

Using pay and benefits in real estate
firms – an initial look at the Swedish
experience

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KTH Infrastructure

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**Using pay and benefits in real estate firms – an initial look at
the Swedish experience**

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Table of Contents

- Acknowledgements
- Introduction
- Paper 1: Incentive plans and real estate companies – a literature review
- Paper 2 – A Survey of how Swedish real estate firms use pay and other benefits to manage employees
- Paper 3 - Does ownership and size matter? Incentive plans within Swedish real estate firms.

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Introduction

This collection of essays makes up a dissertation written in partial fulfilment of the requirements for the award of the Licentiate degree at the Royal Institute of Technology (KTH) in Stockholm. The research was conducted in the Division of Building and Real Estate Economics.

The essays focus on incentive plans as a people management tool for real estate companies. Three major innovations that have enhanced real estate as an investment asset over the past couple of decades have been:

- The de-coupling of ownership of property from its management, and
- The recognition of real estate as an advantageous investment in a portfolio of bonds and stocks.
- The development of institutions and instruments to facilitate investment into real estate.

These innovations have also turned real estate professionals into finance professionals in addition to attracting people with finance backgrounds into the business. To sustain these innovations, the sector needs to develop and implement creative people management strategies. Central to these strategies is the use of incentive plans.

Research in the real estate sector appears to focus, among other issues, on:

- The financial properties of the asset
- Its role as a corporate asset, and
- The appropriate role of government and the market in housing provision.

Strategies to retain the critical talent that will drive the innovations outlined above do not seem to be a research priority. Perhaps it is not even seen to be an issue for real estate researchers. The scale of investment in the asset naturally calls for focus on how to protect and enhance the profitability of these investments. However, what cannot be forgotten is that people drive returns. Without any explicit strategies to retain the critical talent that drives and sustains innovations in the sector, competing sectors like the mainstream finance sector could easily poach the most talented workers.

Even though there is conventional acceptance of the use of incentive plans as a people management tool, its implementation has not only generated controversy but also led to unintended consequences like manipulation of corporate financial statements, needless corporate expansion, and destructive intra-firm competition. Different industries also appear to respond differently to the performance measurement systems on which these plans are based. Performance measurement systems that were not well examined ended up motivating some of the wrong behaviour described in banner headlines in the news. It has also become clear that the nature of a firm's business and the organisation of the various sub-units of the firm could prove to be decisive factors in the success or otherwise of a performance measurement system.

This is why one-size-fits-all solutions do not work and that is why there is the need for research into how the peculiarities of the property sector can affect their choice of how to design and implement incentive plans. What is also clear is that financial incentives may be limited as a motivator under conditions of worker heterogeneity. This limitation also underscores the need for active research into motivating factors in the workplace and how these factors vary according to the worker's socio-economic characteristics.

This research is a modest attempt to highlight the need for including people management issues in real estate research.

Research contribution

All the papers in this dissertation deal with the use of remuneration to manage human resources in real estate companies. There are three papers in all, covering various aspects of the issue. Professor Stellan Lundström, who also provided the initial literature, proposed the initial research idea in 2001. Assoc. Professor Mats Wilhelmsson provided guidance on data analysis. Assoc. Prof. Hans Lind and Dr. Svante Mandell provided guidance on the theoretical framework used to analyse the data.

Paper 1 (*Incentive plans and real estate companies – a literature review*) aims at reviewing the literature on incentive plans, highlighting the paucity of research on the subject within real estate research, as well as drawing attention to issues that may be worth researching into for real estate companies. Paper 2 (*A survey of how Swedish real estate firms use pay and benefits to manage their employees*) attempts a comprehensive description of the status of pay and benefit programmes in Swedish real estate firms. To the best of the author's knowledge, this may be the first such attempt. The paper adopts the total compensation framework to analyse the data. This framework points out specific elements of the job situation that firms can manipulate to elicit discretionary performance, beyond the attraction and retention roles played by financial incentives. Paper 3 (*Does size or ownership matter? Incentive plans for real estate companies in Sweden*), explores the impact of firm size and ownership status on the likelihood of firms use of incentive plans. Using logistic regression to analyse a survey of real estate firms in Sweden, the paper concludes private firms are more likely to use incentive plans than government owned real estate firms. It could, however, not be proven that size was a determinant of firms' use of incentive plans.

Limitations of the research

The primary instrument of data collection was the structured questionnaire, sent to respondents by post. The weaknesses of this approach have been well documented. Two of the most important weaknesses is the low response rate and hence the limited inferential power of the conclusions drawn from the result. However, the method allowed coverage of geographically dispersed firms, saving time and money, compared with face-to-face interviews. The results also provide an initial picture of an issue that can be explored by future research. Thus, from an analytical viewpoint, the method used remains useful. Being a novice researcher, the author's understanding of the issues only improved after the data was collected and being analysed. Thus certain issues were omitted that could have been covered.

Summary of Papers

Paper 1: Incentive plans and real estate companies – a literature review

Long-term business survival depends on consistent value creation. Value creation entails not only excelling in current activities but also leveraging new technologies into usable tools that allow the development of new products, new ways of satisfying current customer needs and entering new markets. This is basically people dependent. However, a recent Towers Perrin research in North America indicates a diverse workforce is becoming more loyal to their own career goals than their employers. This makes people management difficult in unprecedented ways. This conclusion could plausibly apply to the European context.

In spite of growing research into these questions in mainstream management research, these questions do not appear to be priorities in real estate research. This review is an attempt to review recent work on the subject and also explore possible ways in which it can inform research into the people management practices of real estate firms.

Incentives are awards given out when employees of a firm attain usually pre-determined goals. These awards are awarded on the basis of individual or group performance. They can be enjoyed immediately

or they can be deferred in the case of pensions, for example. While they tend to be financial, they can also be in-kind, for example a company car or simply formal recognition for a job well done.

Incentive plans are traditionally used for recruitment, retention and motivation. Theories of motivation abound on the classical management literature but economic theories have grown in importance, their unique contribution being the development of propositions that lend themselves more easily to empirical tests. The commonest economic model is the principal agent model, which prescribes the use of performance related pay to curb opportunistic behaviour by principals who are unable to perfectly monitor the agents. The crucial assumptions of this model are that agents are homogenous and opportunistic in seeking to maximise their economic benefits at the expense of the principal.

These assumptions have been found to be particularly troublesome because they prescribe a uniform monetary solution to the motivation issue, which does not work well in practice. In particular the model ignores the role of non-monetary factors like recognition and power as motivators. Researchers like Lazear (1999) also suggest the use of financial incentives provide more evidence of their sorting role than their use as motivators.

Motivation can also come from the desire to influence one's future career prospects. The career concerns model, attributed to Holmstrom (1982), establishes an implied link between current output and future wages. The link is stronger the more accurately one can measure the worker's output or the more uncertainty there is about his capabilities. The model claims younger workers should be more motivated by career concerns given that they are yet to establish a track record for themselves. Extensions of this model also suggest career concerns are more effective motivators for public sector workers than financial incentives.

Intra-firm pay differences can also motivate workers. The motivation thus generated is strengthened by the wider disparities between workers along the firm hierarchy. Performance related pay is important only at the top of the organisation given the absence of further promotion opportunities at the top. Tournaments, however, can undermine team effort and reduce workers' access to their colleagues' skills and talent, undermining firm-wide productivity in the process.

To avoid arbitrary award of incentives, such plans almost invariably involve performance measurement. The performance measurement process aims at assessing progress towards achieving pre-determined business goals. Performance measures, the actual metrics used to score the extent of goal achievement can be classified as financial or non-financial depending on whether it is directly extracted from the firm's financial statements or not. Hybrid measures combine financial and non-financial measures. Some non-financial measures, such as customer service, are claimed to be even better predictors of long-term financial performance, in repeat business situations. They can also be subjective or objective, the former resulting in the associated incentive payout being classified as merit pay; otherwise it is termed performance related pay. It has been pointed out that performance related pay (PRP) may be inappropriate in government-owned firms even if output were objectively measurable, given the attention it may divert away from equally important but less measurable and consequently difficult to reward tasks.

The real estate sector uses a number of performance measures corresponding to direct or indirect investment in real estate. In the US, with sophisticated vehicles for indirect investment, there are a number of performance measures as well as corresponding measures of direct investment. In Europe, there are a number of national indexes covering mainly direct investment and under the control of Investment Property Databank (IPD), a UK-based firm.

Traditional performance, usually carried out by supervisors on subordinates' work has been criticized for being 'top-down, paternalistic and old-fashioned', and susceptible to manipulation and bias to the extent to which it depends on recall of the most recent events. Performance management, however, is arguably non-adversarial, taking the form of joint agreement between supervisors on performance targets, capacity building, as well as continuous review and coaching. It can thus be a powerful tool for motivation, given the focus on employee development.

The extent to which firms have adopted incentive schemes varies across countries. American firms not only lead the world in the size and extent of adoption of incentive plans, their CEOs also have a greater fraction of their total reward package made up of bonuses. In spite of their merits, controversies surround the size of the incentive packages, elements of the packages, performance measures as well as the reward process especially for senior executives.

The size of the packages especially for senior managers has been characterized as excessive, while stock options have been singled out as creating incentives for inappropriate behavior. On the other hand, others point out that the almost exclusive focus on senior management compensation may be ignoring the motivational effects of firm-wide earning differentials according to the tournament model. The wisdom of using incentives for staff retention, especially when the firm has not made unique investments in the worker or the worker does not have unique skills, is also questionable.

Research on American Real Estate Investment Trust (REIT) CEO compensation showed executive compensation rising in the late 1990s even as REIT stock prices fell. Compensation changes were related to stock returns, with younger managers enjoying higher pay raises.

Private firms have been said to be more likely to use incentive plans than public firms. The reason given is that the former typically try to maximize profits and shareholder value, making it easier for performance contracts to be written, implemented and rewarded. Public sector firms, however, tend to have multiple objectives, some of which are difficult to measure, making it difficult for them to use incentives.

Incentive plans are accepted as a people management tool. However, the theoretical justifications for their use, especially agency theory, have been questioned. As already mentioned, these recommendations rest on disputed assumptions that do not sufficiently consider worker diversity and the motivational impact of non-financial incentives. Socio-economic features of employees have been shown to have a differential impact on reward preferences.

Innovation is essentially a people-driven process that makes business survival people dependent. The sectors most talented workers and researchers basically drove the innovations that have increased professionalism in property management as well as enhancing property's investment attractiveness. Research into retaining and motivating this critical labor force would require the same enthusiasm that drove research into development of institutions and instruments for investing in real estate. In particular, the role of incentive plans and associated performance measurement systems needs to be systematically investigated. This research must take into account the business strategies of the individual firms, as well as other peculiarities of the real estate asset, which distinguish it from other financial assets. It is also important to research into possible differences between private and government owned firms in adopting variable pay schemes.

In conclusion, business success has become increasingly people dependent even as employees become less loyal to their employers. To navigate the choppy waters of people management, employers often resort to using incentive plans. Current research focuses largely on executives, while little has been done on the real estate sector. It is therefore important to begin exploring what types of incentives and performance measurement systems will allow the sector to retain the talent necessary to sustain and even accelerate the current pace of innovation.

Paper 2 – A Survey of how Swedish real estate firms use pay and other benefits to manage employees

This paper has two objectives: provide a preliminary description of the use of pay and benefits within real estate firms, and analyse the survey results using the 'total compensation' framework. Total compensation here includes pay, benefits, training and development as well as the work environment. Pay includes fixed and variable pay. Variable pay can be based on objective measures of performance or only subjective assessments. This corresponds to their classification as performance-related pay and merit pay, respectively. Benefits include pensions, company cars and special clothes. Benefits offer

advantages to employers as they are tax exempt and can be cheaply provided due to economies of scale. They also serve as good retention tools.

Learning and development include all activities aimed at closing discrepancies between required capacities of the firm and employees' competencies. Such activities range from technical training, leadership training, and succession planning to performance management. Work environment includes employee involvement in decision-making, promotion and respect of diversity and everything else that makes a firm 'a great place to work'.

The reasons for providing these four types of reward/compensation is that they are potentially effective tools in recruiting, retaining and motivating the critical labour force that drives the value creating innovations that enable the companies to survive long-term.

As already indicated in the previous papers, from an economic perspective, motivation can come from tying pay to performance, concerns about one's future career prospects as well as intra-firm pay differences due to one's position in the firm. The important thing to remember is that employee diversity implies that there can be no one-size-fits-all policy towards employee motivation. Thus employers have to recognise the limits of performance related pay as well as the motivational impacts of non-financial elements of the job situation. That is where the total compensation package, consisting of financial and non-financial rewards come in. As indicated by research elsewhere, pay - whether fixed or variable - can serve to recruit, but retention and motivation may come from the other three components of the total reward package.

The adequacy or otherwise of an essentially 'North-American' framework for analysing people management in Swedish real estate firms requires a look at the status of the human resource management function in Sweden. Mabon (1995) notes that the human resource management function in Swedish companies is usually not a strategic issue and is therefore carried out by a manager at least two levels from senior management. The Human Resource manager's function is further limited by the influence of the unions. The status of people management as a strategic issue among real estate firms is one of the issues covered later in the paper.

Concerning pay, base pay is susceptible to union influence. Variable pay almost invariably takes the form of annual bonuses for companies that use it. This could be due to the service nature of the job and the resultant difficulty of measuring output. Accounting profits dominates as a performance measure; what is debatable is its credibility given the ease with which it can be manipulated, its historic nature and its questionable suitability for non-managers. It also says almost nothing about the efficiency of asset utilisation. One may want to argue that Economic Value Added (EVA) takes care of this defect even though it has its own shortfalls. In order to motivate future performance one may even consider using a performance measure that is linked to future performance since companies use incentives not so much to reward past performance as to motivate future performance. In that regard, customer satisfaction, in a repeat sales environment is suitable for consideration; even a few companies use it.

Benefits include loans for cars and houses as well as for personal uses. Insurance consists of health, travel and life insurance. The distribution of both loans and insurance, however, varies across the firm. Time off includes the annual leave that everyone is entitled to, paid sick leave as well as paid maternity leave. In-kind allowances include company cars (mostly for senior management), and club membership for senior and some middle managers. Allowances are also paid for lunch and employee-initiated training.

While there was no detailed inquiry into learning and development, the distribution of allowances for employee-initiated training in addition to the obvious company initiated training programmes the frequency of which was not explored. However, that provided evidence that at least some companies do recognise the need to engage in capacity building for their employees.

Indirect evidence for work environment took the form of determining employee involvement in variable pay scheme design and implementation. However, it appears that in spite of the rather flat

nature of Swedish companies, there is very little employee involvement in certain decisions as the determination of how much bonuses they earn.

Within the real estate sector, there is indirect evidence to suggest that human resource management is not considered a strategic issue. Only four out of twenty one listed real estate companies in Sweden have a strategic manager in charge of human resources. This may explain the relative under utilization of learning and development as well as the work environment as tools for retaining and motivating of critical manpower within the sector. It is also likely that the small size of the companies would imply that a general manager in charge of administration absorbs the people management function.

The conclusion of this paper is that firms within the sector use standard pay and benefits packages; however, their people management potential may be overestimated, at the expense of non-monetary factors like training and development as well as conditions that create a supportive work environment. However, further research is needed to draw definite conclusions about this.

Paper 3 - Does ownership and size matter? Incentive plans within Swedish real estate firms.

This paper is a partial presentation of the results of a survey of the use of incentive plans among real estate companies in Sweden. The survey was aimed at identifying respondent firms' motives for adopting variable pay plans, in addition to determining whether size and ownership had any impact on the probability of firms' adoption of incentive plans.

Incentives can be awarded on the basis of individual or group performance. If performance is objectively measurable, the payout is labelled performance related pay; otherwise it is merit pay. Lazear's (1986) piece-rate model suggests large firms have a cost advantage in performance measurement and should be more likely to use performance related pay; this is one of the propositions tested in the paper.

The principal economic models explored in this paper are the principal-agent model, career concerns theory and the tournament model. The principal-agent model suggests variable pay will reduce the likelihood for opportunistic behaviour on the part of managers and employees whose behaviour is difficult to monitor by the firm's owners. Thus financial incentives are a way to motivate good behaviour. The career concerns model also suggests that concerns about future career prospects can be effective in motivating appropriate behaviour especially on the part of young employees who are yet to establish a track record for themselves at work. Extensions of this model suggest that private firms should be more likely to use variable pay than public firms, with public sector workers more likely to be motivated by career concerns. This is discussed in the empirical section. The tournament model suggests promotions and the associated intra-firm pay differences are a source of motivation.

The empirical analysis shows motivation is the most frequently cited reason for adopting variable pay plans, even though recruitment and retention roles of incentives was recognised. Research elsewhere has, however, shown that variable pay plans are effective in recruitment and retention; motivation requires other factors, most of which are non-financial. Three hypotheses were tested to see the impact of firm ownership and size on the probability of adopting variable pay plans. The tests suggest that private firms are more likely to use incentive plans than their public sector counterparts.

One may want to argue that this conclusion does not necessarily put private firms completely at an advantage. They may have an edge in recruitment and retention but they may not necessarily be winning the motivation game, since research elsewhere shows non-financial factors may be even more powerful as motivators. Career concerns role as a motivator also indicates that if public sector firms create, among other things, challenging working conditions, offer work that promotes balance between work and personal life as well as exercise strong and empowering leadership, they can create a motivating workplace that will draw especially younger and/or risk averse workers. They may still be at a disadvantage obviously as the absence of attractive pay and benefits would imply that they might

experience high turnover of their best workers into the private sector. However, identifying non-financial retention factors could help them stem this flow.

Company size could not be proven to be a predictor of the likelihood of a firm adopting incentive plans. The explanation could be smaller companies trying to match bigger companies use of incentive plans in order to retain their best workers. It also could be that the lack of sophistication of performance measurement systems that accompany the schemes implies big firms do not enjoy any cost advantages over small firms.

The conclusion of the paper is that the motivation role of incentive is recognised even if their actual impact remains unclear. Their role as recruitment and retention tools was also recognised. It is not certain if private firms' use of these schemes provides them with clear advantages in recruitment and retention. Given the potentially motivating role of career concerns and intra-firm pay differences as well as the work of other researchers which points to non-financial motivators, one may want to argue that further research be made to explore what additional factors could be used to strengthen motivation within the sector.



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Incentive plans and real estate firms – a literature review

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Abstract

Issues of talent management are becoming increasingly important as research points to a growing awareness within the business firms about how much business is people-driven and how diverse the workforce actually is. Both academic and practitioner literature point to the need for more innovative steps to tackle an increasingly challenging task of managing human resources in business organizations, including real estate firms. This paper has outlined the reasons given for using incentive plans as well as exploring the various types of incentives in use. Given that incentive plans involve some degree of performance measurement, the various types and potential impacts of performance measures have been discussed. In particular, the potential role of non-financial performance measures has been identified. A number of alternative and complementary theoretical frameworks underlying the use of incentive plans were also discussed.

The paper also reviews the controversies surrounding the use of incentive plans; these have ranged from the actual incentive items to performance measures. The assumptions underlying agency theory, the principal paradigm underlying the design and implementation of incentive plans has also been questioned by socio economists– these questions draw attention to the need to look beyond financial incentives as motivators. There will be the need for detailed research into current incentive plans in order to determine what works and why, as well as explore what can be done differently.

Key words: incentive plans, performance measurement, performance management

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1. Introduction

“ The real estate sector is beginning to acknowledge that good human capital is hard to come by, harder to keep, expensive to lose and overwhelmingly the greatest determinant of success” (Equinox Partners, 2003)

This is because long-term profitability requires firms to create value in continuously meeting market needs (Sim and Koh, 2001). Value creation arises partly from businesses achieving excellence in their normal operations; it is also created when companies innovate by identifying new customers and markets as well as emerging needs of existing and future customers using its critical talent (Kaplan and Norton, 1996, cited in *ibid*). Sometimes, firms even diversify their workforce to more closely reflect an increasingly diverse customer base (Towers Perrin, 2001). Business success is thus, to a large extent, becoming very people-driven.

However, an increasingly sophisticated and socio-economically diverse workforce that is very well informed about their career options is becoming less loyal to employers (*ibid*). The growing importance of people in corporate success, coupled with an increasingly diverse and more mobile workforce makes talent management¹ particularly complex. One of the principal tools for managing people is the incentive plan.

This paper reviews the literature on incentives plans in order to highlight how little attention this issue receives in real estate research. This is in spite of the innovations that have made real estate a credible investment alternative to stocks and bonds, turning real estate professionals into finance professionals in the process. It is also to delineate preliminary issues that could form the basis of a broader research agenda for the real estate sector.

The rest of the paper is organized as follows: types of incentives will be outlined followed by a review of largely economic theories of worker motivation. Performance measurement will be examined. The implementation of incentive plans will then be discussed. In conclusion, a number of issues to be explored by further research are raised.

2. Types of incentives

Incentives will be defined as awards given out when pre-determined objectives have been attained within an organization. When an employee's performance exceeds a pre-determined target², they tend to be granted a form of incentive payout (Appelbaum and Mackenzie, 1996). This payout can be a one-off payment, a bonus, or take the form of an addition to base pay which then remains until the next

¹ Defined as “the collective actions an organization takes to attract, engage and retain employees”. Towers Perrin (2001).

