# Corporate Incentives for Managers in American Industry, 1900-1940

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George W. Perkins, who represented J.P. Morgan on the boards of United States Steel and other turn-of-the-century mergers, naturally had a high regard for financiers' role in improving American industry. Yet his experience in industrial organization convinced him by 1912 that "the principal problems" he faced were those "of men rather than of money." Many historians would readily agree with this judgment. Most accounts of the rise of big business focus on how companies developed structures of management; financial advances are at best a proximate or secondary cause [1]. Yet personnel policies to motivate managers, one of Perkins' great concerns, have received little attention.

Personnel policies are particularly interesting in light of the current wave of corporate reforms, aimed at reversing decades of policies that gave managers' job security, generous pay, and extensive promotional opportunities [2]. These changes have provoked a debate among economists over how companies can best motivate their managerial employees. Two schools of thought have emerged, and their theories can be applied to the growth of large corporations in the first four decades of the twentieth century.

One school, influenced by neo-classical theory, treats the owners of companies as the "principals" and the employees as their "agents" [4]. Companies should work for the interest of the principals, so the principals need to insure that the agents are working toward this goal rather than for their own interests. Corporate owners do this by setting up plans to reward employees for performance that benefits the owners. According to this school, the best plans mimic the market in remunerating individual agents according to the level of their good performance -- these include bonus, stock-ownership and promotional plans. Like markets, these plans discipline agents into behaving in ways that maximize overall economic welfare. Agents with declining compensation have a powerful incentive to adopt alternative courses of action.

Another school, following organizational theory, sees the firm as a social institution without any principals [3]. The members of the firm succeed the most when they commit themselves to the long-run strength of the firm. This

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commitment, organizational theorists argue, leads to mutual trust among all the members: those who provide capital, those who manage, and those who carry out the orders on the floor. Performance-based incentives, especially for individuals, tend to sow divisiveness among the members of the firm. Personnel policies should instead emphasize rewards for loyalty to the organization -- with plans based more on length of service than exceptional performance. Loyal members give corporations the capability to overcome crises because they are willing to sacrifice for the short run.

The leaders of large manufacturing companies in the United States faced these issues in the aftermath of the great wave of mergers around 1900. Within ten years, Morgan and other financiers had combined almost two thousand small, typically owner-managed firms into two hundred combinations. Most of these owners were happy to sell out and retire, and their heirs rarely had much interest in management. Merger promoters usually had to install hired managers to run their new corporations, managers who owned insignificant shares of stock.

In the years before World War I, financiers and other corporate leaders showed a good deal of interest in the attitudes of these hired managers. Yet few adopted compensation plans that linked managers' pay with performance. Contemporary surveys of pay practices indicate that bonus plans were rare before the war, in perhaps a fifth of large firms, and academic observers also noted the absence of these plans. Instead, corporate decision-makers concentrated on making their organizations agreeable to the recruits they needed to staff their creations. Mergers in industry and retail stores were eliminating traditional opportunities for middle-class men to maintain their independence. Young men wrote to newspapers complaining that the "trusts" were forcing them to depend on plutocrats for a living. To counteract these fears of "dependence," moral and economic, corporate leaders proclaimed that their positions of responsibility went not to the stockholders' relatives but to the men who showed ability in rising from the ranks. Managers at different levels also had a great deal of autonomy in carrying out their duties.

These promotional hierarchies did not reward good performance only. In this era of nativism, companies routinely discriminated against ethnic minorities as well as women, whatever their qualifications. A growing collar line divided skilled manual workers from office and other white-collar workers [5]. By the 1920s, many corporations would divide recruits into two groups, reserving management positions only to those who had attended college. Selective promotions reassured anxious young men concerned about being lumped with groups of lower status.

This early strategy of winning managers' commitment to the corporation can be seen clearly in the policies of the United States Steel Corporation, the largest of the industrial mergers. J. P. Morgan had organized U. S. Steel to end the instability created by Carnegie Steel and other aggressive competitors. His zeal for cooperation extended to personnel policies as well. George Perkins convinced the rest of U. S. Steel's board to recast the bonus plan that Andrew Carnegie had set for his company. (Perkins had considered dropping this bonus plan entirely, but managers at other subsidiaries had heard of the Carnegie policy and had begun clamoring for one as well.) In order to motivate his managers, Carnegie had given sizable rewards to those with excellent individual performances, and several eventually became millionaires. Perkins' bonus plan amounted in practice to small gifts for nearly all managers. Managers typically received their bonuses in proportion to their salaries; the level of bonuses varied only with the corporation's

overall profitability. Because a manager usually received his annual bonus over a period of a few years, the plan did discourage some turnover. Much of the plan's value probably came from its symbolism, as Perkins tried to convince the managers of the corporation's many subsidiaries to work together. Yet Perkins' strategy failed to take root, as the corporation remained largely unintegrated until it was reorganized in the 1930s.

The pre-war record suggests that most companies stressed the sort of employee commitment now emphasized by the organizational school. But corporate policies shifted after the war, particularly at the executive level. (Policies for middle managers, for which evidence is scarce, may not have changed much.) By 1929, two-thirds of 100 largest manufacturing companies gave their president and vice-presidents both salaries and performance-based compensation. Academics and other observers in the 1920s applauded the rapid spread of bonus plans.

