Top Executive Incentives in Germany, Japan and the U.S.: A Comparison

by

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ABSTRACT

This paper compares top executive incentives in Germany, Japan, and the U.S. First, the paper summarizes my work on top executive turnover and compensation, and their relation to firm performance in the largest companies in the three countries. Executive turnover in all three countries increases significantly with poor stock performance and earnings losses. Executive compensation in Japan and the U.S. is also related to these variables. The relations for executives in the three countries are generally economically and statistically similar. The fortunes of German and Japanese top executives, therefore, like those in the U.S., are positively correlated with stock performance and with current cash flows (or with factors contributing to such performance). Sales growth (or market share) plays a smaller role. A simple economic interpretation of these results is that current stock price and current cash flows provide good measures of a company's overall prospects and value. Second, when stock and option ownership is considered, the incentives of U.S. executives are the most highly correlated with stock performance. The paper offers an explanation for these findings and with some conjectures on the relative advantages and disadvantages of the three governance systems.

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1. Introduction

Executive compensation and corporate governance systems have received an increasing amount of attention -- from academics, government, the popular press, and businesses themselves. Much of this attention has focused on differences between the U.S. system and those of its strongest industrial competitors -- Germany and Japan. The U.S. corporate governance system is generally characterized as a market-based system. U.S. capital markets are liquid and company ownership is relatively unconcentrated. Managers are supposedly monitored by an external market for corporate control and by boards of directors usually dominated by outsiders. The German and Japanese governance systems, in contrast, are characterized as relationship-oriented systems. Ownership in Germany and Japan is concentrated and capital markets are relatively illiquid. Managers there are allegedly monitored by a combination of banks, large corporate shareholders, and other intercorporate relationships that are maintained over long periods. An external market for corporate control is small, if not absent. Chart 1 summarizes these differences.\(^1\)

The differences in governance systems, in turn, are usually associated with differences in managerial behavior and firm objectives. One view argues that the close financial ties and relationships in Germany and Japan "reduce agency costs and allow investors to monitor managers more effectively than in the U.S."\(^2\) According to this view, there are lower costs to changing poorly performing management because banks and large shareholders have the power to make needed changes. Costly hostile takeovers or proxy fights are avoided.

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\(^1\) See also La Porta et al. (1996) and Shleifer and Vishny (1997) for a discussion of international differences in corporate governance.

\(^2\) Grundfest (1990), p. 98. See also Aoki et al. (1994), Hoshi et al. (1990 and 1991), Lipton and Rosenblum
This view has also been associated with claims that German and Japanese firms are less concerned with or affected by short-term earnings, and, therefore, better able than U.S. firms to manage for the long-term -- i.e., invest in projects with long-term payoffs. This position assumes that current stock prices can diverge from long-term shareholder values. Because banks and large shareholders have both better information and more power to use that information than the widely dispersed shareholders of the typical U.S. company, financing is more readily available for value-increasing long-term projects in Germany and Japan. The supposed monitoring and information advantages have led some to call for the U.S. corporate governance system to imitate aspects of the German and Japanese systems.³

Others, however, argue the alternative view that the German and Japanese systems entrench managers and employees at the expense of shareholders. Banks, allied with incumbent managers, may receive abnormally high fees or interest rates in exchange for agreeing to bail out managers (and their companies) in cases of poor performance and financial distress even if not efficient to do so.⁴

As suggested above, many observers have been quick to distinguish the U.S. system from its Germany and Japanese counterparts, and to draw conclusions about the nature of those differences. Most of these distinctions were initially based on anecdotes, cases, and surveys.

³ In particular, see Porter (1992) who argues that the U.S. system leads to underinvestment.

⁴ See Abegglen and Stalk (1985), Baums (1992 and 1993), and Coffee (1991) for a discussion of these views. Milgrom and Roberts (1992) and Roe (1993) are also sympathetic to this conclusion.
In contrast, my work -- Kaplan (1994a and 1994b) and Kaplan and Minton (1994) -- provided some of the first systematic evidence on how the German and Japanese systems operate and how they differ from the U.S. system. The results challenged those anecdotes.

In this essay, I summarize and discuss the implications of the results in those three papers. Executive turnover in all three countries increases significantly with poor stock performance and earnings losses. Executive compensation in Japan and the U.S. is also related to stock returns and earnings losses. The effects in all three countries are generally economically and statistically similar. The fortunes of German and Japanese top executives, therefore, like those in the U.S., are strongly affected by stock performance and current cash flows. Sales growth, a measure of market share, plays a smaller role. There is no evidence, therefore, that U.S. managers have any more incentive to be short-term oriented than their German and Japanese counterparts. There appears to be, however, one substantial difference between the U.S. and the rest of the world -- stock and option ownership. U.S. managers own more stock and options. I conclude the paper with an explanation for my results and with some conjectures on the relative advantages and disadvantages of the three governance systems.

2. What incentives do corporate governance systems provide?

As I noted above, most discussions of managerial motivations in Germany, Japan, and the U.S. are based on anecdotes or surveys. In my research, I decided to test the anecdotes by asking one simple question: What incentives do the different corporate governance systems really provide to top managers? Specifically, by understanding why top managers are fired
and why they are paid more, one can infer what incentives they actually have.