² Of course in some organizations, meeting the target is enough to qualify for incentives.

decision period. Bonuses in the future then become contingent on future performance whereas additions to base pay become part of the compensation landscape once it is granted, being independent of future performance. Sometimes, opportunities for career progression are seen as an incentive device because they ultimately entail financial rewards and, in a lot of cases, involve opportunities for growth and development. The following sections discuss some of the commonest classifications of employee incentives.

2.1 Individual v. group incentives

Milgrom and Roberts (1992) have identified 'individual' as well as 'group incentives'. Examples of the former include stock options and commissions. Individual incentives could induce hard work and discourage mediocre employees from joining the organization (Lazear, 1998a). Kanungo and Mendonca (1992) identify the following requirements for schemes for individuals:

- The employee must be capable of attaining the desired level of performance
- The employee must consider the reward valuable and highly dependent on performance.

This latter condition creates a 'line of sight' between performance and reward. 'Line of sight' describes the employee's ability to see how effort translates to higher performance and ultimately greater rewards (Zobal, 1999). Individual incentives may, however, undermine productivity in a team environment where cooperation is key to improved performance.

Examples of group incentives include Profit Sharing Plans, Employee Stock Ownership Plans (ESOPs) and Gain Sharing Plans. Team/group incentives could introduce a sense of collective responsibility within the firm with the aim of achieving superior performance through team effort. The reason is that organizational change that emphasizes teamwork among people who previously worked largely as individuals will lead to higher performance only if cooperation is rewarded (Zobal, 1998). Team rewards could be undermined by free riding, which weakens incentives for individuals to do their best. Team rewards may call for a system of peer monitoring, in addition to pre-employment screening of potential employees who are not team players (Ichniowsky and Shaw, 2003). This cannot obviously eliminate free riders completely.

2.2 Short-term v. long-term incentives

Short-term incentives include annual bonuses and commissions based on the preceding period's performance. Incentives can also be deferred or long-term in the sense that the benefits are not realized until after some time period has elapsed. Examples include contributions to pension funds for company executives and non-vested options awarded to employees. In the case of the latter, the employee must stay with the company for a specified period in order to vest the options; the employee loses the options if they quit the company earlier (Lazear, 1999). The usual argument is that such non-vested

options encourage employee retention. The issue of worker retention will be explored in another section.

2.3 Financial v. non-financial incentives

The examples above are examples of financial incentives. However, there are also non-monetary incentives that do not always involve actual cash awards. Examples of non-monetary incentives include company cars, recognition and opportunities for training and development. The next section explores mainly economic theories of worker motivation.

3. Economic theories of worker motivation

The problem of motivating workers is not new. Even though economics has been dealing with organizational issues, its contribution appears to have grown in importance in recent years. As noted by Lazear (1999), the earliest records of using economics to explain human resource issues in firms are credited to Slichter (1928), Reder (1955) and Doeringer and Piore (1971). Laffont and Martimot (2002) ascribed the first attempt at developing a theory of incentives in management to Barnard (1938).

Proponents of the economic approach, notably, Lazear (1999) have argued that some of the issues, by their very nature are economic. Furthermore, he argues, even the non-economic issues yield themselves to analysis using economic models. Personnel economics has not only come out with specific theoretical predictions; some of these predictions have also been tested and verified by empirical data. Some of the recurrent issues in this regard are talent management, the related issue of employee motivation as well as the role reward programmes can play. This paper will focus therefore on economic theories of employee motivation.

One of the principal economic models of motivation is agency theory. Eisenhardt (1989) identifies an abstract and mathematical version of agency theory as the principal-agent model that has wide application, one of which is the problem that arises from the separation of ownership of a company and its management.

The principal agent problem arises out of two issues: lack of goal congruence and differences in risk preferences (Wright and Mukherji, 1999). The goal conflict arises because whereas the principal's costs and benefits are primarily financial, the agent's costs and benefits are both financial and non-financial (Wright et al, 1996, cited in *ibid*). Thus, while the principal tries to maximize his wealth, the agent tries to maximize not only his financial but also non-financial benefits. Differences in risk preferences arise because the principal can be risk neutral by diversifying his investment in many

firms. The agent, however, is more risk averse since s/he is unable to diversify their employment opportunities.

The agency model postulates that differences in risk preferences, goal divergence and the inability of the principal to perfectly observe the agent could lead to the agent engaging in opportunistic behavior, at the expense of the principal. The contract is the unit of analysis in the model. The model aims at finding the optimal contract for the principal and the agent.

The two central problems of the agency relationship are information failures resulting from pre-contractual withholding of private information by the agent (adverse selection) and the post-contractual opportunistic behavior by the agent (moral hazard). Holmstrom (1982) defines adverse selection as the situation “where actions can be observed, but it cannot be verified whether the action was the correct one, given the agent’s contingency, which he privately observes.” He also defines moral hazard as the “problem of inducing agents to supply proper amounts of productive inputs when their actions cannot be observed and contracted for directly”. The introduction of the concept of moral hazard is credited to Arrow (1963), with the latter’s work further extended and relabeled as the ‘agency problem’ by Wilson (1968) and Ross (1973)³.

The principal-agent model suggests either performance monitoring or contracting on the outcomes of the cooperation process (with more risk being passed on to the agent) can mitigate these problems. The model points to trade-offs between the costs of monitoring and the cost of measuring outcomes on the one hand, and transferring risk to the agent. Thus incentive contracts, with the associated monetary reward are an attempt to align employee interests with those of the owners of the firm. Laffont and Martimot (2002) attribute some of the application of agency theory to organizations in recent times to the work of Jensen and Meckling (1976), Fama (1980), Fama and Jensen (1983).

Using the principal agent model to justify the provision of incentives for managers has been criticized at both a theoretical and empirical level. The usual framework of analysis is a single-principal and a single agent. However, business organizations are characterized by:

- Multiple principals (shareholders) and multiple agents (employees including the executives)
- Multiple principals and a single agent; for example a real estate broker dealing with different clients

Lazear (1999) points out that free-rider effects in a multi-agent setting dilutes the incentives to each agent to the point of trivializing it. Holmstrom (1982) also notes that for teams, moral hazard is possible even if there is no uncertainty in output because free riders are difficult to identify if joint output is the only observable indicator of agents’ performance.

³ Laffont and Martimot (2002)

Socio-economic theorists have also challenged some assumptions of agency theory. They argue that agency theory's assumptions about principals and agents do not lead to the attainment of competitive advantage (Wright and Mukherji, 1999). In particular, they contend that agency theory's assumptions exclude the possibility that different individuals behave differently. They explain that agents are not always selfish, neither are they all similar in trying to maximize only economic benefits from their contractual relationship with the principal. The implication would then be that financial rewards are not always motivating for every agent.

Lazear (1999) also suggests that empirical data supports the sorting role of incentive contracts more than motivation. Furthermore, executives' owning company stock does very little to align their incentives with the owners of the firm. This, he explains, is because the proportion of the company that is usually owned by say, the CEO of a firm is too small to have any real motivating effects on them. To him, even if one considers the extreme situation of making the CEO the full residual claimant of the firm's earnings, bankruptcy possibilities protect the manager from fully bearing the brunt of a downturn in the firm's fortunes. Thus, the 'insurance against loss' can actually turn an otherwise risk-neutral CEO into a risk lover, creating incentives for the CEO to make decisions that put the company at risk. In addition, given that *all*⁴ workers need to be motivated, Lazear shows the impracticability of making all workers residual claimants of the firm.

An alternative school of thought is that a worker's motivation can be generated by career concerns (Holmstrom, 1982)⁵. The model suggests workers are motivated to work hard in order to influence the labor market's beliefs regarding their capabilities. The model establishes a link between wages and expected productivity, which in turn, depends on observed output in previous periods. An implied link is thus created between current output and future wages.

Burgess and Metcalfe (1999) note the following as some of the central conclusions of the career concerns model:

- Career concerns are more effective motivators if output observations are more accurate or if there is more uncertainty about the worker's abilities
- Given that the market's information is believed to be more diffuse for younger workers, they tend to work harder in order to establish a credible track record

A number of extensions to the Holmstrom (1982) model have been made. Drawing on some these extensions especially that of Wilson (1989), Burgess and Metcalfe (1999) have suggested that career concerns may be more important for public officials than financial incentives. They infer from Dixit's

⁴ Emphasis supplied

⁵ See Burgess and Metcalfe (1999) for a review of this model.

(1997) extension to the Holmstrom and Milgrom (1991) model that firms in the public sector are less likely to offer performance-related pay.

Motivation can also come from intra-firm pay differences (Lazear and Rosen, 1981). Lazear and Rosen's tournament/relative compensation model has the following features:

- Wage slots, fixed in advance, are independent of absolute performance
- A worker's promotion depends on how he compares with everyone else in his cohort
- The higher the salary increase associated with the promotion, the higher the effort a worker expends on trying to qualify for a promotion

This latter feature suggests motivation for hard work arises from and strengthened by promotions and associated wage disparities. Given that promotions would cease to motivate at the top of the organization, performance related pay would be appropriate for senior executives.

The potential downside of workers competing for promotions is the potential for diminished cooperation. In a team setting this could imply that even if individual effort increases, overall organizational output might suffer because competition reduces the amount of 'connective capital' available to each worker. Ichniowsky and Shaw (2003) define connective capital as "a worker's access to the knowledge and skills of co-workers"; they identify this as a key ingredient in effective problem solving in a team environment, and a source of increases in productivity. The absence of connective capital when cooperation fails could explain the adverse effects on an organization that uses an incentive plan that undermines team effort. The next section explores performance measurement.

4. Performance measurement

If the award of incentives to the employees of an organization is not to be arbitrary, a performance measurement system must be an integral part of an incentive plan.

4.1 Definitions

Jensen and Meckling (1986) describe performance measurement as a process of attributing value weights to various levels of performance to represent the magnitude of achievement on each measure. Amaratunga and Baldry (2003) define it as "a process of assessing progress towards achieving pre-determined goals, including information on the efficiency by which resources are transformed into goods and services, the quality of those outputs and outcomes, and the effectiveness of organizational operations in terms of their specific contributions to organizational objectives". Neely et al (1995) define a performance measure as a "metric used to quantify the efficiency and/or effectiveness of an action". Typically, within an organization, a collection of metrics are used, forming a "performance measurement system"(ibid). The performance measurement system is not only the basis for

determining who qualifies for rewards but even more importantly a reflection of the goals and strategies of the organization as a whole (Woodford and Maes, 2002).

Peck (2000) distinguishes between market based performance measures and accounting based measures. McKenzie and Shilling (1998) identify traditional accounting measures, the commonest example being accounting profits and value-based measures with Economic Value Added (EVA) as the easiest example; hybrid measures combine financial and non-financial measures, the balanced scorecard being a typical example.

The real estate sector uses a number of performance measures corresponding to direct or indirect investment in real estate (Baum, 2000). In the US, with sophisticated vehicles for indirect investment, there are a number of performance measures such as the NAREIT Equity REIT Share Price Index for Equity REITs, a corresponding index for mortgage REITs as well as a hybrid index for REITs that own properties and make loans. The NCREIF Index measures performance of direct investment.

In Europe, there are a number of national indexes covering mainly direct investment and under the control of Investment Property Databank (IPD), a UK-based firm. It provides benchmark measurement services in 12 European countries. They are compiled from valuation and management records for individual properties in complete portfolios, collected directly from investors by IPD. Examples of typical measures include income return, capital return and their sum, total return. Baum (2000) notes that performance measurement organizations in the UK and the US typically use total return measures for one-period performance assessment for all assets. There is also the time-weighted rate of return, which is deemed appropriate for quoted unitised and other co-mingled funds, in a situation where the manager has discretion over cash flows and investments.

Performance measures can also be classified as financial, non-financial, subjective and objective. Financial measures are extracted from the statements issued by the firm on its financial performance. This includes accounting profits, earning per share and Economic Value Added. The latter is used to evaluate a manager on the relation between profits and the assets used to generate them. It is appropriate in a line of activity where asset utilization costs are important (Jensen and Meckling, 1986).

Non-financial performance measures are not derived strictly from financial records. Examples include product quality, customer satisfaction, market share or even employee turnover. They are normally used jointly with financial performance measures, as in the balanced scorecard. They are considered better than short-term profits in measuring the firm's progress towards its long-term goals. Whereas financial measures evaluate past achievement, some non-financial measures could be shown to be drivers of future performance. They also enjoy the advantage of being less susceptible to manipulation

in addition to being easy to understand, providing feedback for timely corrective action (Banker et al, 1998).

Perhaps the most important reason cited by Banker et al (1998) for using a non-financial performance measure is that they are lead indicators of financial performance. Among the non-financial measures identified above, customer satisfaction has been identified as a key measure that is an important predictor of long term performance in business areas where repeat business is important (Phillips et al 1990; Griffin and Hauser, 1993; Hauser et al, 1994)⁶. Using the case of a chain of establishments in the hospitality industry, Banker et al (1998) demonstrated that both financial and non-financial performance improved after implementing an incentive plan designed to include non-financial measures.

A number of real estate transactions qualify as repeat business: renewal of lease and asset management contracts. Thus the case can be made for considering the use of customer satisfaction as a performance measure in an incentive plan that is geared towards driving long-term financial success. This will be further discussed in the concluding sections of this paper.

4.2 Objective v. subjective performance measures

Performance measurement can be more or less subjective or objective depending on the difficulty of measuring a worker's output. Where this is easy, the appropriate incentive scheme is usually called performance-related pay (PRP). PRP would then involve paying the worker an amount that depends on some objective measure of his output.

Holmstrom and Milgrom (1991) show the difficulties of implementing incentive pay in multi-tasking situations. Burgess and Metcalfe (1999) infer from this that PRP could be inappropriate even if performance can be measured accurately because it may increase attraction for activities that are measurable and rewarded, at the expense of not so easy to measure but equally important tasks. They infer from Holmstrom's model that performance-related pay would be inappropriate in public sector firms, given that such jobs involve many difficult to measure tasks.

In service firms, where output/performance measurement may be problematic, subjective measures come into play. Incentive payments are thus classified as merit pay. Subjective assessments are not verifiable by a third party; thus the evaluator could distort the evaluation *ex-post* for private gain, weakening the incentives for employees to work hard (Burgess and Metcalfe, 1999). Measurement difficulties should increase the likelihood of the use of merit pay plans, team rewards and bonuses in service organizations, (including the real estate sector) instead of explicit PRP schemes.

⁶ Cited in *ibid*.

The exact nature of a performance measurement system depends on whether a sub-unit of the firm is organized as a cost, revenue, profit, and expense or investment center. A cost center aims at minimizing costs for a given output. Revenue centers aim at maximizing total revenue for a given price. A profit center's performance derives from the difference between its revenues and costs. A variant of a profit center, an investment center focuses on the relationship between profits and the assets used to generate them. A sub-unit of a firm can also be organized as an expense center typically providing services for the rest of the firm without levying any charges on the consuming sub-units of the firm. Real estate firms may be organized as cost, revenue, profit or investment centers depending on their core business and internal subdivisions. Thus a single firm could be a combination of cost, revenue, profit and expense centers.

Thus, the performance measure used for an incentive plan within an organization may vary across sub-units of the firm. Peck (2000) notes the widespread use of Accounting Profits as the basis of determining executive bonuses. Jensen and Meckling (1986) and Delves (1999) suggest, for example the use of EVA for firms that use a lot of physical capital such as real estate companies. Delves (1999) points out the merits of EVA over accounting profits as a performance measure. Accounting profits do not take into account the use of the firm's equity. Thus, what EVA does is to subtract from the firm's after tax net operating profits some form of rent for using its own assets. Thus, a firm may be profitable accounting wise and yet show negative performance once this profit is compared with the owners' asset charges.

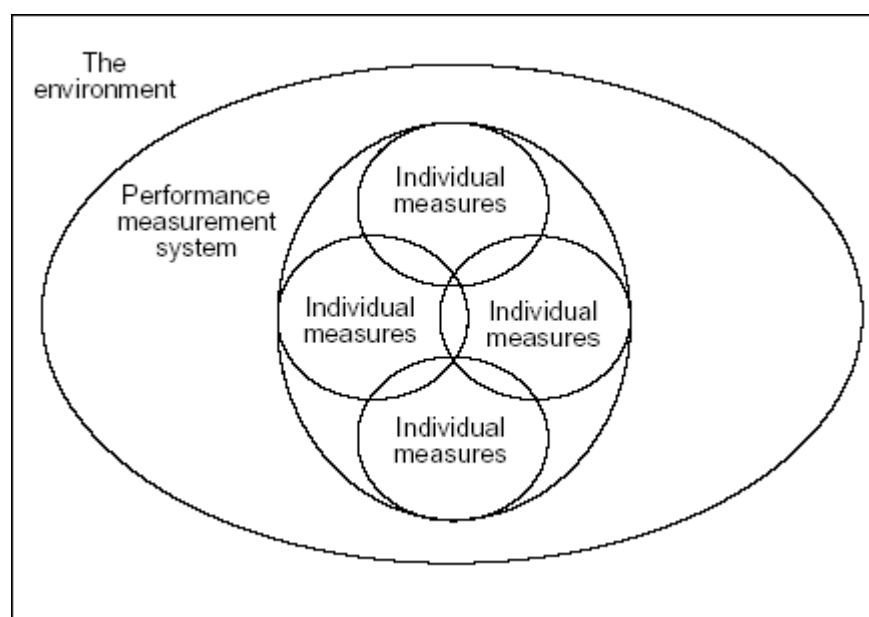


Figure 1. Analytic framework for design of performance measurement systems (Neely, Gregory and Platts, 1995)

Neely et al (1995) suggests a 3-level analysis of any performance measurement system. At the level of individual measures, they suggest an assessment of the actual measures used, their purpose, costs as well as benefits. Analyzing the system as a whole involves, among other things, considering what they regard as all the appropriate elements of a performance system: internal, external, financial and non-financial; the relationship between the measures and the long and short-term objectives of the firm; the presence or absence of any conflict between the measures. At the firm level, the system can be analyzed in terms of the extent to which it conforms to the firm's strategies as well as the organizational culture; whether the measurement system is consistent with the existing recognition and reward structure; whether some measures deal with customer satisfaction as well as how the firm compares with its competitors.

4.3 Performance management

Traditionally, performance measurement entails a manager/supervisor annually writing his/her judgment regarding the performance of a subordinate employee in a predetermined format. The assumption is that "the immediate superior usually has the best knowledge of the individual job content, objective and overall performance" (Hume, 1995). However, in most cases the appraisal is based on recall of understandably the most recent events. Heathfield (2002) characterizes this as "old fashioned, paternalistic, top-down autocratic mode of management that treats employees as possessions of the company" and inconsistent "with the values-driven, mission oriented, participative work environments favored by forward thinking organizations today".

Performance management takes this process further. Macaulay and Cook (1994) define performance management as an approach aimed at harnessing and focusing employee performance. According to Armstrong (2000), performance management

" [...] is about the agreement of objectives, knowledge, skill and competence requirement, and work and personal development plans. It involves the joint and continuing review of performances against these objectives, requirements and plans, and the agreement and implementation of improvement and further development plans. The focus is on improvement, learning, development and motivation."

Performance management thus appears to be forward looking. One can argue that the way in which the worker's output is assessed could actually serve to de-motivate the worker; proper handling of the assessment/evaluation process would communicate the values of the organization and motivate workers towards attaining them. At this juncture, one may want to examine issues surrounding the implementation of incentive plans.

5. Incentive plans in practice

The extent to which firms have adopted incentive schemes varies across countries. The United States (US) leads the world in the size and extent of adoption of incentive plans as part of the corporate compensation schemes. Peck (2000) notes that US CEOs not only earn more than their UK counterparts, but also have a greater fraction of their total reward package made up of bonuses.

5.1 Controversies surrounding compensation schemes

Incentive schemes are hardly without controversy. While there appears to be consensus over using incentives to align employees and managers' interest with owners, there is disagreement on the size of the packages, elements of the packages, performance measures as well as the process of determining rewards especially for senior executives.

Conventional wisdom suggests adequate compensation induces strong performance. According to Peck (2000), the evidence in Europe is mixed, as a strong positive link between pay and company size dominates a smaller but significant positive link between pay and performance. He inferred that management might be more interested in growing the company for its own sake rather than improving performance.

5.1.1 The size of the packages

The executive compensation component of incentive plans has become synonymous with corporate greed. The criticism is strongest in the United States, and quite naturally because *Business Week's* annual survey put the average annual CEO pay for a major corporation at \$12.4 million in 1999. This was an increase of 17% from the previous year, and 475 times more than the average blue-collar worker, and 6 times the average CEO pay check of 1990. The comparison is even worse for companies that have global operations.

The perceived inequity could undermine employee morale and productivity. A compensation system that is characterized by proportionality between CEO pay and that of the average worker, reflecting the recognition that all employees contribute to the firm's success appears justifiable. Criticisms are not just about the size of CEO paychecks; they are about the pay setting process and the role of board members and Executive search firms as well (Cox and Power, 1991).

On the other hand, the almost exclusive focus on senior management compensation may be ignoring the motivational effects of firm-wide earning differentials according to the tournament model. Lazear (1998) notes:

American CEOs have recently come under attack for their high salaries, particularly in comparison to their European counterparts. While their salaries may be too high, focusing on salaries alone misses the entire point of the compensation structure. The CEO's salary is there not so much to motivate the CEO, as it is to motivate everyone under him to attain that job. It is impossible to determine whether the CEO is overpaid simply by looking at the relation of the CEO compensation to output. [...] the structure of compensation is key [...] it makes no sense to evaluate a job independent of the rest of the firm's hierarchical structure.

