an "inside out" perspective if the leaders and the organizations claim to be responsible in genuine sense. (Auster and Freeman 2013).

But what if the existential life is perverted and the satisfaction of the innate needs are thwarted? Economic rationality may take such a serious grip on the managers' thought and behavior that it colonizes their private life-world. On such a background it is possible to be very rich and poor at the same time. Economic wealth and greed do not lead to joy, deep satisfaction, and happiness. Numerous psychological studies demonstrate that the more people prioritize materialistic goals, the lower their personal well-being and the more likely they are to engage in manipulative, competitive, and ecologically degrading behaviors (Kasser 2011).

Alternative Solutions

Considering all the relevant aspects of the executive compensation problem (i.e., technical–scientific, interpersonal–social, systemic–ecological, and existential–spiritual) alternative solutions can be developed. Swiss economists, Bruno Frey and Margit Osterloh, suggest that the firm should be looked at in terms of a bundle of common pool resources. Common pool resources are collective goods which generate a joint surplus not attributable to single actors. It is essential that the production of such collective goods depends on prosocial intrinsic incentives (Frey and Osterloh 2005).

Alternative solutions consistent with the view of firms are common pool resources emerge in the practice of "conscious capitalist" enterprises which adopted a policy that caps executive pays. For example, at the Whole Food Market—a leading organic food retailer company in the USA—the total cash compensation, including bonuses, for top managers cannot be higher than 19 times of the average pay of the employees. In other publically traded companies in the USA, this ratio is as high as 400–500 times (Mackey and Sisodia 2013, p. 93).

Caps on executive compensation create a sense of fairness because the compensation system is perceived by employees to be fair. With constrained compensation executives get less money than their counterparts in mainstream business organizations but they are usually compensated by getting higher moral satisfaction. Offering existential–spiritual, social, and ecological pay-offs for business leaders responsible organizations can get the right persons in the right position. Pre-selection occurs, and the persons who are intrinsically motivated to work for high-purpose, high-mission companies happen to be the executive positions at those companies.

Summary

In this paper, we have explored the adverse effects on managerial performance of relying on ever-increasing levels of executive compensation. Rather than conceiving of performance in a one-dimensional, technical–economic sense, we have illuminated how such compensation schemes may undermine holistic individual and organizational performance. Specifically, we have argued that relying on external rewards is associated with the danger of crowding out existential, social, and ecological values in executives' behavior and performance. Our main argument is that we have to go beyond traditional economic rationality in which employees and organizations are mainly perceived as instruments to produce increased profits and financial wealth. In such an environment, the managers will be motivated by external compensation alone. We need a model of compensation that encompasses other dimensions as well; a model that takes into account man as a whole being whose commitment to important existential, social, and ecological values not only is reflected in his or her performance, but it is also the very point from where that performance springs.

There is no doubt that the technical–scientific paradigm has been enormously successful in solving economic problems. The danger is that it has swallowed other

important dimensions, and when using a scientific–technical perspective on social, ecological, and existential problem dimensions we may entail counterproductive behavior of managers.

Mitroff's four dimensions of problem-solving are not antithetical, but are mutually supportive. The major problem arises when one dimension, the scientific–technical, becomes dominant and other dimensions are ignored. The sensitivity to the needs of other beings and stakeholders are vital for corporate success and survival in a broad and long-term sense. Taking the existential, social, and ecological perspectives seriously might lead to an improved capability for reflection on the usefulness of high compensations of managers and the negative effects generated by such practices.

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