2.1 The relation of managerial rewards and punishments to firm performance

Kaplan (1994a and 1994b) study corporate governance in the largest companies in the three countries -- 42 in Germany, 119 in Japan, and 146 in the U.S. -- from 1980 to 1988. The analyses focus on the top group of managers or operating executives in each firm in these countries. These executives are management board members in Germany; representative directors in Japan; and executive directors in the U.S. In the next several paragraphs, I describe the management and board structures in the three countries in more detail.

In Germany, the management board -- the Vorstand -- is comprised of the 7 or 8 top managers. They include the Chairman who is the equivalent of the CEO. German firms also have a supervisory board -- the Aufsichtsrat -- which is the equivalent of an outside board in the United States. Under the German co-determination system, the supervisory board includes both shareholder and labor representatives. In larger public companies, the supervisory board will typically have 19 members.

In Japan, the typical board has 21 members almost all of whom are insiders. The president is the chief executive officer or CEO. In each company, three or four directors, including the president, are given special rights to represent the company. These are known as the representative directors.

Finally, in the U.S., the firm is governed by a board of directors of typically 13 or 14 members. Approximately 1/3 are insiders and 2/3 are outsiders. The CEO is the most powerful of the managers and directors. In my research, I study executive directors -- the operating
managers who also are on the board of directors. This group typically includes 4 or 5 members and always includes the CEO.

The first question I asked is what kind of performance causes the top operating managers in these firms to lose their jobs? In technical terms, this involved estimating the following regression:

\[
\text{Probability of losing job} = a + \beta \times \text{Performance} + e
\]

I use four measures of firm performance: (1) company stock returns; (2) sales growth; (3) change in pre-tax income as a fraction of total assets; (4) and a dummy variable equal to one if pre-tax income is negative. Sales growth is meant to be a measure of market share, and, presumably a measure of “long-term” management. The dummy variable for negative pre-tax income, in contrast, which indicates that accounting earnings are less than operating and financial expenses, is perhaps the most short-term measure of performance.

The turnover results are presented in graphs 1 - 3. In all three countries, managers are more likely to lose their jobs when their company’s stock performs poorly (Graph 1). In all three countries, managers are more likely to lose their jobs when their company experiences an earnings loss (Graph 2). In fact, Japanese and German managers are approximately twice as likely to lose their jobs in a year with a loss than in a year with positive earnings. Interestingly, the sensitivities or relations in the three countries are not different from one another in a statistical sense. Finally, managers are more likely to lose their jobs in Japan and the U.S. when sales growth is poor (Graph 3). Surprisingly, German managers are unaffected by poor sales performance. Furthermore, sales growth is less important in Japan than earnings and stock performance.
The second set of tests considers top management compensation and its relation to firm performance in Japan and the U.S. It is true, as is commonly believed, that Japanese executives do earn lower levels of cash compensation than U.S. executives. The important question for incentives, however, is when are the top managers in those two countries paid more? To answer this, as with turnover, I estimate a simple regression:

\[
\text{Percentage change in compensation} = a + \beta \times \text{Performance} + \epsilon
\]

using the same four measures of performance.

The results are presented in graphs 4 and 5. Just as is the case with top executive turnover, Japanese management compensation is strongly related to earnings, stock, and sales performance. And again, the sensitivities in Japan and the U.S. are virtually identical. A two standard deviation change in stock returns leads to roughly an 8% increase in compensation in both Japan and the U.S. An earnings loss leads to a 13% pay cut in Japan and a (statistically indistinguishable) pay cut of 18% in the U.S.

What do these results for turnover and compensation mean? Three very different systems generate very similar outcomes. The fortunes of German and Japanese managers (and U.S. managers) are tied to stock performance and current cash flows -- measures that some would refer to as “short-term.” Furthermore, the punishments and rewards for German and Japanese managers are not more sensitive to sales growth -- a measure some would refer to as “long-term” -- than those of the U.S. If anything, they are less sensitive. It is difficult, therefore, to reconcile these findings with the view that German and Japanese managers are

\[\text{These data were unavailable for German executives.}\]
more patient -- i.e., can ignore current cash flows to pursue increases in market share or sales growth. Finally, it is also difficult to reconcile these results with the view that the U.S. system is more short-term.

These results, in turn, suggest two broader conclusions. First, successful corporate governance systems respond to current measures of performance -- earnings and stock prices. Second, the current stock price reflects a firm's current and future health.

2.2 The impact of banks, corporate shareholders, and relationships

The results for top executive punishments and rewards relative to stock and earnings performance in Germany and Japan cannot be driven by an external market for corporate control because such a market does not exist in either country. This section considers possible explanations for or sources of the turnover-performance and compensation-performance results. As noted earlier, the most likely forces behind those results are banks, large corporate shareholders, and other intercorporate relationships. Kaplan (1994a) and Kaplan and Minton (1994) present evidence on the importance of those forces in Germany and Japan, respectively.