5.1.2 Elements of the package

Stock options have been singled out as the most important part of the increase in executive compensation. Graef Crystal has cited 3 reasons for this:

- The strong performance of the stock market in 1990s,
- The fact that options needed not be charged against earnings, making it 'cost-free compensation',
- The belief that it provides an incentive to improve corporate performance.

On the contrary, Crystal is reported to have found that the exercise of stock options by executives is not correlated with stock appreciation. In a study of the relationship between CEO option gains and stock price appreciation over 10 years, he found stock appreciation accounted for only 15% of the variation. This he attributed to the lack of a 'down-side' to option grants, due to the possibility for executives to often swap lower priced options for underwater ones. The latter possibility has been made difficult, at least in the US, by the Financial Accounting Standards Board, which has formalized its ruling requiring companies that cancel underwater options⁷ in order to reissue lower priced ones to take a substantial charge against earnings (Reingold and Jespersen, 2000). Nevertheless, it is a well-known fact that a lot of average managers reap millions of dollars in a bull market, while hardworking executives sometimes fail to translate their corporate profits into stronger P-E numbers.

ESOPs have been touted as a better alternative because it turns employees into owners, resulting in goal congruence. They are also expected to foster long term thinking on the part of employees. The problem with ESOPs is that employee beneficiaries may leave just to realize the benefits due to diversification concerns. In response to this, firms sometimes have clauses in the plans that defer distribution to the legal limit⁸. Firms may also not want former employees to continue to participate in the growth of their stocks.

⁷ Options that become worthless as a result of a fall in their current price

⁸'Converting ESOP Stock into Other Investments for Former Employees', excerpts from the Employee Ownership Report, <http://www.nceo.org/columns/news20.html>, 2nd March 2001.

Lazear (1999) also criticizes the use of non-vested stock options to retain workers. He explains that equity-based rewards shift risk from capital to labor even though employees are poorer bearers of risk than outside investors, given the diversification opportunities available to outside investors. He points out, for example, that bonds that are put in an escrow account for a defined time period will provide the same retention effects without having any risk passed onto the worker.

The controversy surrounding stock-based compensation has only deepened especially since the recent corporate scandals in the US and Europe. Stock-based compensation creates incentives for executives to exaggerate expectations about company earnings, given that this is what drives stock prices (Martin, 2003). These executives can use their knowledge of the company to cash in on their rewards before earning expectations and hence stock prices fall. He suggests that executive reward be instead based on real earnings growth.

5.2 Public-private sector differences

Private firms typically try to maximize profits and shareholder value. Public sector firms, however, tend to have multiple objectives, which in some cases exclude profits. As already indicated, public sector firms with multiple objectives, some of which are difficult to measure, should be less likely to use incentive contracts. Burgess and Metcalfe (1999) also refer to the work of Dixit (1997) in describing public agencies as agents with multiple principals, each with different objectives. Given that these principals are not colluding, they argue that using incentive contracts will be extremely costly, relative to the case where they actually collude.

5.3 Compensation within the real estate industry

As already pointed out, very little work has been done on compensation within the real estate industry. So far, such studies appear to have been limited to Senior Executives of REITS in the United States. The most general of such studies was by Davis and Shelor (1995), who tested for possible links between financial performance (EPS and net income), firm size (measured in terms of asset holdings) and executive compensation for real estate firms. They found firm size (measured as total assets) to be the most important variable that explains the level of total executive compensation (measured as base pay plus annual bonus). Chopin, Dickens and Shelor (1995) found increases in sales have a positive impact on REIT manager rewards, but unexpected profit had no appreciable effect on top manager pay.

Hardin's (1998) study focuses on a REIT sub-market: equity REITS. He concludes that firm size (measured as the market value) is only one of the determinants of EREIT executive compensation. He finds property type (retail EREIT), the fraction of manager ownership, and the number of years since the EREIT's initial public offering as positive determinants as well. However, the dollar amount of dividends paid to senior managers had a negative impact on senior manager pay. Hardin concludes that further research needs to focus on models incorporating industry specific factors in order to explain variations in executive pay. Pennathur and Shelor (2002) investigated the relationship between

increases in CEO pay, industry-specific performance measures and stock returns for REITs. They found that change in CEO pay depends on previous year stock returns but is less related to changes in funds from operations. They also found CEO age had a negative impact on the change in compensation.

5.4 Limitations of incentive plans as employee motivator

Incentive plans are accepted as a people management tool. This arguably is in line with recommendations of agency theorists who believe this is one of the best ways of taming opportunistic managers and motivating employees. As already mentioned, these recommendations rest on two disputed assumptions about agents – opportunistic behavior and economic rationality. In particular, if all agents are not out to maximize their economic benefits, then the reliance on financial incentives as a motivator for all employees becomes questionable.

Some of the major conclusions of the Towers Perrin Talent Report (2001) are that attractive pay and benefit packages may serve as effective recruitment tools, but retention may require factors such as leadership development and the extent to which employee skills are tapped. In addition, employee motivation depends on factors such as recognition and promotion of talented workers, and a culture that promotes teamwork and innovation. Employee motivators also differ across age groups; thus while leadership development and challenging work would motivate workers between the ages of 30 and 44, work/life balance and recognition/reward for talent and leadership issues appear to be important to older workers⁹. These findings have also been confirmed by a survey of the real estate sector (The Equinox Report 2003).

Given that competing firms replicate pay and benefit programmes, retention and motivation of workers require firms to differentiate themselves in terms of non-financial rewards. All this is in agreement with socio-economic views that agent heterogeneity imply different things motivate different people. Lazear (1999) questions the wisdom of staff retention, especially when the value of a worker's outside opportunities exceeds his intra-firm value; he suggests everyone will be better off negotiating his/her exit. He recommends retention only when the firm has made unique investments in the worker or that the worker has talents that are uniquely valuable to the firm.

Recent research on the limitations of incentive plans would suggest that firms can limit the adverse effects of the presence or absence of incentive contracts if they implement what is called 'complementary human resource practices': employee training, hiring criteria that screens out free riders or people without good team skills¹⁰, establishment of a team culture, job design and employee

⁹ It is important to remember this study was conducted in North America.

¹⁰ This calls for extremely strong interviewing skills on the part of the human resource departments as well as other concerned senior managers in the respective firms.

hierarchies. These not only limit the negative impacts of using incentive pay but also strengthen their productivity impacts (Ichniowsky and Shaw, 2003).

6. Challenges for the real estate sector

It is obvious people management issues should be of concern to the property sector. This is because the innovations that have made property a credible investment alternative to bonds and stocks have been people-driven. It has also turned real estate professionals into finance professionals. In order to sustain the innovation the sector must formulate people management strategies that are competitive with those of the mainstream finance sector. Incentive plans are also obviously being used to an extent in the sector. The question therefore that arises is what types of incentive items should they use under which circumstances?

One of the major conclusions of the Towers and Perrin study is that incentives may not be effective as non-financial factors as motivators. It would be pertinent to test the extent to which these conclusions apply to the real estate sector, the level of awareness of these issues among human resource professionals and the implications this would have for their incentive plan design and implementation.

The existing literature also shows that performance management as a process can influence employee behavior towards the fulfillment of the long-term goals of the firm. One may therefore need to know which performance measures would be appropriate for the real estate sector, and what would be the appropriate mix between the measures. Then there is also the issue of examining which real estate specific factors can explain the remuneration patterns of Swedish real estate executives.

The weakness of accounting profits in real estate firms where the use of physical assets is primary was already discussed. The question is whether EVA may be a better performance measure. In addition, as shown by research on REITs in the United States, there are a number of measures specific to the real estate sector, some of which could provide useful benchmarks for evaluating how companies perform, relative to the market, given that contributors to such benchmarks use common valuation guidelines.

These measures can be contrasted with stock-based performance measures, which can lead to average workers and managers enjoying rewards arising from general increases in stock prices. Conversely, a downturn in general stock market conditions would imply that otherwise hardworking employees would fail to qualify for any bonuses. This can demoralize hardworking employees and lead to increased employee turnover. Does this provide a case for using a benchmark that is real estate

specific, which cancels out the influence of general stock market movements, rewarding performance only in comparison to other companies or a collection of companies?

There are also a number of other performance measures, particularly relevant for fund and asset management situations. What is unclear is whether such funds should be evaluated on the basis of total return or internal rate of return (IRR). There is also the question of whether there should be a single measure or whether a set of multiple measures should be used. Having decided on the measures, there is an equally relevant question of what will be an appropriate time frame over which performance can be measured. One year measures may not accurately reflect a fund manager's abilities if general market conditions undermine his investment decisions, or if he rides on the back of favorable market movements to qualify for bonuses; longer time frames may provide a better idea of their abilities and provide an indication of how consistently they can outperform a benchmark.

Given that financial measures largely measure historic performance, a lot of attention is being paid to non-financial measures, particularly those that are linked to future performance. The commonest examples of these are customer service, market share and service quality. There is a growing call for a consideration of the use of non-financial performance measures. The question is, which ones should be used? It is also important to test the extent to which the performance measurement systems support the companies' business strategies.

Given theoretical predictions backed by empirical evidence from elsewhere it will also be important to determine and explain possible differences between the public and private sub-sectors in their use of incentive plans. In addition one may want to know what implications this will have for their talent management strategies. Specifically, will the private sector have the upper hand in recruiting, retaining and motivating talent? What role will differences in worker risk aversion play in which sub-sectors they choose to work for? Further research should also answer the question as to whether large firms will be more likely to use incentive plan than small firms.

In order to create a line of sight between performance and reward, it will be important to assess workers on the basis of measures they can actually control. It will be important therefore to test the extent of employee involvement in incentive plan design.

To conclude, issues of talent management will increasingly become important as real estate firms become more and more aware of how much the business is people-driven and changes in workforce loyalty. This will call for more innovative steps to tackle an increasingly challenging task of managing people. This paper has outlined the reasons for using incentive plans as well as exploring the various types of incentives. Given that incentive plans involve some degree of performance measurement, issues around performance measurement have been discussed. The potential role of non-financial

performance measures has been identified. A number of alternative and complementary theoretical frameworks underlying the use of incentive plans were also discussed.

The paper also identifies the controversies surrounding the use of incentive plans; these have ranged from the actual incentive items to performance measures. The assumptions underlying agency theory, the principal paradigm underlying incentive plans has also been questioned – these questions would imply the need to look beyond financial incentives as motivators. There will be the need for real estate researchers to investigate current incentive plans in order to determine what works and why, as well as explore what can be done differently.

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**ROYAL INSTITUTE
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**A survey of how Swedish real estate firms use pay and other
benefits to manage employees.**

SAMUEL AZASU

Stockholm 2004

Real Estate Economics
KTH: Infrastructure
Royal Institute of Technology



A survey of how Swedish real estate firms reward their employees.

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Abstract

At a time when business has become more people-driven, employees have only become more loyal to themselves. This underscores the need for studies into how firms, including real estate firms can best manage people in order to attract, retain and motivate critical talent. Remuneration programmes are important tools in this regard; however, studies on these programmes have focused almost exclusively on senior executives, and little has been done on real estate firms in particular. This paper reports a survey of remuneration schemes within real estate firms in Sweden.

The remuneration plans used by the firms were analyzed from a total compensation perspective. The survey points to the fact that while most of the firms use standard pay and benefits packages, there is relatively less emphasis on learning and development for non-managers and almost no involvement of non-managers in determining the variable pay component of the total reward package. The survey also finds financial performance measures are most widely used among firms that implement some form of variable pay as part of their reward schemes.

What remains unclear from the study is whether firms in the real estate sector in Sweden are sufficiently aware of the motivational impacts of two components of the total rewards package, namely learning and development as well as the work environment. Improper handling of these two components could compromise the sector's ability to retain and motivate critical talent. In addition, the focus on using mainly financial performance measures, which are essentially historical, may imply that remuneration programs are not being oriented enough towards ensuring future long-term financial performance of the firms.

Key words: remuneration, total compensation, performance measurement, and performance management

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1. Introduction

“ The real estate sector is beginning to acknowledge that good human capital is hard to come by, harder to keep, expensive to lose and overwhelmingly the greatest determinant of success”¹¹

As noted by Sim and Koh (2001), the long-term survival of a business depends upon its ability to create value in providing goods and/or services that meet market needs. Traditionally, value creation is centred on businesses achieving excellence in their normal operations. However, as pointed out by Kaplan and Norton (1996, cited in *ibid*), there is growing recognition that value is created in companies through innovation, a process that entails identification of new customers and markets as well as emerging needs of existing and future customers. Sometimes, firms may feel compelled to diversify their workforce to more closely reflect an increasingly diverse customer base (Towers Perrin, 2001). To put it simply, more than ever before, business is becoming very people-driven.

Towers-Perrin (2001) also draws attention to an increasingly sophisticated workforce that is very well informed about their career options with a weakening sense of loyalty about job tenure. Three groups of workers may be found in any firm:

- Workers who aspire to develop a broad skill set from being rotated on the job,
- Those who aspire for a balance between work and private life, and
- Fast trackers who desire challenging work, high rewards and quick career progression.

It has to be pointed out, that workers may not fall neatly into these categories; there could be overlaps for any one employee, and a worker may transition between these types during his working life. What is more, workers differ in terms of age, marital status, and cultural background and, of course skill and talent. The growing importance of people in driving corporate success, coupled with dealing with a mix of workers whose characteristics are as described above makes talent management¹² particularly complex. Thus, while business has become increasingly people-driven, workforce management has become increasingly complex. One of the principal tools for managing the firm's workforce is the remuneration plan.

This paper reports a survey on remuneration plans within real estate firms in Sweden. It is a largely descriptive analysis of compensation from a non-traditional viewpoint using Gherson and Todd's (2001) total compensation framework. The survey is important in the sense of summarizing what is known about the use of compensation plans and their effectiveness as a talent management tool within real estate firms in Sweden. The analytical framework also exposes elements of the total reward package that needs to be investigated by further studies.

¹¹ Equinox Partners. Real Estate – The Human Capital Factor. *The Equinox Report 2003*.

¹² Defined as “the collective actions an organization takes to attract, engage and retain employees”. Towers Perrin (2001).

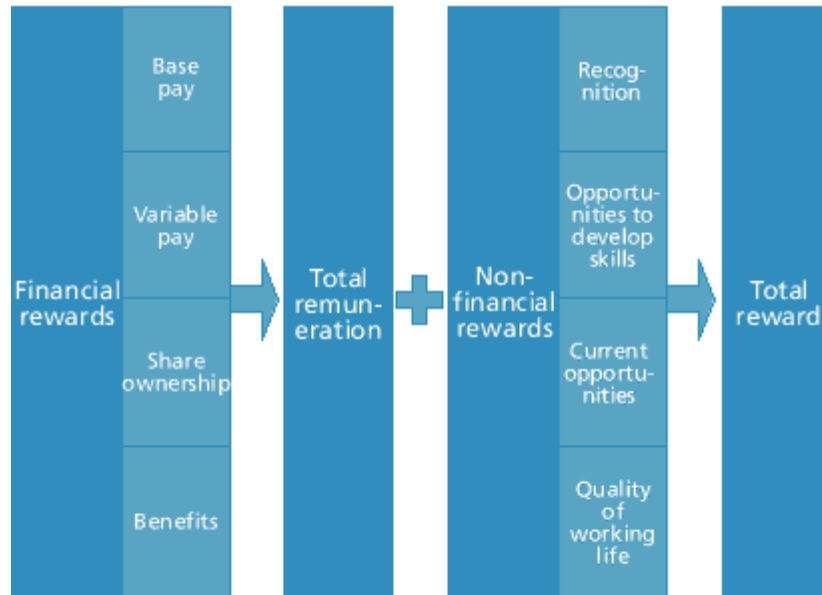
The rest of the paper is organized as follows: compensation/remuneration will be defined; an outline of Gherson and Todd's (2001) total reward framework will precede a review of the theories of worker motivation. Issues relating to performance measurement and the related concept of performance management will then be briefly discussed, followed by a summary of the status of Swedish industrial relations. The results of the survey will be presented and discussed. The paper will conclude by stating the implications of the results for the talent management strategy of the real estate sector in Sweden and raising a number of issues to be explored by further research.

2. Compensation/Remuneration

Article 1 of the Equal Remuneration Convention of the International Labor Organization defines remuneration as including '[...] the ordinary, basic or minimum wage or salary and any additional emoluments whatsoever payable directly or indirectly, whether in cash or in kind, by the employer to the worker and arising out of the worker's employment'¹³ The above definition is typical of the traditional approach to remuneration; it essentially consists of pay and benefits. Gherson and Todd (2001) define pay to include: base salary, variable pay, recognition and stock. Benefits include health care, retirement, savings and time off. In their new definition of reward, they added two new classes of items, which they label 'learning and development' and 'work environment'. These are the four components of what they call a total compensation framework.

The Chartered Institute of Personnel and Development also defines total rewards as a "[...] term that has been adopted to describe a reward strategy that brings additional components such as learning and development, together with aspects of the working environment, into the benefits package. It goes beyond standard remuneration by embracing the company culture, and is aimed at giving all employees a voice in the operation, with the employer in return receiving an engaged employee performance". The implication here is that it takes more than the traditional pay and benefits to create a workplace characterised by consistently motivated workers. The total rewards package is illustrated in the picture below:

¹³ Equal Remuneration Convention (No.100) concerning Equal Remuneration for Men and Women Workers for Work of Equal Value. Adopted on 29 June 1951 by the General Conference of the International Labour Organisation at its thirty-fourth session *entry into force* 23 May 1953, in accordance with Article 6. Retrieved March 31, 2004 from http://www.unhcr.ch/html/menu3/b/d_ilo100.htm



Source: Michael Armstrong and Duncan Brown, *New Dimensions in Pay Management*, CIPD, 2001

2.1 Pay

Pay consists of base pay and variable pay. Variable pay can provide incentives for individual or group performance (Milgrom and Roberts, 1992). It can also be classified as merit pay or performance-related pay (Burgess and Metcalfe, 1999). Merit pay is based on a subjective assessment of worker performance. The problem with subjective assessments, according to Burgess and Metcalfe (1999), is that they are not verifiable by a third party; thus the evaluator has an incentive to distort the evaluation *ex-post* for private gain, weakening the incentives for employees to work hard.

Performance-related pay (PRP), as the name implies, involves paying the worker an amount that depends on some objective measure of his output. The commonest example is piece-rates, defined as payment for a given amount of output. Lazear (1986) in his model on piece rates, points out that it sorts out more able workers, increasing the average ability of the workforce. Performance-related pay can be inappropriate even when accurate performance measures are in place. The reason for this is worker bias towards only those activities that are measurable and attract rewards, at the expense of less easy to measure but equally important tasks. Holmstrom and Milgrom (1991) show the difficulties of implementing incentive pay in multi-tasking situations. Burgess and Metcalfe (1999) infer from Holmstrom's model that performance-related pay would be inappropriate in public sector firms, given that such jobs involve many difficult to measure tasks.

2.2 Benefits

Beardwell and Holden (1997) cite a number of reasons for firms' use of benefits for employees. Most fringe benefits are tax-exempt; both employer and especially the highly paid employee are better off. Firms also enjoy economies of scale, enabling them to provide these benefits cheaply. Some of the benefits like company cars for property managers and special clothes are actually needed by employees in order to more effectively discharge their duties. More importantly, benefits can also serve as an important retention tool; pension rights as a seniority benefit serve as a deterrent since it imposes large economic costs on employees who quit early (Green et al, 1985, cited in *ibid*).

Beardwell and Holden (1997) also identify what they call 'cafeteria benefits'; this entails allocating the employee a budget to spend on a menu of selected benefits. Employees are given the freedom to choose the specific benefit items they prefer and the precise balance between benefits and cash pay. The advantage in using a flexible benefit scheme is to ensure benefits are sufficiently customised to meet employee needs in order to increase retention as well as motivate them. As will be shown below, this approach to benefit administration recognises that all employees are not alike; it is therefore imperative to allow some degree of flexibility in benefit administration to ensure motivation. One potential problem with such schemes could be costs of administration due to loss of economies of scale (*ibid*).

2.3 Learning and Development

Gherson and Todd (2001) define this to include 'training, skill development, performance management and career management programmes'. All the elements of learning and development are aimed at developing and closing any discrepancies that exist between individuals' skills and competencies and the firm's desired capacities. Typical examples include technical training courses, leadership training, and succession planning as well as incentive-related performance management.

Succession planning is even more important nowadays when it is no longer particularly negatively regarded to change jobs. This makes staff retention rather difficult, which would imply that succession planning becomes important across the firm, as new replacements are expensive to train, apart from the time lapses that may occur between a person leaving the job and finding a suitable replacement. For those at the beginning of their careers, training and development opportunities within a firm can serve as a serious tool for retention and motivation as they seek to develop skills that improve their career prospects.

2.4 Work Environment

This has been defined to include employee involvement in decision-making, extent of and promotion of and respect for diversity, encouragement of a balance between life and work, as well as organizational culture. Gherson and Todd (2001) point out that the right work environment promotes effective

decision-making as well as creating avenues for employees to make meaningful contributions. It also creates an atmosphere in which employees are valued for their different skills, abilities, and perspectives. The right work environment promotes a good balance between work and life, an element that has been shown to serve as an important motivator for older workers (Towers Perrin, 2001). The right work environment, according to Gherson and Todd (2001), would also offer non-financial recognition to its employees, making it 'a great place to work'.