Companies adopted the bonus plans partly to encourage the growing practice of committee management. Where before a president or executive had administered his company or department largely on his own, now executives made decisions after deliberations with fellow managers. Most bonus plans resembled U. S. Steel's in rewarding executives according to the overall profitability of the corporation. These plans encouraged managers to look beyond their own area of responsibility and cooperate in making the firm succeed as a whole.

Yet most commentators and participants stressed a different reason for the popularity of bonuses. By the 1920s, Morgan and other financiers had generally stopped supervising their merged companies. Their hired managers had succeeded in issuing regular dividends and maintaining share prices. Postwar prosperity and the savings of the middle class (first prompted by wartime bonds) also greatly boosted the availability of capital for industrial investment. At the same time, most large firms were building up their managerial ranks to improve the coordination of their diverse operations. By the 1920s, observers spoke of a shortage of executive talent relative to capital.

Top managers made the most of their bargaining position. They found themselves largely free from the dictates of stock and bondholders -- they could now "hire capital" rather than be hired by "owners." While mere employees in a legal sense, they increasingly saw themselves as the newest generation of leading entrepreneurs -- and they began to claim entrepreneurial rewards. John Raskob, an executive at General Motors, argued that companies would need to pay bonuses to keep able managers from going elsewhere. Economists agreed: before the 1920s they had held that all profits should go to the legal owners, but now many contended that managers deserved a share of the earnings. The bull market on Wall Street gave a special boost to bonus plans involving shares of stock. George T. Washington, a lawyer who advised several corporations on executive compensation in these years, noted that even stockholders who maintained effective voting control over their firms usually recognized executives' power. These investors were generally willing to cede a share of profits to the ambitions of hired executives with scarce talent.

While bonus plans did tie executive compensation to performance, their popularity does not reflect corporate leaders' belated worries about employee performance. A contemporary study of corporate profit-sharing in the late 1920s compared total compensation for executives at large firms with and without bonuses. If bonuses acted as carrots, then companies with bonuses should have

reduced executive salaries by an amount close to the size of the average expected bonus. But salaries for executives at bonus firms were only slightly lower than salaries at firms without bonuses. In practice, bonuses were largely a gift on top of already substantial salaries. Indeed, crude evidence suggests that total executive compensation was more than twice as high in the late 1920s as it was in the ten years before the war. The executive ranks even became something of an exclusive preserve, as many companies also set up special executive track training programs. These programs took the most promising college graduates and preferred them for positions leading to the top.

Bethlehem Steel, which paid the largest bonuses in industry, was a variant on this phenomenon. The dozen members of its executive committee received a percentage of corporate profits before depreciation. In the 1920s, these executives acquired several rival steel companies, greatly expanding the earnings basis for the bonus. Their bonus correspondingly increased, to the point where the president received an average of $800,000 annual compensation in the decade -- even though Bethlehem's profitability was average for its maturing industry. The bonus plan essentially rewarded executives for empire-building. These developments took place as the company's only large stockholder was selling out of the company.

The Great Depression put an end to most corporate bonus plans, and the crisis did much to discredit these policies in the eyes of academics. Many observers now argued that managers should adopt a professional ethos of service, making bonuses unnecessary at best. But as corporate profits rebounded by the end of the decade, large firms revived bonus plans as well. Executives had gained control over corporate compensation and would continue to insist on special rewards for their leadership.

Executives were settling into an ambiguous relationship to the corporation: neither owner, nor mere agent, nor regular member. It was a status that worried even the sophisticated administrative thinkers at the Du Pont Company, manufacturers of explosives and other chemicals. At the same time that Pierre du Pont and his cousins were devising the well-known structural innovations to manage the diversified company, they were also trying to ensure that the du Pont family would control the company after they retired. The du Ponts essentially sought corporate commitment from mid-level managers, but owner-like attitudes from the executives. Pierre du Pont experimented with executive bonus plans to mimic the sense of ownership (and to keep talented managers from leaving), but finally concluded that without enormous gifts of stock, these bonuses would not suffice. A special program to boost the careers of young du Ponters in the company failed to bring up family talent -- it foundered on the hostility of non-family members and on headquarters' ambivalence over such favoritism. The elder du Ponts' plan to reserve seats on the Finance Committee for family members also went nowhere, as outsiders charged that such exceptions to the rule of meritocracy would demoralize the organization.

After a long debate within the Finance Committee in the 1940s, the du Ponts were forced to cede practical control over the company to hired managers. They hoped that employees' commitment to the corporation, the "Du Pont Spirit," would keep the top managers in line, but it was a strategy they accepted without enthusiasm. Their extensive structural reforms required responsible leadership from headquarters, and they wondered whether hired managers would show such responsibility in the long run.

This history of corporate personnel policies suggests inadequacies in both schools of thought on the issue. Neo-classical models insist too strongly on the principal-agent model. When managing employees gain superior bargaining positions relative to stockholders, their power can affect the actual goals of the firm. Policies that might seem to function as monitoring devices for owners, can in fact reflect managers' opportunism.

Yet organizational theorists, for their part, neglect what agency theorists have always known well -- that individuals will not easily commit themselves to larger entities. Members of firms are likely to have ambitions that cannot be satisfied in otherwise efficient firms. Plans aimed at winning corporate commitment can turn into ways for one group of members to benefit at the expense of others.

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