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Troubled by unequal pay rather than low pay: The incentive effects of a top management team pay gap[☆,☆☆]

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ABSTRACT

We examine the relationships with firm performance of the internal pay gap among individual members of the top management team (TMT) and the compensation level of TMT members relative to their industry peers. We find that pay gap is positively related to firm performance and that this positive relation is stronger when the TMT pay level is higher than the industry median. However, we do not observe such effects in Chinese state-owned enterprises (SOEs), in which both the executive managerial market and compensation are government-regulated. We also document that cutting central SOE managers' pay level can increase firm value, whereas doing so for local SOE managers has the opposite effect. Our findings have important implications for research on TMT compensation as well as for policy makers considering SOE compensation reform.

1. Introduction

Top management team (TMT) incentive-based contract design is a topic of considerable interest to academics and practitioners. It is an especially important issue in China because both the level of TMT

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compensation has increased considerably and the compensation differentials among members of the TMT have widened significantly following the introduction of market-oriented reforms in China in 1978. Our focus in this study is on implications of the variation and the level of TMT pay for firm performance.

We define the variation in pay among the TMT as the difference between the CEO's pay and that of the other executives in the TMT, and refer to this difference as "TMT pay gap." TMT pay gap thus concerns the reward that non-CEO executives can expect if they are promoted to CEO. Prior research makes conflicting predictions about whether a large TMT pay gap promotes competition among TMT members and whether it enhances firm performance. Tournament theory, on the one hand, posits that a pay gap among different organizational levels provides a competition incentive such that the larger the pay gap, the better the firm's performance. Social comparison theory, on the other hand, stresses teamwork and cooperation within the TMT, and thus posits that a smaller pay gap can improve satisfaction and willingness to cooperate, thereby boosting firm performance. However, whether a team engages in competition or cooperation is an empirical issue (Harbring and Irlenbusch, 2003), and this relationship is moderated by many factors, including task dependence and the individual incentive system (Shaw et al., 2002; Kepes et al., 2009).

In addition to TMT pay gap, the level of TMT pay is also an important factor that affects firm performance. We define "TMT pay level" as the difference between the average pay of the TMT and the average pay of industry peer TMTs (Gerhart and Milkovich, 1992), and refer to this difference as "TMT pay level." TMT pay level thus reflects the external competitiveness of the firm's compensation policy (He and Hao, 2014). TMT pay level may have both a direct and an indirect effect on firm performance. First, as an important factor in the TMT's incentive system, TMT pay level has direct implications for firm performance. Second, TMT pay level may also have an indirect effect on firm performance because it moderates the relationship between TMT pay gap and firm performance. Excluding the effects of pay level from the model would thus result in a biased estimate of the relationship between TMT pay gap and firm performance.[2] However, most of the related research in China does not consider this interactive effect of TMT pay level (Lin et al., 2003; Chen and Zhang, 2006). Additionally, firms often use industry peers as a benchmark when negotiating contracts with top executives (Jiang, 2011). Different TMT pay levels lead to an external comparison between firms, and top executives and then form corresponding levels of satisfaction with their compensation, which in turn influences the competition–cooperation relationship within the TMT.

As indicated earlier, we conduct our empirical analysis using compensation data from Chinese firms. The market-oriented reforms introduced in China in 1978 have led to substantial increases in the compensation levels of some executives, especially those at monopoly and public welfare firms. Further, the pay gap among Chinese firms' TMTs has considerably widened during this period (Zhang, 2008; Li and Hu, 2012). Concerned about the widening pay gap and increasing compensation level, China's Central Political Bureau passed a resolution on 29 August 2014 to reform the pay system for the responsible persons of centrally managed companies. The program focuses on five main areas: (1) improvement of the reward system, (2) adjustment of the pay structure, (3) strengthening of supervision, (4) regulation of the pay level, and (5) treatment standardization. The last two areas, in particular, are intended to address unreasonably high incomes and pay gaps to promote social justice.

"Pay gap" can refer either to the income gap between executives and general staff or the gap between TMT members' pay. Chinese are generally more sensitive to the former gap, particularly since the round of pay cuts and layoffs in 2008 that saw executives retain high pay levels (Liu and Sun, 2010). However, because the TMT is at the highest managerial level of the firm, the within-team pay gap is related to the distribution of limited compensation among executives, and thus plays an important role in the TMT incentive system. Moreover, if the overall TMT pay level is adjusted, the question is whether and how income should be distributed among team members to ensure the effectiveness of the compensation incentive mechanism. To answer this question, we explore the relationship between a TMT's overall pay level and the pay gap among its members.

Since 2005, it has been mandatory for China's listed firms to disclose their executives' compensation. In this study, we examine whether TMT pay level affects the relationship between a TMT pay gap and firm

[2] For example, Knoeber and Thurman (1994) point out that Ehrenberg and Bognanno (1990a,b) ignore the incentive effect of prize level when using the behavior of professional golfers to examine tournament theory. Because the prize structure was identical across tournaments, larger prize gaps were always the result of higher prize levels.