3. Economic theories of worker motivation and incentive contracts

The problem of motivating workers has long pre-occupied sociologists, industrial psychologists, and management researchers. However, economic theories have arguably grown in importance in analyzing and shaping thoughts about how to manage talent within business organizations. Proponents of this approach, notably, Lazear (1999) have argued that some of the issues, by their very nature are economic. Furthermore even the non-economic issues yield themselves to analysis using economic models. Personnel economics has not only come out with specific theoretical predictions; some of these predictions have also been tested and verified by firm-based data. One of the recurrent issues in this regard is talent management and the related issue of employee motivation as well as the role reward programmes can play in this regard. This section will focus therefore on economic theories of employee motivation.

One may argue that perhaps the most influential theoretical model of incentive contracting is agency theory. Eisenhardt (1989) identifies an abstract and mathematical version of agency theory as the principal-agent model that has wide applicability. One application is the problems that arise from the separation of ownership of a publicly held company and its managers.

The principal agent problem arises out of two issues: lack of goal congruence and differences in risk preferences (Wright and Mukherji, 1999). The goal conflict entails the principal seeking to maximize his wealth, while the agent tries to maximize not only his financial but also non-financial benefits. The principal is assumed to be risk neutral because he can diversify his investment in many firms while the agent is usually risk averse due to his inability to diversify his employment opportunities.

These differences in risk preferences, the lack of goal congruence as well as the inability of the principal to perfectly observe the agent could lead to the agent engaging in opportunistic behavior, at the expense of the principal. Thus variable pay schemes are an attempt to provide incentives, which align employee interests with those of the owners of the firm.

The dominance of the principal agent model in the arguments used to justify the implementation of variable pay plans has been questioned theoretically and empirically. Theoretically, the single-principal

and a single agent framework runs into trouble when applied to business organizations, which are characterized by multiple principals (shareholders) and multiple agents (employees), or multiple principals and a single agent; for example a real estate broker dealing with different clients.

Free riding characterizes multi-agent contractual arrangements, which dilutes the incentives to each agent to the point of trivializing it (Lazear, 1999). Another problem with teams is that post contractual opportunism is possible even if there is no uncertainty in output because free riders are difficult to identify if joint output is the only observable indicator of agents' performance (Holmstrom, 1982).

Agency theory's assumptions about principals and agents do not lead to the attainment of competitive advantage (Wright, and Mukherji, 1999). In particular, agency theory is too narrow given that it assumes all agents are opportunistic economic 'maximizers'. Socio-economic theorists have pointed out that agents are not always selfish, neither are they all similar in trying to maximize only economic benefits from their contractual relationship with the principal (ibid). The implication would then be that economic rewards, while not unwelcome, are not necessarily motivating for every agent in the contract situation.

A worker's motivation can be generated by career concerns (1982)¹⁴. The essence of this idea is that workers are motivated to work hard in order to influence the labor market's beliefs regarding their capabilities. The model establishes a link between wages and expected productivity, which in turn, depends on observed output in previous periods. Current output is thus linked to future wages. An important conclusion of the model is that career concerns strongly motivate younger workers who are eager to establish a track record for themselves, given the rather diffuse nature of the labor market's information about their capabilities (Burgess and Metcalfe, 1999). This conclusion reinforces the inference from socio-economic criticisms of the motivational impacts of variable pay. At least one class of workers is likely to be more motivated by skill acquisition through job rotation and the provision of training and development programmes.

Motivation can also arise from pay differences within the organizational hierarchy (Lazear and Rosen, 1981, cited in Lazear, 1998). The appropriate model, the tournament/relative compensation model essentially says that incentives are created for the worker to exert effort to the extent that wage disparities exist along the organizational hierarchy. Motivation is therefore strengthened by wider disparities along the organizational hierarchy. Since promotions cease to motivate as one reaches the top of the organization, Lazear and Rosen suggest the use of performance related pay among senior executives of the organization.

¹⁴ See Burgess and Metcalfe (1999) for a review of this model.

The competition generated within a tournament context is likely to lead to diminished cooperation between workers. The competition reduces the amount of ‘connective capital’¹⁵ available to each worker. Connective capital has been identified as a key ingredient in effective problem solving in a team environment, and a source of increases in productivity. The absence of connective capital when cooperation fails could cancel out the expected productivity gains from the implementation of a remuneration scheme that rewards individual performance.

What the above theories suggest is that motivation comes from various sources: performance related pay, future career concerns, one’s position in the organizational hierarchy. Socioeconomic challenges to agency theory also suggest that non-economic factors like autonomy, responsibility and recognition could also motivate. Given the difficulty of knowing exactly what motivates each worker, one may argue that the total reward framework is a more comprehensive approach to the motivation question.

4. Performance measurement

If the implementation of remuneration schemes in an organization is not to be arbitrary, some methods for performance assessment must be developed. Thus, a performance measurement system is an integral part of an incentive plan.

4.1 Definitions

A number of definitions related to performance measurement are presented in this section. Jensen and Meckling (1986) define *performance measurement/evaluation* as a process by which value weights are assigned to various dimensions of performance to represent the extent of achievement on each dimension. It is also defined as “a process of assessing progress towards achieving pre-determined goals, including information on the efficiency by which resources are transformed into goods and services, the quality of those outputs and outcomes, and the effectiveness of organizational operations in terms of their specific contributions to organizational objectives” (Amaratunga and Baldry, 2003). Neely, Gregory and Platts (1995) define a *performance measure* as a metric used to quantify the efficiency and/or effectiveness of an action. The collection of metrics used within a firm constitutes a *performance measurement system*. The performance measurement system is not only the basis for determining who qualifies for incentive rewards but even more importantly a reflection of the goals and strategies of the organization as a whole (Woodford and Maes, 2002).

There are a number of ways of classifying performance measures. There are *market based performance measures* and *accounting based performance measures* (Peck, 2000). There are also traditional

¹⁵ Defined as ‘a worker’s access to the knowledge and skills of co-workers’ (Ichniowsky and Shaw, 2003).

accounting measures, value-based measures and hybrid measures which combine financial and non-financial measures (McKenzie and Shilling, 1998).

The real estate sector has a number of performance measures, depending on whether one is referring to direct or indirect investment in real estate (Baum, 2000). The US market, characterised by a large secondary market has a number of performance measures such as the NAREIT Equity REIT Share Price Index for Equity REITs, with a corresponding index for mortgage REITs as well as a hybrid index for REITs that own properties and make loans. The NCREIF Index measures performance on direct investment.

Europe, on the other hand, has a number of national indexes covering direct investment; these are under the control of the Investment Property Databank (IPD), a UK-based firm that provides benchmark measurement services in 12 European countries including Sweden as well as Canada. They are compiled from valuation and management records for individual properties in complete portfolios, collected direct from investors by IPD. Typical performance measures include income return, capital return and total return.

Performance measures can also be classified as financial when they are extracted from a company's financial records¹⁶, and non-financial¹⁷, otherwise. They are objective when one can easily assign numerical values to performance or output; otherwise they are subjective.

4.5 Performance management

Traditionally, performance measurement entails a manager or supervisor annually writing his/her judgment regarding the performance of a subordinate employee on a document provided by the Human Resources Department. The implied assumption here is that “ the immediate superior usually has the best knowledge of the individual job content, objective and overall performance” (Hume, 1995). However, in most cases the appraisal captures only what the immediate supervisor/manager can remember and these are understandably either the most recent events, or critical events, some of which may be detrimental to the employee. Heathfield (2003) also identifies the following weaknesses in traditional performance appraisal:

- It is reminiscent of the “ old fashioned, paternalistic, top-down autocratic mode of management that treats employees as possessions of the company”
- It is not in consonance “with the values-driven, mission oriented, participative work environments favoured by forward thinking organizations today”
- “It is harmful to performance development; damages work place trust, undermines harmony and fails to encourage personal best performance”.

¹⁶ Examples include accounting profits and earnings per share

¹⁷ Customer satisfaction and market share are typical examples

The alternative to performance measurement is performance management. Macaulay and Cook (1994) describe performance management as an approach to management aimed at consolidating employee performance. Armstrong (2000) describes performance management as a process by which the employee and his superior agree about work objectives, and the knowledge, skill and competence requirement to achieve these objectives. It also involves the joint formulation of work and personal development plans, the joint and continuing review of performances against these objectives, requirements and plans. The supervisor and subordinate must also agree on how to implement improvement and further development plans. "The focus is on improvement, learning, development and motivation".

Essentially therefore, performance management appears to be forward looking. One may want to argue that the assessment process, if handled carelessly, could actually serve to de-motivate the worker; proper handling of the assessment/evaluation process is essential to communicating the values of the organization and motivating workers towards attaining them.

5. Human resource management and industrial relations in Sweden

The theories of motivation outlined above are essentially 'North-American' in orientation. The extent to which they provide an adequate framework for analysis of the remuneration policies of Swedish companies requires some awareness of both the status of Human Resource Management (HRM) within Swedish firms as well as the current state of industrial relations in Sweden.

As noted by Mabon (1995), Human Resource Management evolved from Personnel Administration, with the latter usually concerned with routine issues involving employees. Human Resource Management in Sweden currently is seen, at least theoretically, as a strategic issue - a feature Mabon (1995) notes is North American in orientation. At the same time, the role of HRM in business organisations did not enjoy the same status as managers in charge of finance, legal or technical issues. Mabon (1995) notes that HR managers are often subordinates of heads of administration, and thus at least two levels from senior management; the decentralisation of the HRM function further weakens the power of the HR manager. What is more, the unions heavily influence issues related to remuneration systems, limiting the influence of the HR professional.

Sweden has the most unionised labour market in the world. Union membership stood at 85% of the labour force in 1998 (Wickman, undated). This makes the unions important players when it comes to the formulation of labour market legislation and wage setting. An interesting feature of wage setting was the system of wage negotiations based on solidarity. Centralised wage negotiations between the

unions and employers' representatives resulted in similar wage increases for public and private firms, efficient or inefficient. This may have made it difficult for these companies to recruit from abroad; there is currently a provision in the Swedish tax law, which means that foreign experts working for Swedish companies qualify for tax relief¹⁸.

Two important laws governing the labour market have had serious implications for talent management within Swedish firms: the Co-determination Act requires negotiation between employers and unions on issues concerning the labour force. An upshot of this law is that interactions between employers and unions has been characterised by consensus building and negotiation. The Act on Security of Employment made it quite difficult for employers to dispose of workers for reasons other than downsizing; in the case of the latter, strict rules applied concerning length of employment and chances of re-employment if situations improve.

Length of employment restrictions implied that in a situation of downsizing, recent employees were the first to be laid off; this may have in a lot of cases forced companies to dispose of talent with the most up to date and relevant knowledge, in favour of older workers whose knowledge may have been rather obsolete. This could have severely constrained companies' ability to innovate in the face of fierce global competition. In addition, it may have imposed undue financial burdens on companies as they sought to sidestep the law by offering older workers financial inducements to retire early. Even though a change of government in the early 1990's saw some modifications to this law, the return of the Social Democrats to power after 1994 led to a reversal of these modifications.

What is clear from the above is that the role of the unions and the legal environment within the labour market imposes significant constraints on the status of the human resource management professionals within the firm and also the extent to which they can use remuneration to differentiate and motivate employees.

6. Results and analysis

This section presents and analyses the results of the survey. They are broken down into the following sub-sections: Pay, benefits, training and development as well as work environment. The data for the study was generated from the responses to a questionnaire¹⁹ survey addressed to CEOs of the following firms in the Real Estate Sector:

¹⁸ Swedish National Tax Board. Tax relief for foreign key personnel. Retrieved 2004-04-28 from <http://skatteverket.se/english/taxrelief.html>

¹⁹ The choice of postal questionnaires was driven by practical considerations. Given the spatial distribution of the Municipal Housing Companies in particular, it would have been costly in time and money to undertake face-to-face interviews. The author therefore took the risk of experiencing a low response rate, typical of postal questionnaire surveys. However, a response rate of forty-nine percent can be considered adequate for the purposes of analysis.

- Listed companies
- Unlisted companies
- Municipal Housing companies
- Portfolio/Fund Managers and Property Consultants
- Bank/Insurance and Investment Companies

The above classification generates natural strata for sampling purposes. All the listed companies and the portfolio/fund managers were covered (since their number was small), while all the other companies were sampled. Systematic sampling was used for each of the other group of firms. Eighty-one questionnaires were sent out between January and March 2003. Forty completed questionnaires were returned, giving a response rate of approximately fifty percent.

As shown in Table 1, the respondent companies were classified according to whether they were in the public or private sector. Public sector here is taken to mean ownership by government, whether it is national or local government (the municipalities). On the aggregate, a little over sixty percent of the firms are in the private sector, with the remainder belonging to the public sector.

Table 1. Respondent classification – public versus private firms

Company type	Number	Percentage
Public Sector	14	36%
Private Sector	25	64%
Total	39	100%

A more detailed breakdown is done in Table 2. The respondent companies were quite different from each other size-wise. Size here is measured as the number of employees. The mean number of employees is approximately 82.

Table 2. Description of respondent companies

Company type	Number	Percentage of total
Listed Companies	12	30%
Unlisted Companies	8	20%
Municipal Housing Company	14	35%
Portfolio/Fund Managers & Consultants	3	8%
Bank/Insurance/Investment Company	2	5%
Construction Company	1	3%
Total	40	100%

6.1 Pay

This is the fundamental element of the total reward package. It includes base pay, variable pay (for those companies that implement incentive plans), recognition and stock. In Sweden base pay is usually determined from negotiations between employers representatives and the unions. Given that Sweden is the most unionized country in the world, the influence of the unions is rather strong in the determination of base pay. For companies that use variable pay, the most frequently cited reason for its adoption is worker motivation. Staff retention is also important even though recruitment is not that important. This is shown in Figure 1. It must be pointed out that respondents usually cited more than one motive for using incentive plans.

A related issue is what determines the use of variable pay. According to the respondents, the most important determinants are the individual worker's performance as well as comparisons with other companies. Relatively less important determinants are the company's financial position as well as union pressure (Figure 2).

The most important variable pay items for senior managers (including the CEOs) appear to be end-of-year bonuses as well as performance-based bonuses (Figure 3); profit shares are not that frequently used. Severance payments are used in some companies for senior managers. Individual performance measures and accounting profits are the most important measures used to determine the size of the bonuses (Figure 4).

Variable pay is used slightly differently for middle managers (figure 5); performance-based bonuses are slightly more frequently used than for senior managers. Annual bonuses are next in importance with profit shares again being the least important. Accounting profits is the most important performance measure, followed by individual performance measures. Customer Satisfaction and Net

Operating Income are tied as the next most important performance measures for middle managers (Figure 6).

End of year bonuses are the most frequently used variable pay item for non-managers, followed by performance-based bonuses (Figure 7). These bonuses depend largely on accounting profits and divisional performance targets as well as efficiency ratio for property management (Figure 8). Individual performance, earnings per share, and the customer satisfaction index belong to a second tier of performance measures.

The relative importance of annual bonuses as against performance-related bonuses for majority of employees of the firms could be taken as indicative of the reluctance to use pay to differentiate between employees. It could also be indicative of the difficulty of measuring individual output in service firms. It has already been indicated that performance related pay is implemented when it is easy to measure a worker's output. That happens more in manufacturing than in services, for manual rather than non-manual workers (Burgess and Metcalfe, 1999). Annual bonuses may be easier to implement than performance-based bonuses given that it would not require a lot of objective performance measurement especially at the individual level. The service-providing nature of the real estate firms creates problems with measuring output objectively, given that output is only a proxy for performance. Thus the use of annual bonuses (an example of merit pay) accords with theoretical predictions about the predominance of merit pay when output cannot be objectively measured. What is unclear is the relatively more widespread use of performance-based bonuses for middle managers. Nevertheless, there is still an element of hierarchy as some senior managers of some firms are entitled to severance payments. To the extent that the companies foster teamwork, the tournament model suggests these disparities across the corporate hierarchy could be a motivator for high performance

Concerning performance measures, the widespread use of accounting profits to measure performance is in conformity with practice elsewhere (Peck, 2000). Their relative importance however differs across the organizational hierarchy. In the case of senior managers, it is second to individual performance measures. For middle managers, the reverse is the case. This may suggest that some risk is being passed onto individual managers in assessing their performance for reward. In other words, the level of individual accountability grows as one goes up the corporate ladder.

It is, however, doubtful if the use of accounting profits to assess performance of senior management is a good idea. Recent debate about the possibility of manipulation dents its credibility as a performance measure. It is also backward looking in the sense that it does not say a lot about the company's future performance. Given that the sector deals with real estate as income producing investments, accounting profits also say nothing about how efficiently these assets are being utilized.

Asset utilization has traditionally been dealt with using measures such as return on assets (ROA) or return on equity (ROE). Jensen (1986) points out how susceptible they also are to gaming. He illustrates this by showing that the use of ROA creates incentives for the manager to reduce the investment portfolio to include only the single asset with highest return. Economic value added (EVA, the difference between net cash flow and a capital charge) does not suffer this defect and emphasizes asset utilization. It also informs managers about the real cost of capital (including equity capital) used in the business. Thus while ordinary accounting statements would show a profit, an EVA accounting statement would show the reverse when net cash flows prove inadequate to cover the full cost of capital of the firm. Thus EVA may be a better performance measure than accounting profits.

It must be pointed out, however, that EVA-based incentive plans, particularly within the real estate sector can be problematic if the EVA definition includes adjustments in market values of the firms' assets. Due to cyclical movements in values over time, when market values rise, a percentage of the value appreciation would be included in the incentives of the employees. However, when the market value falls, there is the risk that this does not translate into a loss of bonuses, removing the downside risk in the scheme. This would then undermine the credibility of the scheme. It may also represent a drain of re-investible capital from the firm.

The use of accounting profits as a performance measure for non-managers is questionable with regards to its power to establish a connection between what the ordinary employee does and how that affects the overall profitability of the firm; a composite measure consisting of lower level measures that they can affect, at least at the team level may have been more effective in this regard.

Of equal importance is the relative under utilisation of the Customer Satisfaction Index, a non-financial performance measure. Banker et al (2000) attribute a number of advantages to this class of measures: they are considered better than short-term profits with respect to measuring the firm's progress towards attaining its long-term goals. Whereas financial measures evaluate past achievement, some non-financial measures could be shown to be determinants of future performance. They are also less susceptible to manipulation in addition to being easy to understand, providing feedback for timely corrective action.

Banker et al (2000) provide a major justification for using a non-financial performance measure: they are lead indicators of financial performance. Customer satisfaction has been identified as a key long-term measure that is an important predictor of long term performance in business areas where repeat business is important (Phillips et al 1990; Griffin and Hauser, 1993; Hauser, Simester and Wernefelt, 1994)²⁰. Using the case of a chain of establishments in the hospitality industry, Banker et al (2000)

²⁰ Cited in *ibid*.

demonstrated that both financial and non-financial performance improved after implementing an incentive plan designed to include non-financial performance measures.

It can thus be argued that perhaps the long-term goals of the firms that use performance management systems will be better served, not only by using a composite of measures including lower-level measures that employees can control, but also measures that more reliably predict future financial performance. This argument is far from settled as there is as yet no systematic investigation between companies' ranking on the Customer Satisfaction Index for any year and their financial performance during subsequent years.

6.2 Benefits

The survey indicates loans are an important benefit for senior managers in the industry; half of the total loan package for senior managers is car loans (fig. 9). The remainder is evenly split between house loan and personal loans. Health Insurance is most important for senior managers, followed by travel insurance and life insurance (fig.10). Paid sick leave and maternity/paternity leave are very important (fig. 11). The human resource management implications for these go beyond the real estate sector. This will be discussed further in a later section. Lunch allowance and training allowance are most important for senior managers, followed by club membership (fig. 12). In-kind allowances for senior managers are mostly company cars; a few companies provide club membership as a senior managerial perk (fig. 13).

Car loans are even more important for middle managers, followed by house loans; personal loans are least important (fig. 14). Again health insurance is most important, followed by travel insurance with accident and life insurance jointly occupying third place (fig. 15). Apart from annual leave to which all employees are entitled, maternity/paternity leave is the most important, followed by paid sick leave (fig. 16). The most important allowance is lunch allowance followed by allowances for training initiated by the manager him/herself (fig. 17). Middle-manager perks are similar to that of senior managers: company cars and club membership (fig.18).

A rather unusual result is the proportion of companies that give car loans to non-managers (fig.19). This is quite unusual in a country with one of the most reliable public transport systems. A likely explanation is that real estate managers will need cars as they attend to business around their asset holdings across the cities and towns. Travel insurance is the most important insurance item for non-managers (fig.20), followed by health and accident insurance. Like senior executives and mid-managers, maternity/paternity leave and paid sick leave are very important for non-managers, outside of annual leave (fig.21). Lunch allowance is most important for non-managers, followed by training allowance (fig.22).

Car loans can serve two purposes: cars are a status symbol; cars can also be very important due to the nature of one's job. Its role as a status symbol will be more important at the top of the organisation than elsewhere. Thus even if the survey shows car loans given throughout the firms that give them, one may, upon further investigation, find differences in the size of these loans along the firm hierarchy. Non-managers' car loans may be due to the nature of specific individuals' jobs, given the relatively reliable nature and high quality of public transport in Swedish towns.