The first question the two papers ask is when do banks or large shareholders take an active interest in the sample companies. The papers measure such an interest as particular types of board appointments. In Germany, I study new appointments to the supervisory board. In Japan, Bernadette Minton and I study appointments of "outsiders" to the board, where outsiders are individuals who are not lifetime firm employees, but have previous work experience at a bank or large shareholder. Both supervisory board appointments in Germany and outside appointments in Japan are increasingly likely as stock performance deteriorates.
These results are consistent with the governance relationships in Germany and Japan playing a monitoring and disciplinary role.

Kaplan and Minton (1994) continue with a more detailed comparison of outside appointments in Japan. Appointments of bank directors in Japan -- outsiders affiliated with banks -- increase with earnings losses, as well as with poor stock performance. Appointments of outsiders in Japan also increase with measures of the intensity of the relationships: appointments of bank directors increase with a firm’s borrowings from banks; appointments of corporate directors increase with shareholder concentration and with corporate group affiliation.

While these results are consistent with the governance relationships in Germany and Japan playing a monitoring and disciplinary role, they are also consistent with an insurance interpretation in which the presence of an outsider signals to suppliers, customers or others that the bank or the affiliated corporation will support -- i.e., bail out, and, therefore, insure -- the appointing firm. Kaplan and Minton (1994) distinguish between the two interpretations by considering the relation between outside director appointments and top executive turnover. Turnover increases substantially in periods when outsiders are appointed, even when controlling for firm performance. We interpret this results as saying that banks and corporate shareholders do play a monitoring and disciplinary role in Japan. In this sense, the relationships appear to at least partially substitute for the more market-oriented U.S. control mechanisms.

3. Why are the results so similar?
The bottom line of my three papers is that very different corporate governance systems in Germany, Japan, and the U.S. generate similar outcomes. The key similarity is that all three countries have successful market economies. In this section, I discuss why I think the results tend to be similar.

To understand this, it helps to look at two dimensions (see Chart 2). First, governance differences should be less important when firms cannot survive if they don't maximize. That will be true when product markets are competitive, government subsidies are small, and few (economic) rents are lying around. In those circumstances, managers face two basic choices: maximize or fail. Managers who do not maximize, and often their firms, will not survive.

Second, governance differences become less important as firms require more capital. When industries are growing or changing and firms need capital, it is difficult to obtain financing to pursue excessive or unprofitable growth. In other words, if a firm's corporate governance structure allows its managers to waste resources, that firm will not be able to obtain financing. Given that competitive product markets and competitive capital markets dominate most capitalist economies, the similarity in the German, Japanese, and U.S. results should not be particularly surprising. Governance, in a real sense, takes care of itself when industries are growing and changing, and when industries are competitive.

Governance differences will matter most in mature industries or in non-competitive industries where firms can survive for substantial periods without maximizing, and waste substantial resources in the process. Jensen (1986) describes such firms and industries as being susceptible to large agency costs of free cash-flow. Oil companies in the U.S. in the 1980s and many Japanese firms in the late 1980s fit this description.
4. **Which system provides the best incentives?**

The final and most interesting question to be addressed is which governance system, if any, provides the best incentives?

On the dimensions I studied in my research, the three systems are similar. There is no clear difference between the three governance systems in responding to poor stock and earnings performance. That result has been confirmed by the recent responses of German companies to competitive difficulties and exchange rate movements. Japanese companies also have responded in “American” ways to its recession and strong yen. There also do not appear to be clear differences in incentives to manage for the “short-term” or for the “long-term.”

As I argued in the previous section, there are good reasons to believe that the similarities are the product of successful market economies. In other words, as long as an economy is competitive or market-based, governance systems will be pushed by the market to become relatively efficient. Different systems, then, will generate satisfactory outcomes.

While the three systems are similar in many respects, the U.S. system has important advantages over the other systems. In particular, the U.S. system provides better incentives to firms that are already performing well. Such firms will include firms in mature industries or in industries that are not perfectly competitive. The better incentives come from the fact that U.S. managers hold much larger stock and option positions that managers in Japan (see graph 6) and, probably, managers in Germany. Because they own more shares, it is arguably less tempting for U.S. managers to overinvest or waste the extra cash that a successful firm
generates.

Since the period studied in my papers, the differences between the U.S. and other systems almost certainly have increased because the wealth of U.S. CEOs has become increasingly sensitive to the performance of their companies' stock. This increased sensitivity has been driven by a substantial increase in the use of equity- and option-based compensation in U.S. firms. In a recent paper, Hall and Liebman [1997] find that from 1980 to 1994, the average annual CEO option grant (valued at issuance) increased more than seven-fold from $145 thousand to just under $1.2 million. As a result, by 1994, equity-based compensation made up almost 50% of total CEO compensation, compared to less than 20% in 1980.

If the U.S. corporate governance and incentive system is superior, one might expect that other countries would start to copy the U.S. This appears to be happening. In Japan, it is no longer illegal to issue executive stock options. (Their issuance, however, is still constrained by regulations relative to those in the U.S.) And in Europe, according to accounts in the popular press, the use of stock options for executives and boards is increasing. I would expect the movement to U.S. incentives to continue.
References


