

The Economic Psychology of Incentives

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New Design Principles for Executive Pay

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Softcover reprint of the hardcover 1st edition 2015 978-1-137-40923-2

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First published 2015 by
PALGRAVE MACMILLAN

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Palgrave Macmillan in the US is a division of St Martin's Press LLC, 175 Fifth Avenue, New York, NY 10010.

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ISBN 978-1-349-68142-6 ISBN 978-1-137-40925-6 (eBook)
DOI 10.1007/978-1-137-40925-6

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources. Logging, pulping and manufacturing processes are expected to conform to the environmental regulations of the country of origin.

A catalogue record for this book is available from the British Library.

A catalog record for this book is available from the Library of Congress.

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Preface and Acknowledgements

The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the steward of a rich man they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

Adam Smith (1776) *An inquiry into the nature and causes of the wealth of nations*. London: Strahan and Cadell. Book V: Chapter 1: Part III. Article 1. "Of the Public Works and Institutions Which Are Necessary for Facilitating Particular Branches of Commerce".

The pleasure which we are to enjoy in ten years hence, interests us so little in comparison with that which we enjoy today, the passion which the first excites, is naturally so weak in comparison with that violent emotion which the second is apt to give occasion to, that one could never be any balance to the other, unless it was supported by a sense of propriety.

Adam Smith (1759) *The theory of moral sentiments*. London: Miller; Edinburgh: Kincaid and Bell. Part IV: Chapter 2. "Of the Beauty Which the Appearance of Utility Bestows Upon the Characters and Actions of Men".

Adam Smith identified the agency problem in public corporations as long ago as 1776 in the *Wealth of Nations*, the first great specialist work of economics. Yet Adam Smith was also a behavioural scientist, writing in 1759 in *The Theory of Moral Sentiments* about

motivation, loss aversion, fairness and inter-temporal choice, among other things.¹ That agency problems in public companies still exist today, and that the kinds of incentive mechanisms advocated by scholars and implemented by practitioners have not achieved their objective of solving these problems, is surely not in dispute: even John Roberts, one of the world's leading organisational economists and a well-known agency theorist, has commented that agency theory did not perform well during the financial crisis of 2008–10.² Nevertheless, it would be unwise to insist that the principal–agent model is now so fundamentally flawed that it should be rejected in its entirety: agency theory comes from a long and highly reputable scholarly tradition which has, over the last 40 years, influenced management scholars and legal theorists, as well as economists.

The objective of this book is to propose a new version of agency theory which is built on more robust assumptions about human behaviour. It develops a line of thinking whose origins can be traced back to an article written by Robert Wiseman and Luiz Gomez-Mejia which was published in the *Academy of Management Review* in 1998.³ My hope is that, by extending the theory and providing empirical evidence in its support, I might encourage other scholars to build on the behavioural agency model and test it with new data. Ultimately, of course, my goal is to have an effect on management practice and to contribute new ideas about executive reward that business will support, which might also help to win back the confidence of the public in public corporations and their managers. It would indeed be very disappointing if “negligence and profusion” were always to prevail in the management of the affairs of public companies.

This monograph brings together in one place the research I have carried out during the past six years with various collaborators and co-authors into what has become known as the “behavioural aspects of senior executive reward systems”, commencing with my doctoral thesis submitted under that title in part fulfilment of the

¹ Ashraf, N., Camerer, C., & Loewenstein, G. (2005). Adam Smith, behavioral economist. *Journal of Economic Perspectives*, 19(3), 131–145.

² Roberts, J. (2010). Designing incentives in organizations. *Journal of Institutional Economics*, 6, 125–132.

³ Wiseman, R., & Gomez-Mejia, L. (1998). A behavioral agency model of managerial risk taking. *Academy of Management Review*, 23(1), 133–153.

requirements of the degree of Doctor of Business Administration (DBA), awarded by the University of Surrey in 2011. Various parts of this book have previously been published in academic journals and are reproduced here with permission of the co-authors and publishers of the respective journals.

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- Pepper, A., & Gore, J. (2012). Behavioral agency theory: New foundations for theorizing about executive compensation. *Journal of Management*, dx.doi.org: 10.1177/0149206312461054. Reproduced with the permission of Sage Publications.
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Many people deserve recognition for their contribution to this work, foremost the co-authors of the journal articles around which the book is based, namely Julie Gore and Alf Crossman at Surrey Business School, University of Surrey, and Tom Gosling at PricewaterhouseCoopers in London. Their contributions to the original articles are noted at the beginning of the relevant chapters. Without their help and support this work would not have been possible.

Numerous others have contributed directly or indirectly to this book. In addition to my co-authors, these include Jon Terry, Sean O'Hare and Gemma Carr at PricewaterhouseCoopers; Wida Amani, Rebecca Campbell and Lori Peterson at the London School of Economics (LSE); Tony Dundon of *Human Resource Management Journal*; Wayne Cascio of *Journal of World Business*; Patrick Wright of *Journal of Management*; and Mathew Sheep of *Human Relations*, along with eight anonymous reviewers.

I am especially grateful to Julie Gore of the Surrey Business School, who originally became involved in this work as the supervisor of my DBA thesis, and who subsequently became my researcher collaborator and co-author. Julie has also been my academic mentor, and her guidance and support as I went through a career change from consultant to academic have been of great importance to me. I also owe a great deal to the Foundation for Management Education, and especially its director Mike Jones, who supported my move from PricewaterhouseCoopers to LSE in 2008, and to Saul Estrin at LSE for taking a risk and taking me on. This book is dedicated to them.