Everyone in the Swedish labour force is covered by health insurance; originally employees were entitled to sick pay from the state amounting to ninety percent of salary from the first day. The result was that being absent from work due to ill health only marginally affected one's earnings. The system was reformed in 1992 by making individual companies responsible for paying for the first two weeks, before the state takes over, providing companies with an incentive to monitor absenteeism. This incentive was further strengthened by compensating the affected firms by 0,3 percent of the wage bill. Thus, companies that monitored and minimised absenteeism would find themselves in a favourable position (Mabon, 1995). However, this measure appears not to have worked, as the number of people on long-term sick leave rose from 112,500 at the start of 2002 and rose to 124,600 by year end (AFA Sickness Insurance – Sweden, 2003).

Absenteeism due to sick leave compels the firms to hire temporary replacements; this may prove to be disruptive of work. Unless experienced replacements are obtained, the firm would have to incur further costs of initial training to bring these new hires up to speed. It may also take time for new recruits to develop the capacity to take on projects that are probably put on hold due to the absence of experienced employees. This can compromise the firm's ability to deliver on its commitments. The result could be loss of business to the firm's rivals that could prove ultimately costly to the firm. Further research is needed to determine the levels of absenteeism in the real estate sector and the impact on firm productivity.

It is also important to note that the state sickness insurance has a ceiling of approximately 80 percent of 25,000 Swedish crowns. Companies therefore provide extra insurance to their employees over and above the government ceiling. Thus extra insurance is an important part of the total reward package. Senior and middle managers would normally earn above the limit set by government schemes; this would explain their relative importance among them. Travel insurance is more important for non-managers. The most reasonable explanation appears to be that this is job related.

Government sponsored paternity and maternity leave is among the most generous in the world. A couple is entitled to 13 months off work between them, with the state paying 80% of lost wages up to a ceiling of SKr24, 562 (\$3,425) a month. A further 90 days can be taken for a token sum (Economist,

2004). In a European context, Norway has the most generous paternity leave scheme of four weeks after child birth, two weeks in Sweden, the UK, and Ireland having the worst situation: paternity leave is entirely at the discretion of the employer. This would suggest that stress due to childcare is relatively low in Sweden.

What is also unclear is whether men in the sector actually take advantage of the paternity leave provided. A German study cited in Time (2003), showed that even though 20 percent of German fathers would like to take parental leave, only 2 percent end up taking it for fear of compromising career progression. Career concerns could therefore be an important determinant in whether or not men are inclined to take paternity leave. Here again, one may want to pursue this issue by researching into the actual proportion of men who take their paternity leave.

6.3 Learning and Development

There were no detailed items on the questionnaire used for the issue of learning and development; however, a look at the distribution of allowances shows that companies are willing to pay allowances for self-initiated training. This is, in addition to the obvious presence of company initiated training programmes. This arguably is indirect evidence of companies' willingness to encourage employees to fill gaps between organizational capabilities and individual competencies. However, it appears senior managers benefit slightly more from self-initiated training allowances than middle and non-managers.

It can be argued from a motivational viewpoint, that training programmes will be particularly important for young workers at the early stages of their career. They are the ones who would most likely be desirous of building a broad skill set, which they can translate into higher rewards later. However, once they receive their training, it is important that firms make an even greater effort to retain them. One way of doing this obviously is to offer challenging work with the appropriate financial and non-financial recognition schemes. Thus, the relative differences in importance of training allowances within firms across the industry may be evidence that somehow, the motivational impact of training especially for workers lower in company hierarchy is being underestimated. As the career concerns model suggests, younger workers eager to establish a track record for themselves are very likely to be motivated by training programmes that expand their skill set as well as deepen what they already know.

Given that much of the knowledge acquired during formal schooling is conceptual and highly theoretical, it is even more imperative to ensure that training programmes, whether self or company initiated, provide skills in knowing how to do things and when to do them. In other words, companies should ensure that training programmes provided or paid for enhance employees' problem solving and decisions making skills. This then becomes an important source of innovation and value creation within the firm. It also signals to employees how much the company cares for their welfare. It can be argued that companies that care about their employees would also ensure they remain competitive in the job

market over the long haul. This is particularly important at a time when knowledge is becoming obsolete very quickly.

In order to assess the effectiveness of this component of the total reward package, however, there is the need for additional research into the types of training that are paid for, as well as their duration. It will also be important to test for any relationship between the frequency of training programmes implemented directly or indirectly by the various companies and staff turnover. This would give an idea of the how effective companies in the sector can be in using learning and development to retain and motivate their workers. It is also important to find out if training programmes are used as differentiators in the sense of providing it to top performers, or if it is an equalizer in the sense of bringing underachievers up to speed.

6.4 Work Environment

Of the four dimensions of the total rewards package, this is probably the most difficult to measure. However, a proxy for measuring the level of employee involvement in decision-making was tested for companies that used variable pay. Respondents were asked to rank the level of employee-involvement in the determination of variable pay on a scale of 1 (no involvement) to 4 (high involvement). Over seventy percent of the respondents indicated little or no-employee involvement in the design and implementation of variable pay schemes (fig. 23). Swedish firms have, on average, three times fewer hierarchies than French firms, for example, and are perceived to be rather decentralized and democratic (Tixier, 1994). Employee representatives, the unions and government regulation appear to be very influential in base pay and benefit setting. However, the determination of the variable part of the pay package appears to be a matter for senior executives, with the implementation left to the personnel administrators.

The absence of employee involvement in the determination of variable pay may weaken the 'line of sight' between performance and reward. 'Line of sight' describes the employee's ability to see how effort translates to higher performance and ultimately greater rewards (Zobal, 1999). The chances of this happening is maximised when performance goals are jointly determined by employees and their supervisors, with reasonably regular monitoring and feedback/coaching, in a performance management context. Given that employee involvement is very limited, it is difficult to see how these variable pay plans could serve to retain or motivate employees.

6.5 Human Resource Management in the Real Estate Sector

There are 21 Real Estate and Construction firms listed on the Stockholm Stock Exchange. Only four of these companies have a strategic level manager in charge of human resources. It will be useful to pursue this issue for all the companies in the sector; but what these preliminary results point to is that people management is probably not regarded as a strategic issue. If this is true, then even if the sector

recognizes how people-dependent the value creation process has become, there is probably not a lot of sophistication shown by the sector in managing its human resources. But the situation could also be due to the small size of the companies, which means people management issues are tackled by a general manager in charge of administration. Here again, one may need to look at the actual number of people doing human resource related jobs in the sector who have had explicit training in either business administration and/or human resource management.

7. Conclusion

There is growing recognition of the role of people in the value creation process not only within real estate companies but also within all business firms. However, the task of managing people has become increasingly complex as employees become more sophisticated 'consumers' of employment opportunities. This paper has surveyed and analyzed reward programmes within real estate firms in Sweden from a total compensation perspective.

Concerning pay, the relative dominance of annual bonuses underscores the service nature of the industry and the consequent difficulty in accurately measuring individual performance especially at the lower levels. In such a situation, aggregate performance measures would be more convenient. This is also buttressed by the fact that accounting profits dominate performance measurement in the firms. Only senior managers appear to be individually held accountable in some firms with respect to performance measurement for reward. That is only fair in the sense that those who earn more should be more accountable for what they do. A non-financial measure that is used to some extent is customer satisfaction.

Benefits in the form of senior manager perks seem to provide a good basis for differentiating between the workers. Nevertheless, state sponsored benefits and favorable welfare legal environment ensures that lower level workers also enjoy benefits that promote a good balance between work and private life. The unsolved issue is the extent of abuse of some of the benefits like paid sick leave within the sector.

The survey points to the fact that while most of the firms use standard pay and benefits packages, there is little or no emphasis on learning and development for non-managers. There is also almost no involvement of non-managers in determining variable pay component of the total reward package.

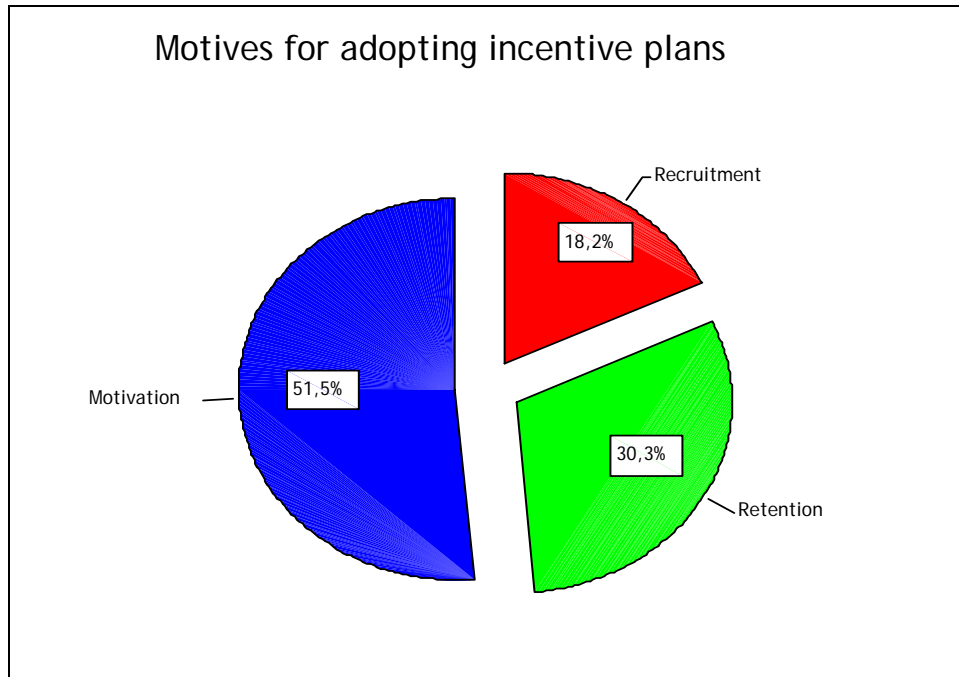
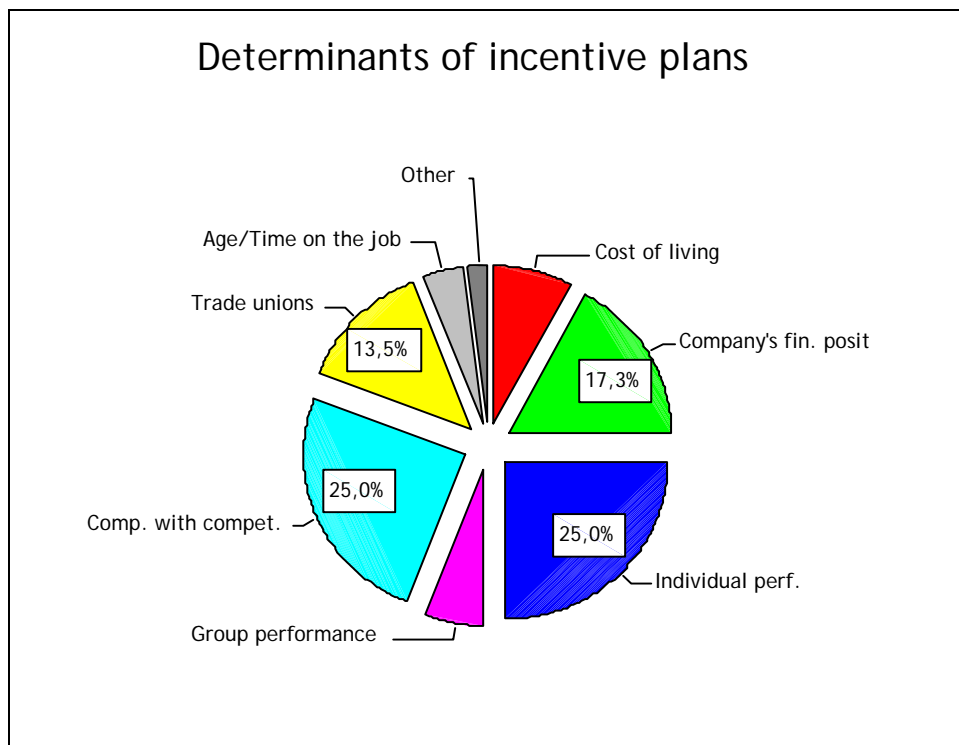
The conclusion of the study is that elements of all four components of the total rewards package are being used within the sector. Motivation is the most important reason for using variable pay among companies that adopt it. What is unclear is whether firms are sufficiently aware of the motivational impacts of two components of the total rewards package, namely learning and development as well as

the work environment. A lack of awareness of this could inadvertently compromise the sector's ability to retain and motivate critical talent. In addition, the focus on using mainly financial performance measures, which are essentially historical, may imply that reward programs are not being oriented enough towards ensuring future long-term financial performance of the firms.

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APPENDIX**Figure 1****Figure 2**

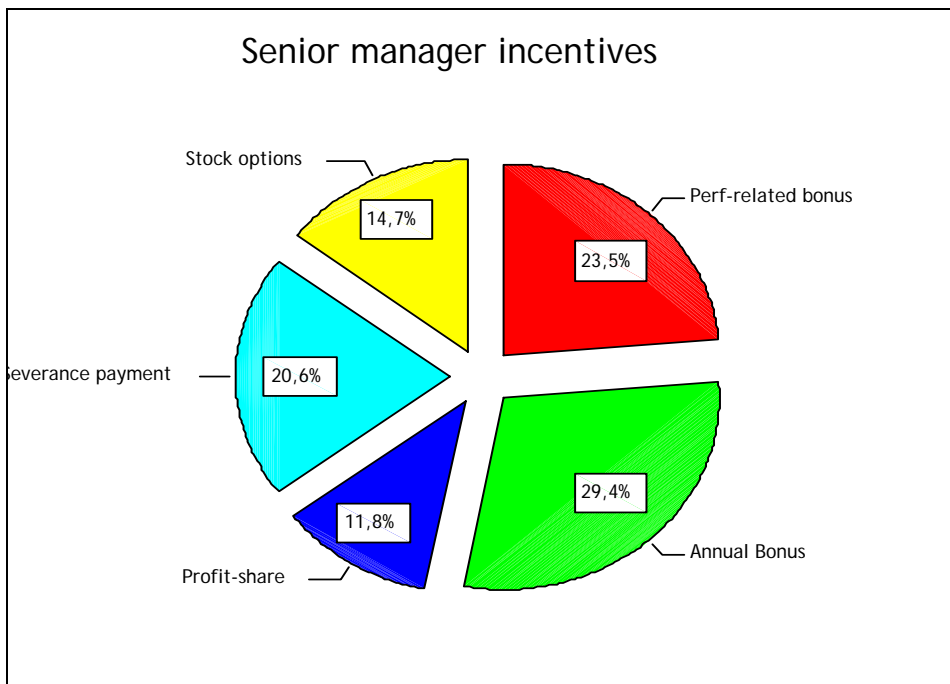


Figure 3

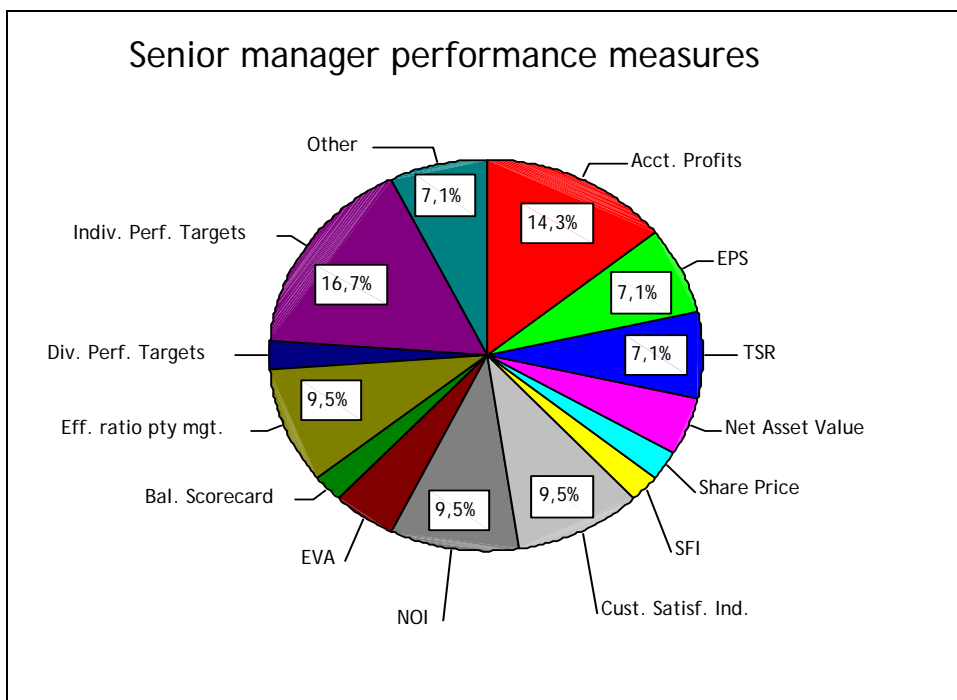


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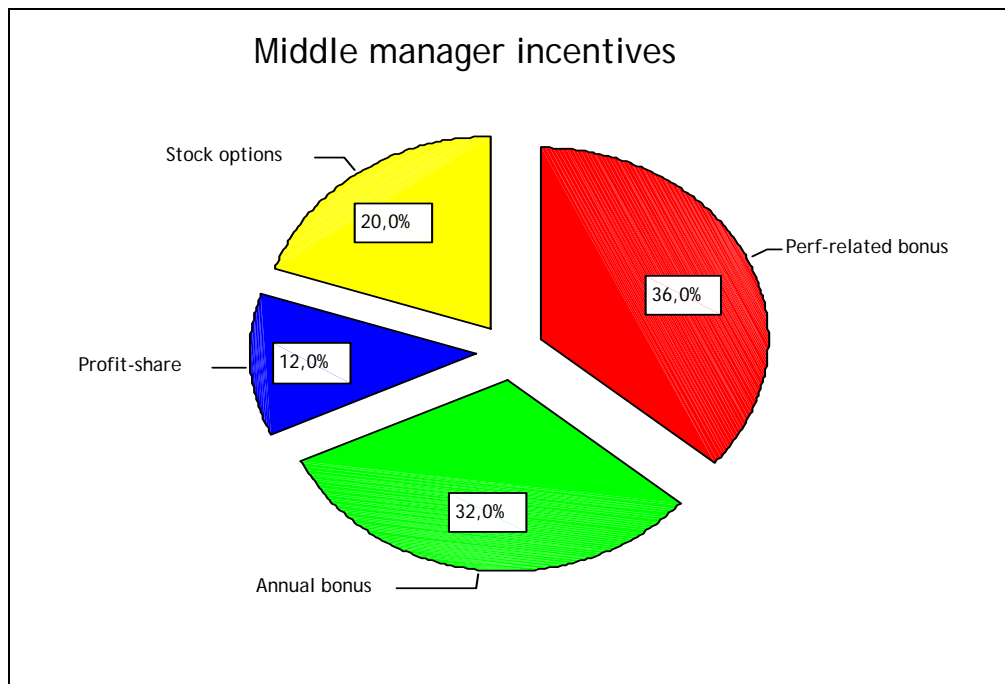


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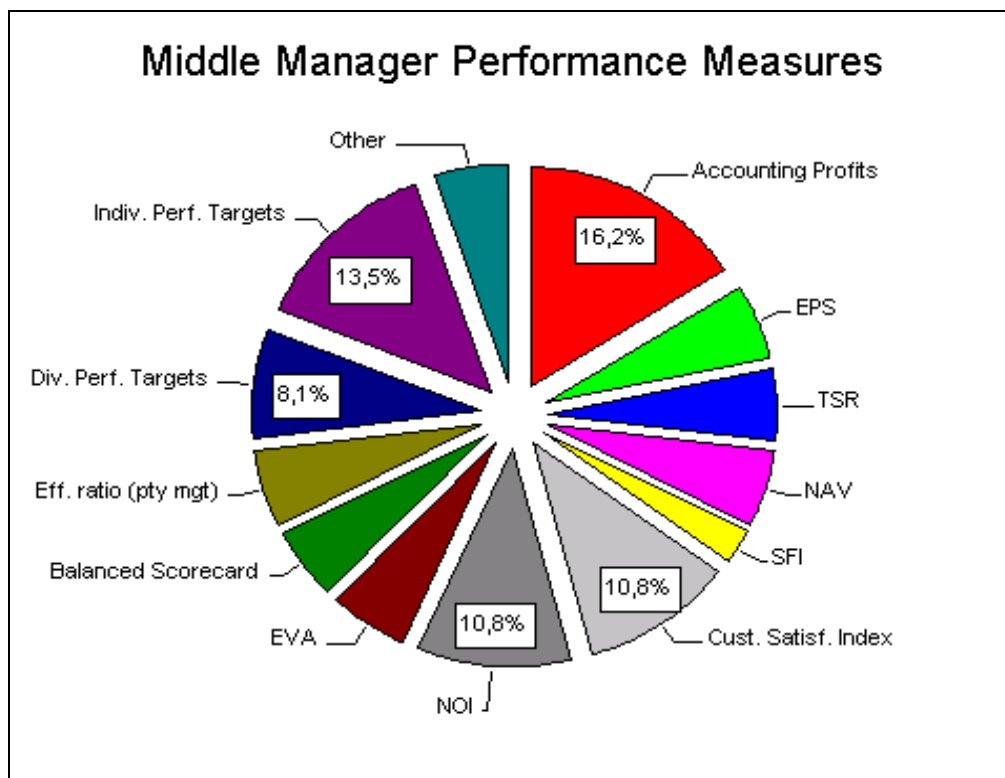


Figure 6

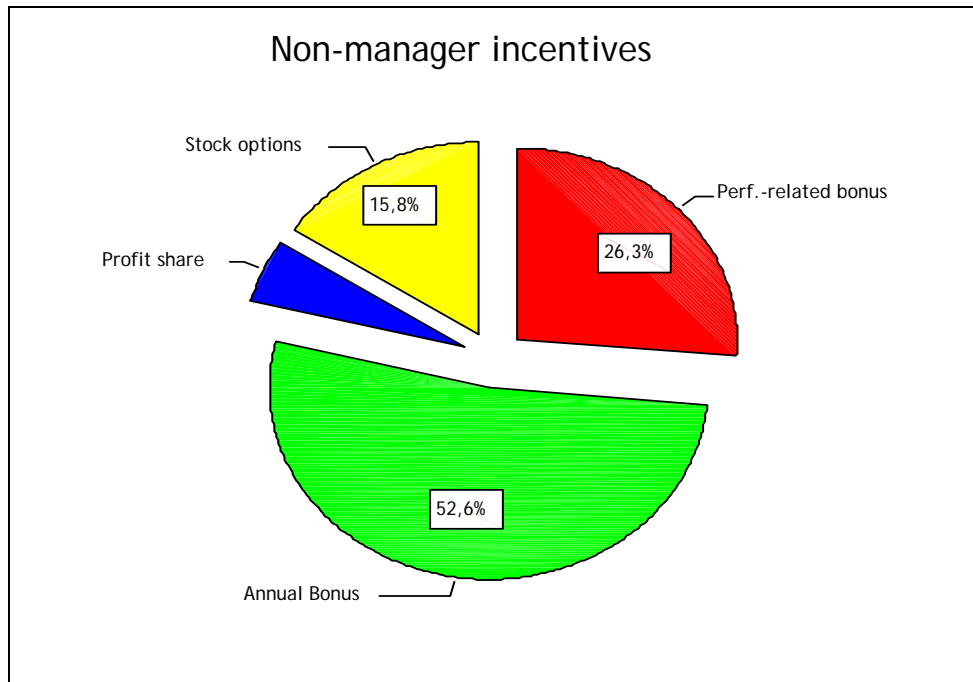


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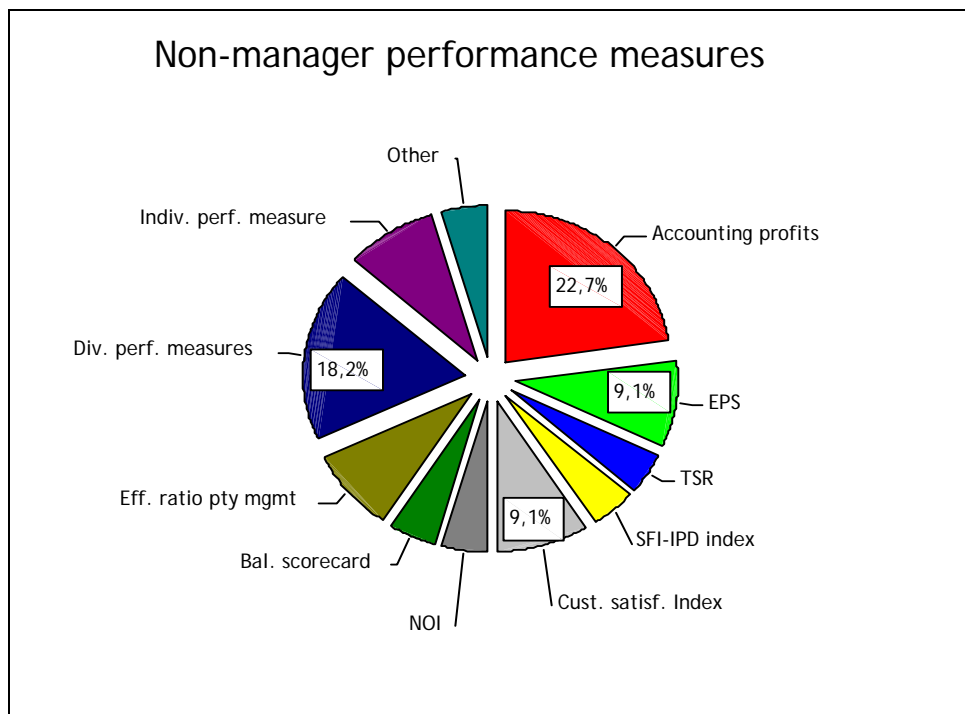


Figure 8

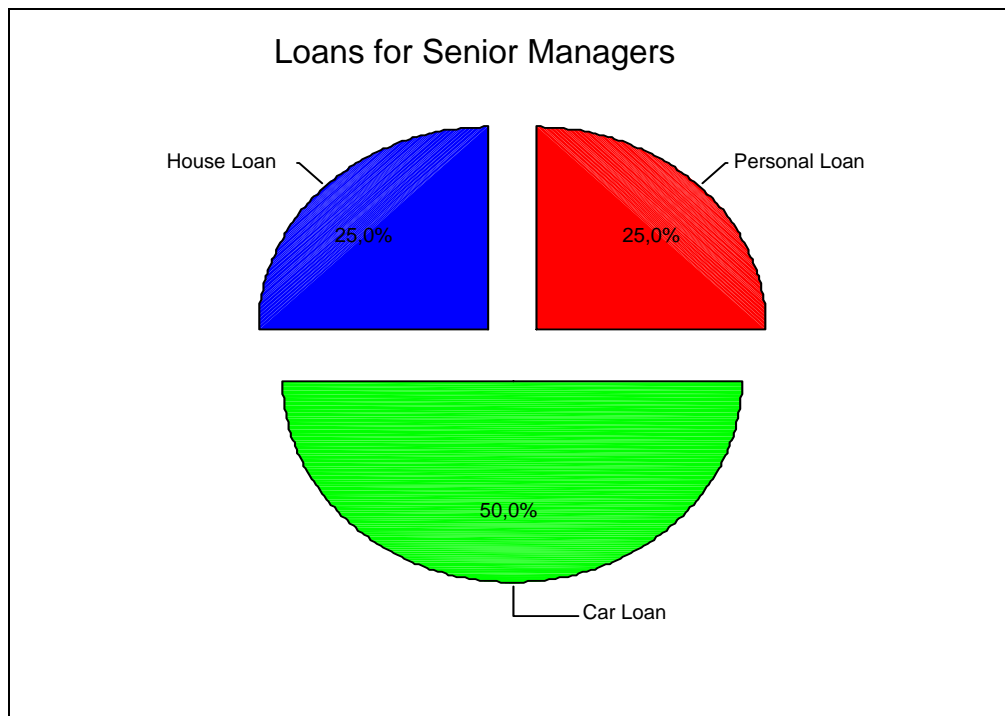


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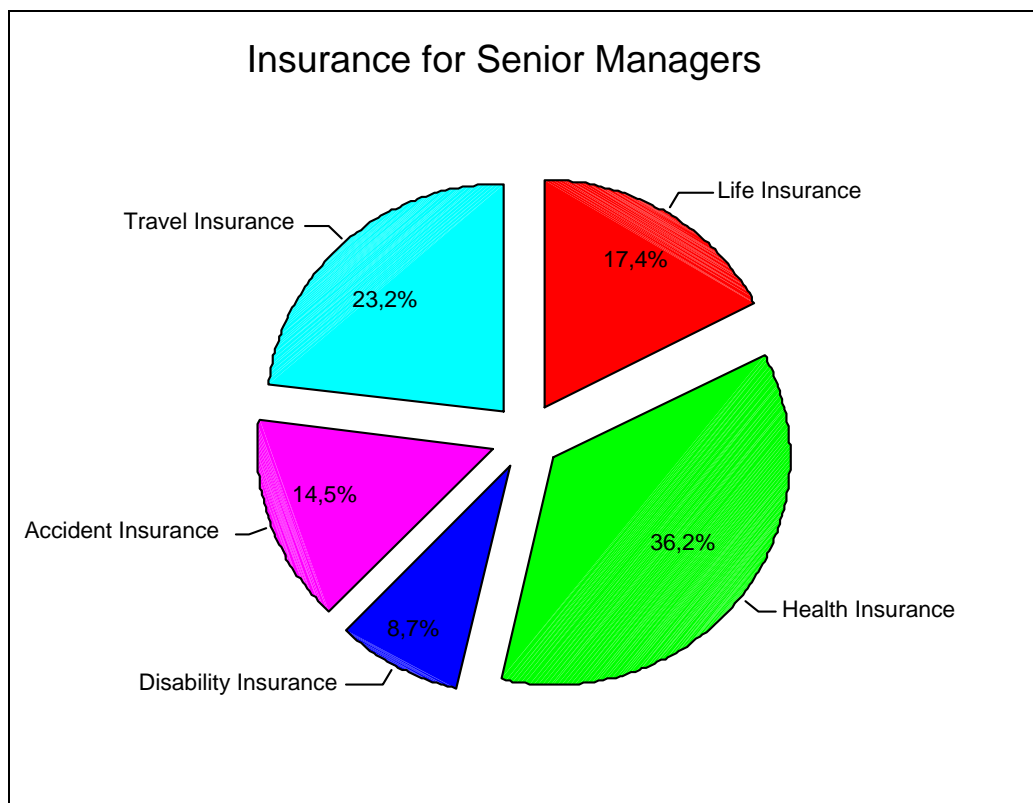


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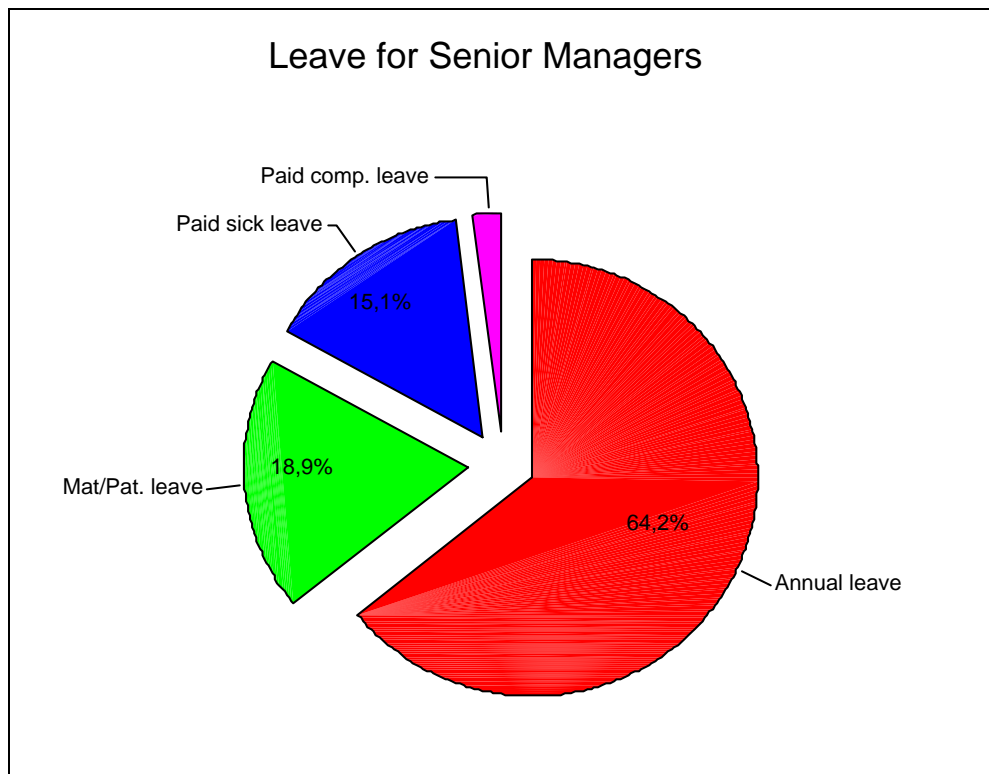


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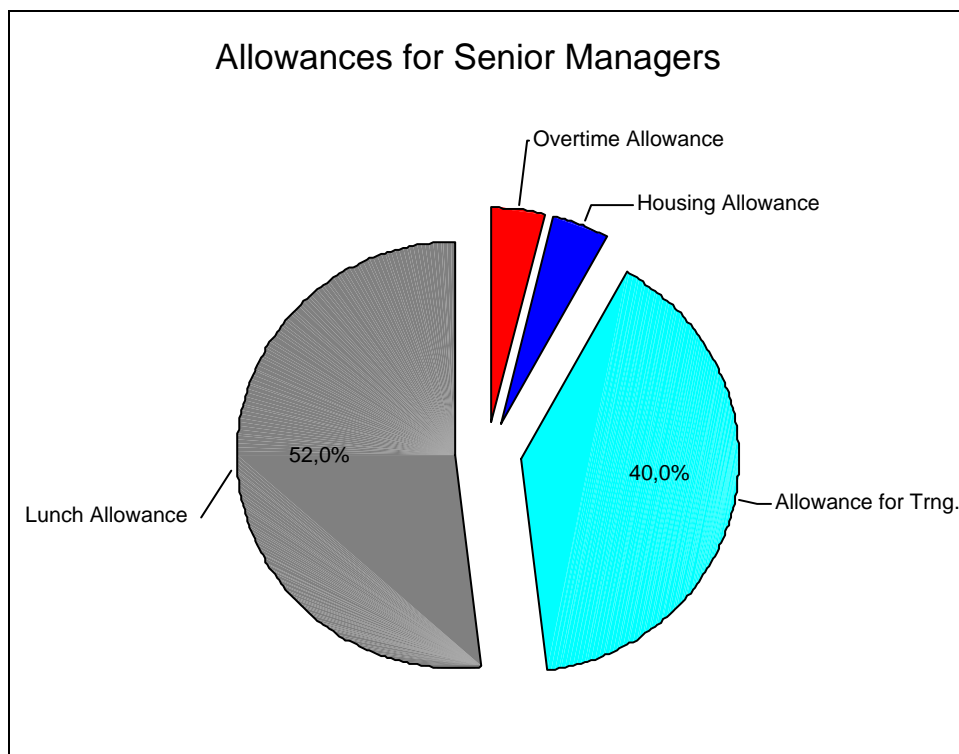


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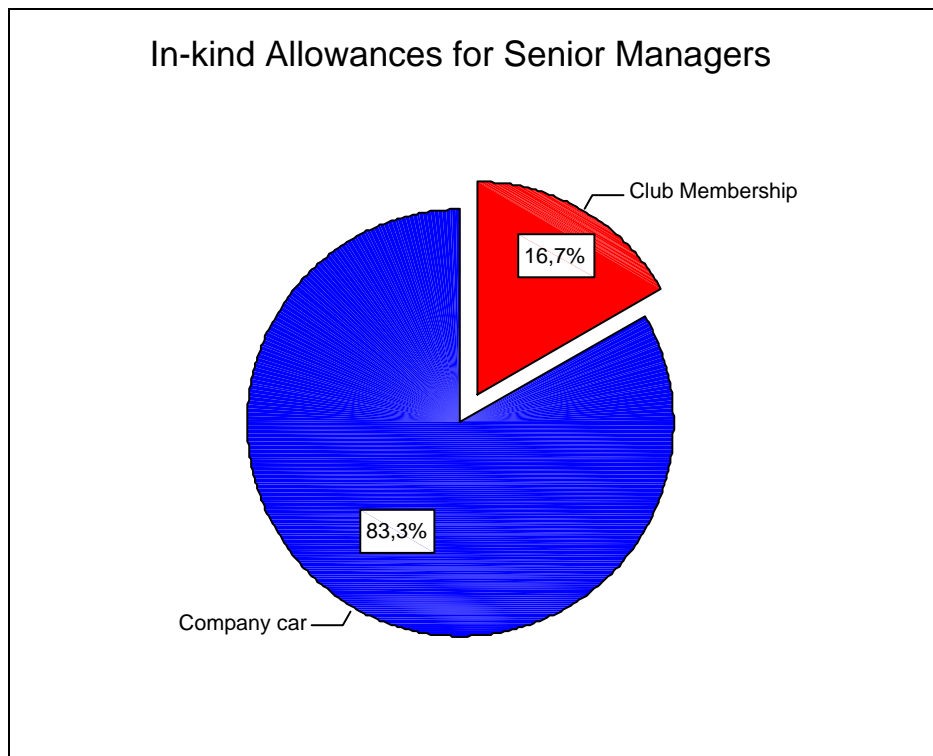


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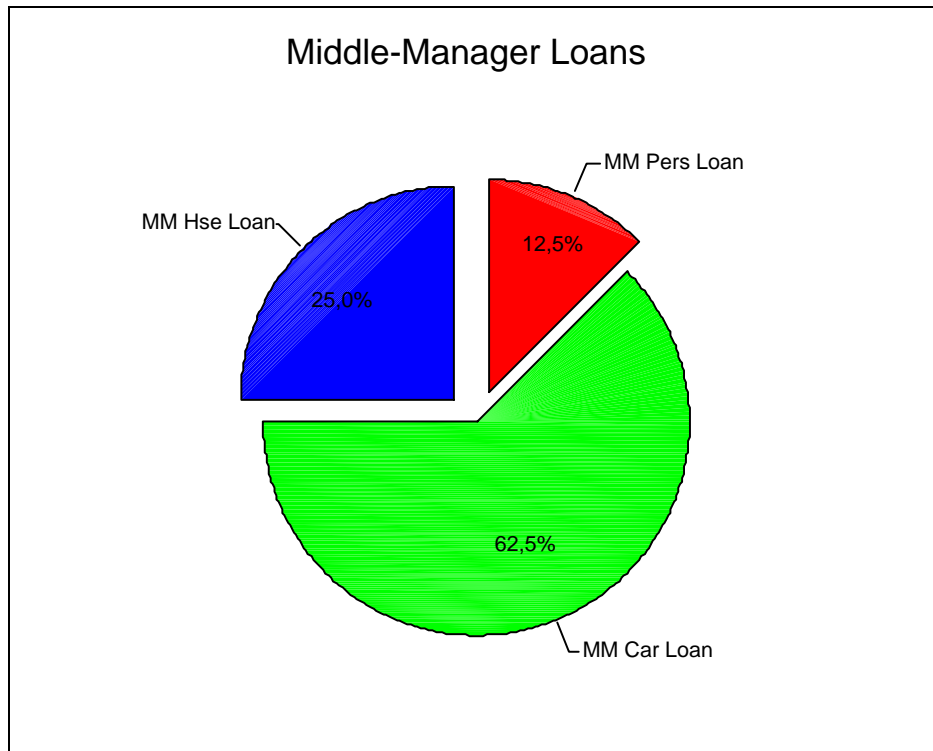


Figure 14

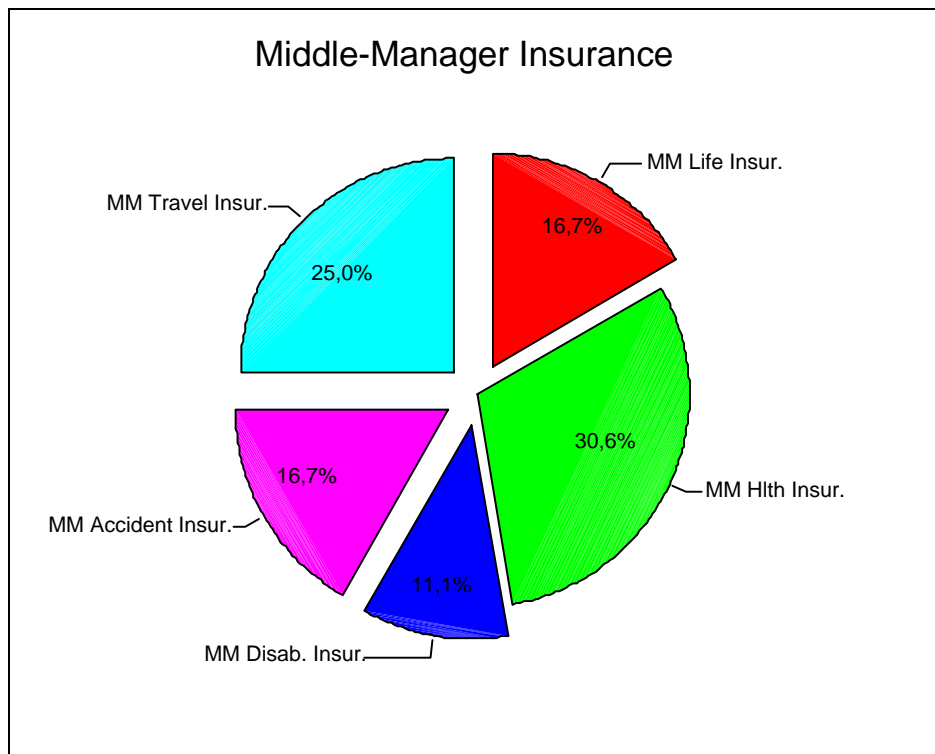


Figure 15

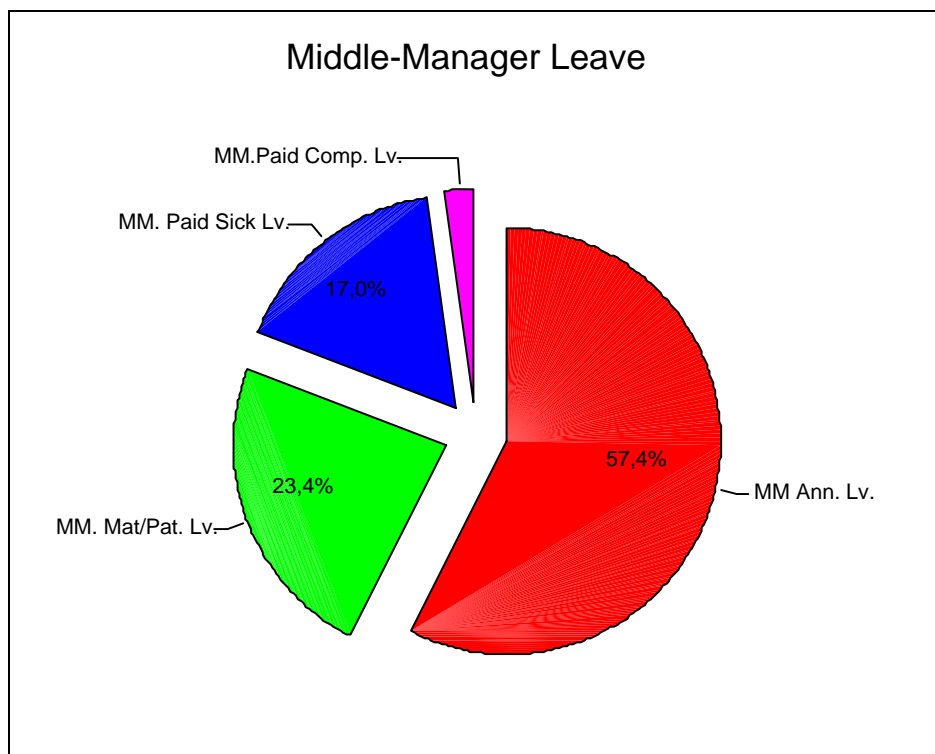


Figure 16

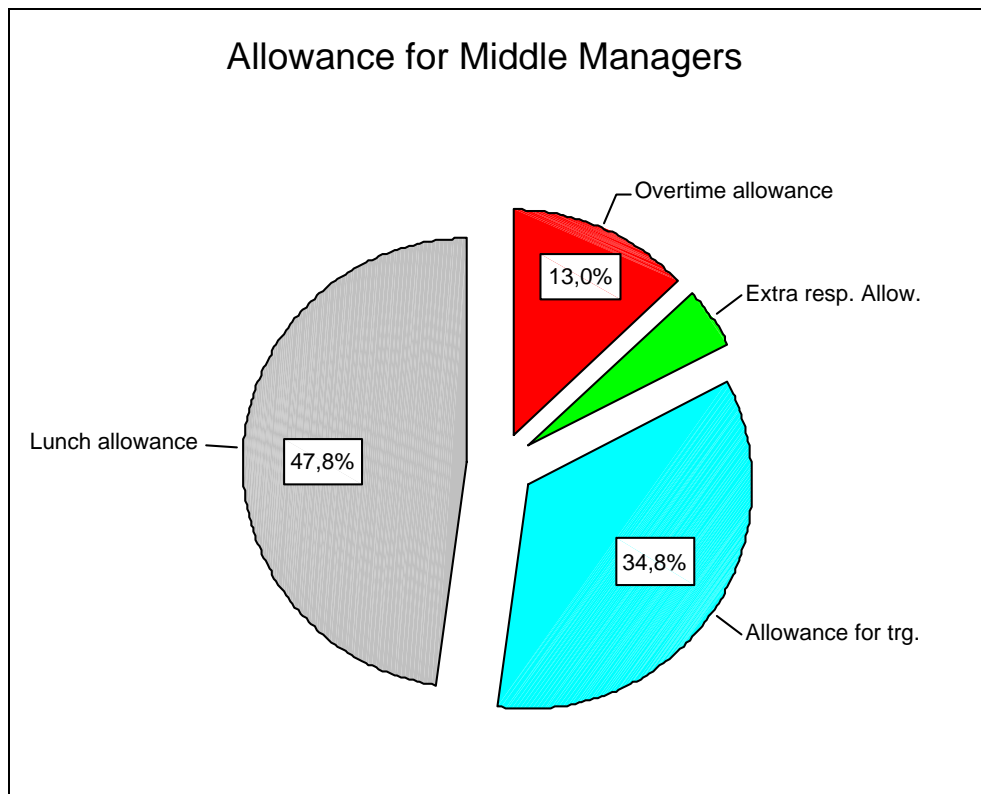


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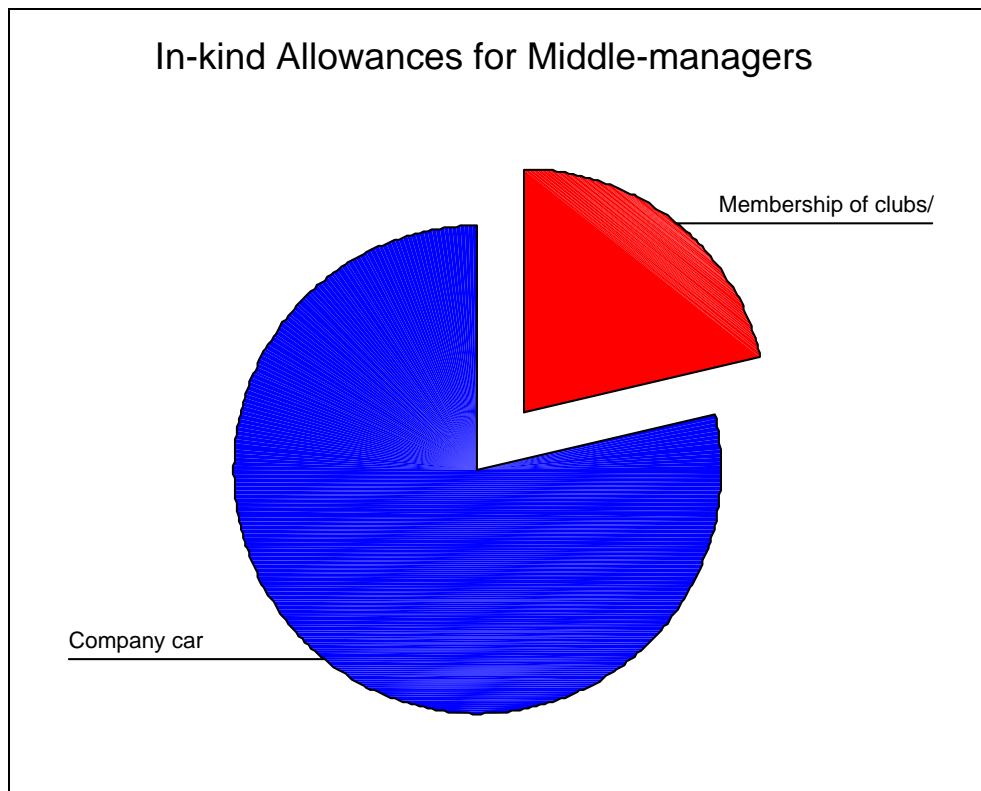


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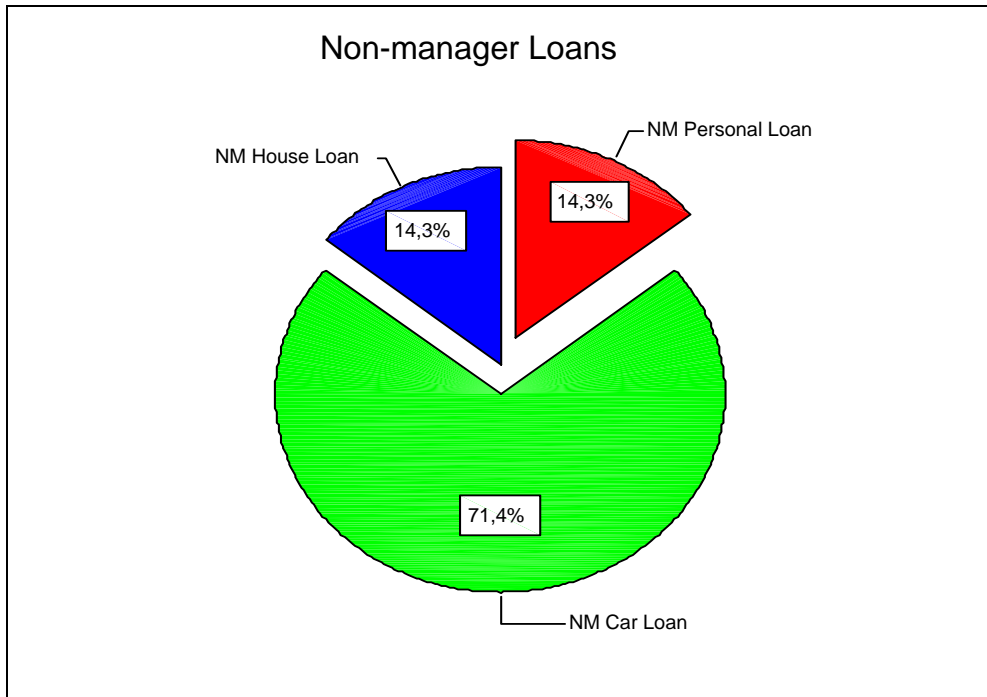


Figure 19

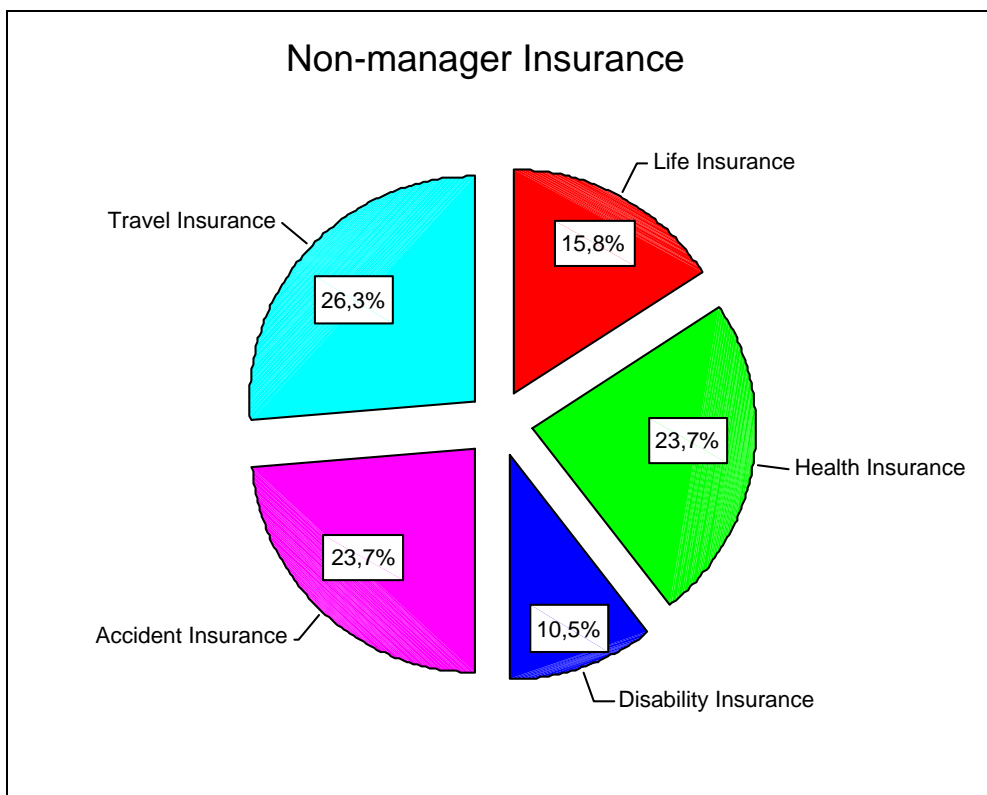


Figure 20

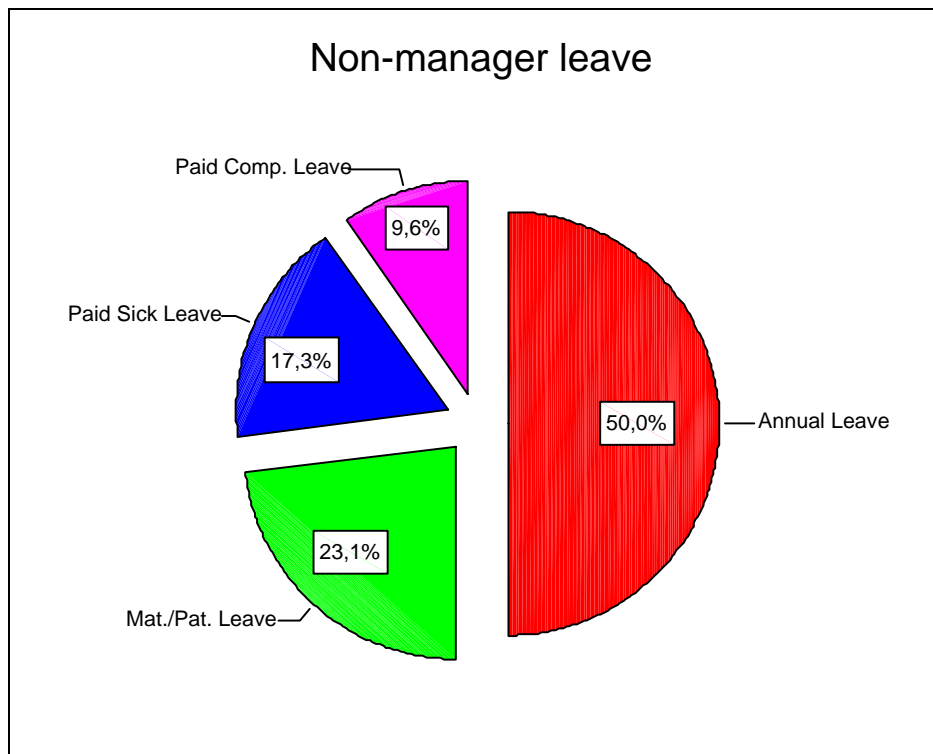


Figure 21

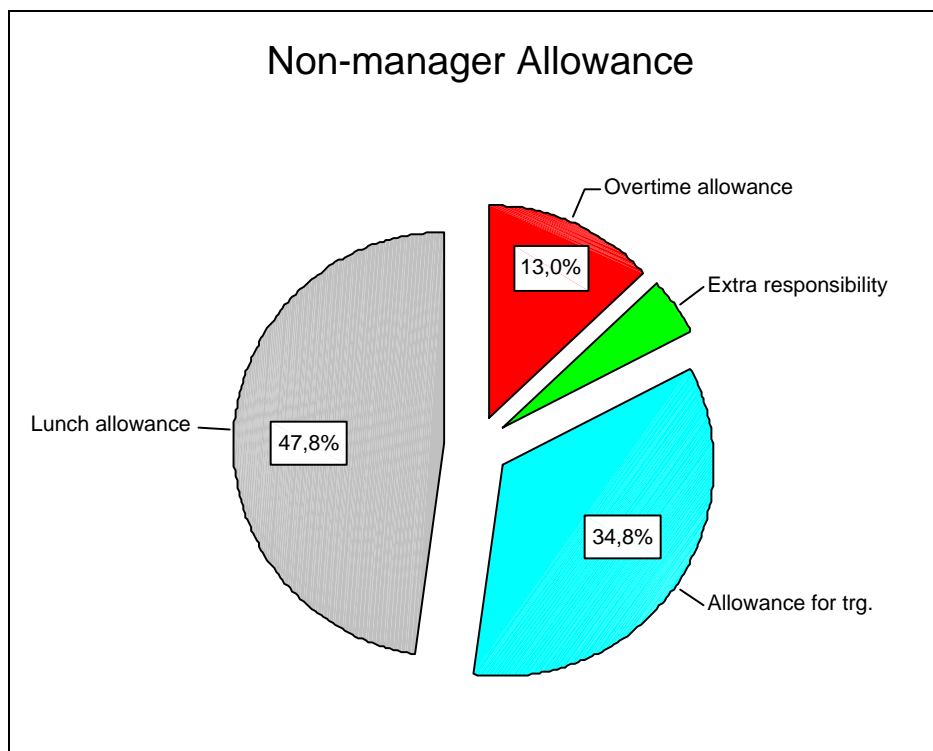


Figure 22

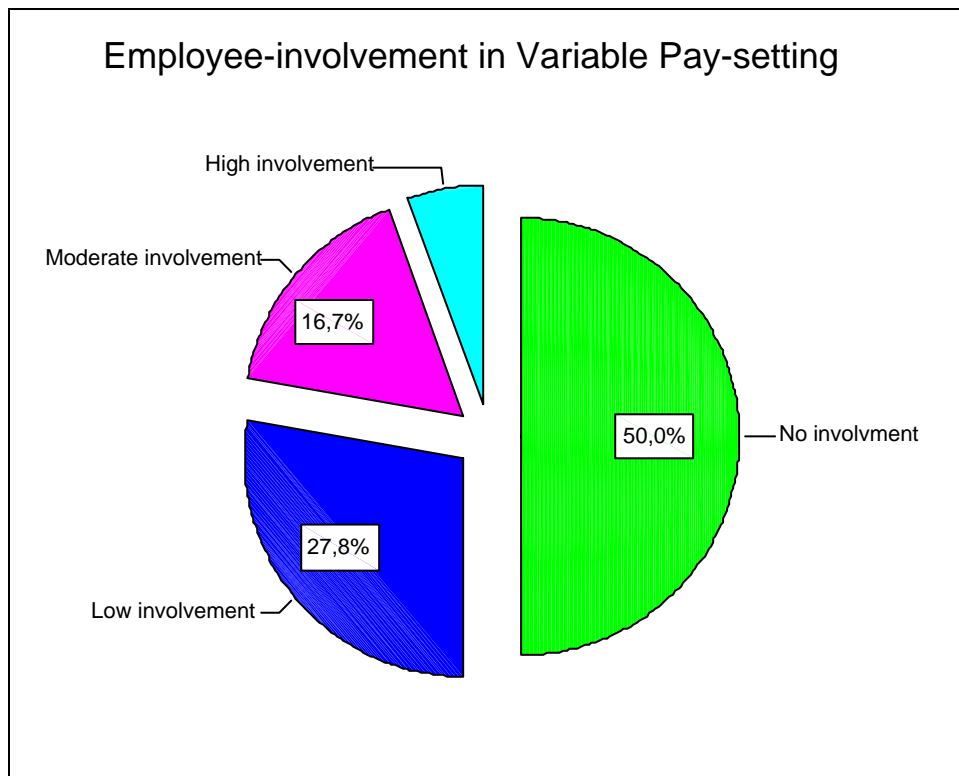


Figure 23



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Does ownership and size matter? Incentive plans within Swedish real estate firms.

SAMUEL AZASU

Stockholm 2003

Working Paper No. 47

Real Estate Economics

KTH: Infrastructure

Royal Institute of Technology



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Does ownership and size matter? Incentive plans within Swedish real estate firms.

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Abstract

This paper examines the use of incentive schemes among real estate firms in Sweden. The investigation was done using a postal questionnaire survey. Extensions of career-concerns theories of motivation suggest differences between the public and private sectors in the use of incentive contracts. The study confirms private sector firms are more likely to use incentive contracts than firms in the public sector. The study also suggests that firms employing a large number of employees are no more likely to use incentives than small firms, contradicting predictions arising from lower average costs of administering incentive contracts for large firms. Even though incentive pay could attract and retain workers, retention may not always be a good idea. Recent research also suggests motivation may require other forms of reward.

Key words: incentive contracts, performance related pay, merit pay.

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The author would like to thank the CEOs of Real Estate Companies across Sweden for participating in the survey. The following people provided material support and very helpful comments: Prof. Stellan Lundström, Assoc. Prof. Hans Lind, Assoc. Prof. Mats Wilhelmsson and Dr Svante Mandell. Financial support for the project came from the Real Estate Academy at KTH.

Introduction

The design and implementation of variable pay schemes within business organizations arouses a lot of interest and controversy among academics, practitioners and the media. However, most of the discussion focuses on senior executives in the United States and mainland Europe, and almost nothing has been done on real estate firms. This paper reports part of a survey of the practice of incentive schemes within real estate firms in Sweden.

The general purpose of this paper is to:

- Identify reasons for using incentive plans,
- Determine any differences in the use of incentive contracts between real estate firms in the private sector and the firms in the public sector,
- Test for the impact of firm size on the likelihood of adopting incentive plans.

Research design

Data for the analysis came from a questionnaire²¹ survey addressed to CEOs of the following firms in the Real Estate Sector:

- Listed companies
- Unlisted companies
- Municipal Housing companies
- Portfolio/Fund Managers and Property Consultants
- Bank/Insurance and Investment Companies

The above classification generates natural strata from which samples could be drawn. The CEOs of all the listed companies and the portfolio/fund managers were covered (since their number was small), while companies from the other strata were sampled. Systematic sampling was used for each of the other group of firms. Eighty-one questionnaires were sent out between January and March 2003. Thirty-nine usable questionnaires were returned, giving a response rate of approximately fifty percent.

As indicated in Table 1, the respondent companies were classified according to whether they were in the public or private sector. Public sector here is taken to mean ownership by government, whether it is national or local government (the municipalities). On the aggregate, a little over sixty percent of the firms are in the private sector, with the remainder belonging to the public sector.

²¹ The decision to use postal questionnaires was driven by practical considerations. Given the spatial distribution of the Municipal Housing Companies in particular, it would have been time consuming and costly to undertake face-to-face interviews. We therefore ran the risk of experiencing a low response rate, typical of postal questionnaire surveys. However, the response rate of approximately fifty percent can be considered adequate for the purposes of analysis.

Table 3. Respondent classification

Company type	Number	Percentage
Public Sector	14	36%
Private Sector	25	64%
Total	39	100%

A more detailed breakdown is done in Table 2. The respondent companies were quite different from each other size-wise. Size here is measured as the number of employees. The mean number of employees is approximately 82.

Table 4. Description of respondent companies

Company type	Number	Percentage of total
Listed Companies	12	30%
Unlisted Companies	8	20%
Municipal Housing Company	14	35%
Portfolio/Fund Managers & Consultants	3	8%
Bank/Insurance/Investment Company	2	5%
Construction Company	1	3%
Total	40	100%

The rest of the paper is organized as follows: the next section is a partial review of the literature on incentive contracts. This is followed by a presentation of the empirical analysis of the survey data and a discussion of the results.

Incentive plans

Incentive plans within business organisations play a number of roles. Delves (1999) and King (2000) identified three reasons for them: recruitment, retention and employee engagement. Lazear (1986), Milgrom and Roberts (1992) also draw attention to their use to keep undesirable workers from joining the firm.

Milgrom and Roberts (1992) classified incentives into incentives for individual performance or group incentives. Another way of looking at incentives is to classify them as merit pay or performance-related pay. Merit pay is a form of variable pay but is based on a subjective assessment of worker performance. The problem with subjective assessments, according to Burgess and Metcalfe (1999), is that they are not verifiable by a third party; thus the evaluator has an incentive to distort the evaluation *ex-post* for private gain, weakening the incentives for employees to work hard.

Performance-related pay (PRP), as the name implies, involves paying the worker an amount that depends on some objective measure of his output. The commonest example is piece-rates, defined as payment for a given amount of output. Lazear (1986) in his model on piece rates, points out that it sorts out more able workers, increasing the average ability of the workforce in firms paying piece rates. However, payment of piece rates entails costs of measuring performance. These fixed measurement costs could be spread over more workers, making it cheaper for large firms to adopt this method of incentive contracting. The piece-rate model thus predicts a positive influence of company size (measured as the number of employees) on the likelihood of PRP.

Performance-related pay can be inappropriate even when accurate performance measures are in place. This is because the worker may become biased towards only those activities that are measurable and rewarded, at the expense of less easy to measure but equally important tasks. Holmstrom and Milgrom (1991) show how difficult implementing incentive pay in multi-tasking situations could be. Burgess and Metcalfe (1999) point out that Holmstrom's model imply that performance-related pay would be inappropriate in public sector firms, given that such jobs involve many difficult to measure tasks. As will be argued later on, Swedish Municipal Housing Companies pursue social welfare and housing policies at the local government level. The effectiveness of their welfare policies may be difficult to measure.

Theories of incentive contracts

One of the principal theoretical models of incentive contracting is agency theory. In a review of agency theory, Eisenhardt (1989) identifies an abstract and mathematical version of agency theory as principal-agent research. This takes the form of a principal-agent model that has wide applicability. The contract is the unit of analysis in the theory. The focus is on finding the optimal contract for a principal and an agent who experience goal conflict, in a situation where the principal cannot verify appropriate behavior by the agent, with the latter being more risk averse. Laffont and Martimot (2002) have made an outstanding exposition of this model.

The two central problems of the agency relationship are information failures resulting from pre-contractual withholding of private information by the agent (adverse selection) and the post-contractual opportunistic behavior by the agent (moral hazard). The introduction of the

concept of moral hazard is credited to Arrow (1963), with the latter's work further extended and relabeled as the 'agency problem' by Wilson (1968) and Ross (1973)²².

The principal-agent model suggests that either investing in information systems, or contracting on the outcomes of the cooperation process (with more risk being passed on to the agent) can solve these problems. The model points to a trade-off between the costs of monitoring and the cost of measuring outcomes and transferring risk to the agent. Thus incentive contracts, with the associated performance-related pay or merit pay, are an attempt to align employee interests with those of the owners of the firm. Some of the application of agency theory to organizations in recent times is credited to the work of Jensen and Meckling (1976), Fama (1980), Fama and Jensen (1983)²³.

A relatively overlooked issue is the motivation generated by career concerns. The model, which explained this link, has been attributed to the work of Holmstrom (1982)²⁴. The essence of this model is that workers are motivated to work hard in order to influence the labor market's beliefs regarding their capabilities. The model establishes a link between wages and expected productivity, which in turn, depends on observed output in previous periods. An implied link is thus created between current output and future wages.

Burgess and Metcalfe (1999) note the following as some of the central conclusions of the career concerns model:

- Career concerns are more effective motivators if output observations are more accurate or if there is more uncertainty about the worker's abilities
- Given that the market's information is believed to be more diffuse for younger workers, they tend to work harder in order to establish a credible track record

A number of extensions to the Holmstrom (1982) model have been made. Drawing on some these extensions especially that of Wilson (1989), Burgess and Metcalfe (1999) have suggested that career concerns may be more important for public officials than financial incentives. They infer from Dixit's (1997) extension to the Holmstrom and Milgrom (1991) model that firms in the public sector are less likely to offer performance-related pay²⁵.

Tournament/relative compensation theory (Lazear and Rosen, 1981) suggests that incentives are created for the worker to exert effort as long as there are wage disparities along the hierarchy of the organization. Workers exert greater effort to qualify for promotions if there are wide disparities between wages at different levels of the hierarchy. Promotions, however, cease to motivate as one reaches the top of the organization; under such circumstances performance related pay must be used. Lazear recommends stock price as an appropriate proxy.

However, recent experience has turned opinions sharply against stock-based compensation (including stock options). According to Martin (2003), stock-based compensation creates incentives for executives to exaggerate expectations about company earnings, which is what drives stock prices. These executives can use their knowledge of the company to cash in on

²² *ibid*

²³ Eisenhardt (1989)

²⁴ See Burgess and Metcalfe (1999) for a review of this model.

²⁵ One of the propositions to be tested in this paper is whether there are any such differences in the use of incentive contracts between public and private sector real estate firms in Sweden.

their rewards before earning expectations, and hence stock prices, fall. He therefore suggested that executive reward be instead based on real earnings growth.

The next section explores the results of the study. It tests one of the implications of career concerns model, namely if ownership of the firms affects their use of incentive contracts. It also tests for the impact of firm size on the likelihood of using incentive contracts, one of the issues arising from the piece-rate model.

Empirical analyses

This section presents some of the results of the survey. An initial analysis of the survey focuses on the motives for and factors determining the use of incentive plans.

The most frequently cited reason for the use of incentive plans is motivation. Staff retention is also important even though recruitment is not that important. This is shown in Figure 1. It must be pointed out that respondents usually cited more than one motive for using incentive plans. A related issue is what determines whether companies actually implement these plans. According to the respondents, the most important determinants are the individual worker's performance as well as what happens in other companies. Slightly less important reasons are the companies' financial position as well as union pressure (Figure 2).

Public and private firms' use of incentives

Three hypotheses were tested using chi-square tests and logistic regression. This was to test for differences in the probability of the use of incentive contracts between real estate firms in the private sector and their public sector counterparts, which are mainly Municipal Housing Companies. The test also explored the impact of firm size on the probability of using incentive contracts. The hypotheses are as follows:

Hypothesis 1: There is no significant association between the legal status of the company and whether or not they implemented incentive plans.

Hypothesis 2: Private sector firms are no more likely to implement incentive plans than public sector firms.

Hypothesis 3: Large firms are no more likely to implement incentive plans than small firms.

The first hypothesis was tested using the data in a contingency table (Table 5). The null hypothesis of independence between the legal status of the firms (i.e. whether they belonged to the public or private sector) and the use of incentive plans was tested against the alternative – which hypothesizes an association between the two categorical variables. The test statistic was the chi-square variable²⁶. The null hypothesis was rejected.

The second and third hypotheses were tested using logistic regression. The results are presented in table 5. Three models are presented; the dependent variable in each is whether the firms surveyed have incentive schemes (PRP=1 if they have incentive schemes, 0 otherwise). The first model includes only status as the explanatory variable (status=1 if the

²⁶ A more precise test is the Fisher's Exact Test, given that one of the cells contains less than 5 observations. The result of that test reaches the same conclusion.

firm is in the private sector and 0 if the firm is in the public sector)²⁷. The second model includes only size (measured as the number of employees) as the explanatory variable²⁸ and the third model includes both status and size as explanatory variables²⁹. The third model includes both size and legal status as explanatory variables.

In model 1, the coefficient of the status variable is significant. The combined model (model 3) shows only a slight reduction in the odds of using incentive contracts due to the status variable changing from 0 to 1. We can thus conclude that as the status of the firm changes from 0 to 1 and the values of the size variable remaining constant, the odds of a firm having incentive contracts increases by a factor of almost 6. In other words, private firms are six times more likely to use incentive contracts than public firms. The second hypothesis was rejected.

In model 2, the size variable is significant at 90% but shows there is a 50-50 chance of incentive contracts being used if size increases by one employee. On the basis of that the third hypothesis could not be rejected. The odds impact of the size variable remains largely the same as before, again confirming the lack of sufficient evidence to reject hypothesis three. However the status variable being significant confirms the rejection of hypothesis two.

Analysis of results

Even though employee motivation has been the most frequently cited reason for adopting incentive plans, it appears there is industry-wide recognition that incentive plans have a role to play in recruitment and staff retention. However, Lazear (1999) has argued that staff retention may not always be efficient, especially when the value of a worker's outside opportunities exceed his value within the firm; in that case everyone will be better off negotiating an exit for the worker. He recommends using incentives for retention only when the firm has made unique investments in the worker or that the worker has talents that are of unique value to the firm. Outside of this, Lazear (1999) argues that it is enough to pay workers exactly their marginal products to induce appropriate turnover behavior.

From the first two hypothesis tests, we can infer that ownership does determine whether the firms use incentive plans or not, and private companies are more likely to use incentive contracts than public companies. These results agree very much with some of the earlier works on the subject. Holmstrom and Milgrom's work in 1991 imply that public sector firms with multiple objectives, some of which are difficult to measure, should be less likely to use incentive contracts. As noted by Burgess and Metcalfe (1999), the output of a public sector employee is typically difficult to measure. They point to how inappropriate it would be to use incentive contracts, given the results of Milgrom and Holmstrom's multi-tasking model.

In addition to the above, they refer to the work of Dixit (1997) in describing public agencies as agents with multiple principals, each of whom has different objectives. Given that these principals are not colluding, using incentive contracts will be extremely costly, relative to the case where they actually collude. The municipalities own the municipal housing companies in

²⁷ The tested model is given as $\log_e\left(\frac{P}{1-p}\right) = \beta_0 + \beta_1 STATUS + \varepsilon_i$

²⁸ Model 2 is $\log_e\left(\frac{P}{1-p}\right) = \beta_0 + \beta_1 SIZE + \varepsilon_i$

²⁹ That is $\log_e\left(\frac{P}{1-p}\right) = \beta_0 + \beta_1 STATUS + \beta_2 SIZE + \varepsilon_i$

Sweden. They are typically non-profit organizations, forming an integral part of both the social welfare policy and housing policy. Current housing policy is focused on giving everybody a good home, at a reasonable price (Swedish Institute, 2000). The interaction of this policy with welfare policy and their attainment by the municipal housing companies will be complex and difficult to measure. Contracting on these outcomes will be difficult. It is thus not surprising that we find differences in the likelihood of the use of incentive contracts between the private and public sector firms.

A most logical question then, is whether municipal housing companies will have problems with recruiting, keeping and motivating good workers. Career concerns models suggest that this need not be the case. These companies can still provide challenging work environments especially for people in the early stages of their career³⁰ and eager to establish a credible track record for bigger and more lucrative careers later on. In addition, recent research suggests private sector firms are not necessarily at an advantage with the use of incentive plans.

Attractive pay packages are essential in attracting and retaining good workers (Towers and Perrin, 2001 and 2003). However, motivating these employees requires the presence of different factors, the most important being:

- Senior management interest in employee well being
- Challenging work
- Decision-making authority
- Customer orientation, and
- Career advancement opportunities

Even though this is the result of a study in North America, its lessons could provide a pointer to the real estate industry in Sweden and highlight the need to look beyond incentive pay as drivers of employee performance.

One the other hand one can also argue that the degree of risk aversion may have a differential impact on the type of workers that go into either sector of the industry. Thus, differing degrees of risk aversion may lead to a situation of self-selection among workers. One can speculate that risk averse workers would prefer working with the Municipal Housing Companies where jobs would be relatively safer, and remuneration not so tied to performance, whereas risk lovers would prefer working for private companies given their preference for performance related pay, everything else equal between the two sectors.

The implication is that it could become even more expensive to implement incentive schemes within public sector firms given that it would require even more compensation to motivate such risk-averse workers to take risks and innovate. Private sector firms might also find themselves having to work harder to retain their relatively risk loving workers. There is the added limitation that free-riding may occur with group incentive contracts, while cooperation may be weak in firms that emphasize differences in reward across the firm depending on individual performance.

Recent research on the limitations of incentive plans would suggest that both sectors can limit the adverse effects of the presence or absence of incentive contracts if they implement what is called ‘complementary human resource practices’: employee training, hiring criteria that

³⁰ This will probably be tested in subsequent studies.

screens out free riders or people without good team skills³¹, establishment of a team culture, job design and employee hierarchies. These not only limit the negative impacts of using incentive pay but also strengthen their productivity impacts (Ichniowsky and Shaw, 2003).

Concerning hypothesis three, we find that size has a limited impact on the likelihood of using incentive contracts. Conventional wisdom on the issue is that larger firms should be more likely to use incentive contracts than smaller firms, given the lower average costs of performance monitoring with the larger firms. The data in this study did not confirm this conclusion. There may be an interaction between the legal status variable and the size variables, given that municipal housing companies are typically small companies in terms of employee numbers³². The test for this was inconclusive so the null hypothesis could not be rejected.

A look at the determinants of incentive contract use shows that firms match their competitors in using incentive contracting in order to avoid losing their workers to their competitors. This may be especially so if they have relatively unsophisticated incentive schemes, with moderate administration costs. Under such circumstances, small firms should be just as likely as large firms to use incentive contracts. The service nature of real estate firms suggests that they will use merit pay rather than performance related pay. This would then obviate an elaborate performance measurement system. The likelihood would then be of a prevalence of team performance measures and annual bonuses, especially for non-managers. This may be a reason hypothesis three could not be rejected. As already pointed out, using incentive contracts for staff retention may not always be a good idea if workers do not have skills specific to the firm and/or if their value outside the firm is higher.

Conclusion

This paper sought to discuss part of the results of a Swedish real estate sector survey, namely the role of incentive plans in the people management practices of the firms. Motivation is the most important reason for using variable pay, even though their recruitment and retention role has been recognized. What is unclear is whether incentives can actually motivate workers in this particular context. Using incentive plans to retain workers may also not always be efficient, especially if the firm-worker relationship is not characterized by specificities. Private firms are more likely to use variable pay than firms owned by government. This does not necessarily put the latter at a disadvantage if they recognize and take advantage of the motivation role of non-monetary factors in the workplace. In the same vein, one cannot conclude that firms that use variable pay are better at motivating their employees, if they do not complement this with supportive human resource management practices. Firm size does not appear to be a good predictor of the likelihood of a firm's use of incentive contracts, possibly due to the desire by small firms to match large firms' use of such contracts.

³¹ This calls for extremely strong interviewing skills on the part of the human resource departments as well as other concerned senior managers in the respective firms.

³² The correlation between the two variables was actually low (22%) and insignificant.

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Appendix

Table 5. Chi-square test of independence between legal status and PRP use

	No PRP	PRP	Total
Public Sector	11	3	14
Private Sector	8	17	25
Total	19	20	39

Degrees of freedom: 1

Chi-square = 7.79090977443609

p is less than or equal to 0.01.

The distribution is significant.

Table 6. Logistic regression results

Variable	Model 1		Model 2		Combined Model		
	Coefficient	Wald	Coefficient	Wald	Coefficient	Wald	Exp B
Constant	-1,30	3,98	-0,68	1,85	-1,69	4,92	0,18
Status	2,05	6,93	-	-	1,72	4,33	5,56
Size	-	-	0,01	2,78	0,01	1,79	1,01
Model Chi-square	8,15	-	4,42	-	9,25	-	-
% Correct Predictions	71,79	-	61,76	-	70,59	-	-

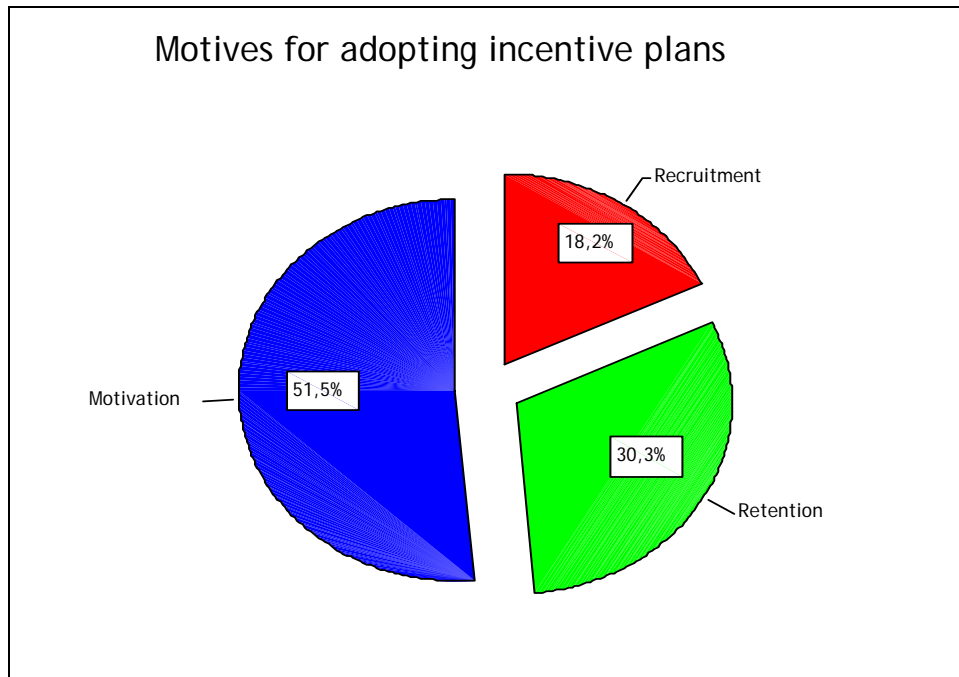


Figure 1

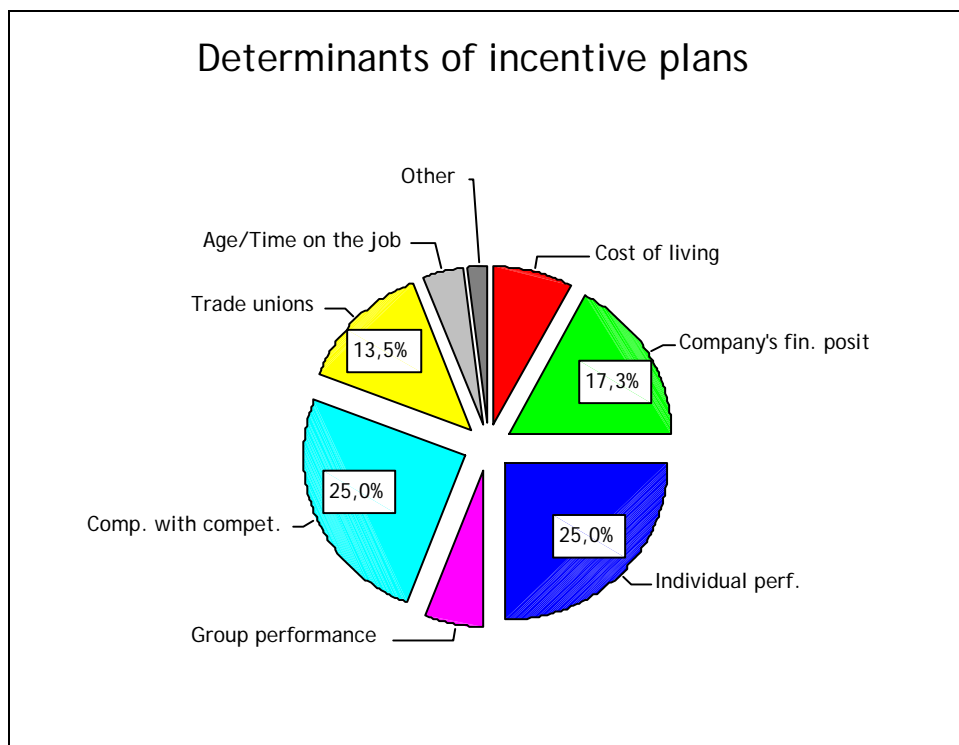


Figure 2

