Journal of Accounting and Economics 59 (2015) 203–220

Contents lists available at ScienceDirect

Journal of Accounting and Economics

journal homepage: www.elsevier.com/locate/jae

Effects of managerial labor market on executive compensation: Evidence from job-hopping ☆

Huasheng Gao [a,*], Juan Luo [b], Tilan Tang [c]

[a] Nanyang Business School, Nanyang Technological University, S3-B1A-06, 50 Nanyang Avenue, Singapore 639798, Singapore
[b] Business School, University of Adelaide, 10 Pulteney Street, Adelaide 5005, Australia
[c] College of Business and Behavioral Science Clemson University, 336E Sirrine Hall, Clemson, SC 29630, USA

ARTICLE INFO

Article history:
Received 3 February 2014
Received in revised form
27 January 2015
Accepted 2 February 2015
Available online 9 February 2015

JEL classification:
G30
J33

Keywords:
Managerial labor market
Executive compensation
Job-hopping

ABSTRACT

We find that companies dramatically raise their incumbent executives' pay, especially equity-based pay, after losing executives to other firms. The pay raise is larger when incumbent executives have greater employment mobility in the labor market, when companies lose senior executives, and when job-hopping executives receive favorable job offers in their new firms. A company's subsequent pay raise to incumbent executives after losing an executive diminishes its deficiency in executive compensation relative to its industry peer firms, and is effective at retaining its incumbent executives. Overall, our evidence suggests that executive job-hopping activity has significant effects on firms' compensation policies.

1. Introduction

In this paper, we shed light on how the managerial labor market influences executive compensation from the perspective of executive job-hopping. Executive job-hopping refers to the case in which one executive leaves her current firm and subsequently takes an executive position in another firm the following year (in most cases, for greater pay and/or for a higher position). We examine how firms adjust their compensation schemes for incumbent executives after losing executives to other companies.

Based on 510 executive job-hopping events from 1993 to 2011, we find that companies dramatically raise pay for their incumbent executives after losing executives in a job-hopping event. From the year prior to the job-hopping event to the year afterwards, the median total compensation for these incumbent executives increases from $1.40 million to $2.04 million (an increase of 46%). Moreover, this pay raise is mainly allotted in the form of equity-based compensation.

☆ We thank Michelle Hanlon (the editor), an anonymous referee, Renee Adams, Tom Berglund, Danlu Bu, Stephen Dimmock, Charlie Hadlock, Jun-Koo Kang, Shane Magee, Adam Yore, Feng Zhang, Le Zhang, the seminar participants at the 2013 European Finance Association conference, the 26th Australasian Finance and Banking conference, 2013 Eastern Finance Association conference, 2014 China Finance and Accounting Conference, Nanyang Technological University, University of Georgia, Clemson University, Shanghai University of Finance and Economics, and Miami University for helpful comments. Gao acknowledges the financial support from Singapore Ministry of Education Academic Research Fund Tier 1 (Reference number: RG 54/12). This paper was previously circulated under the title "Labor Market Competition, Executive Job-hopping, and Compensation." All errors are ours.

* Corresponding author.
E-mail addresses: hsgao@ntu.edu.sg (H. Gao), Jane.luo@adelaide.edu.au (J. Luo), ttang@clemson.edu (T. Tang).

http://dx.doi.org/10.1016/j.jacceco.2015.02.001

The median cash compensation increases from $0.76 million to $0.90 million (an increase of 18%); in contrast, the median equity-based compensation increases from $0.39 million to $0.79 million (an increase of 102%). To the extent that the vesting period associated with restricted stock and option grants can help to retain managers (Balsam and Miharjo, 2007), this evidence suggests that after losing top executives, firms not only increase the level of total compensation for their remaining managers, but also rely more on equity-based compensation for the purpose of better retention.

We further find that the subsequent pay raise of the job-hopping firm (the firm that loses its executives in a job-hopping event) for its incumbent executives is positively associated with its incumbent executives' mobility in the managerial labor market. We use a few proxies to measure a manager's employment mobility. First, considering that it is more difficult for a CEO to find an equivalent or higher-ranking job in another firm, a CEO is expected to have lower mobility than non-CEO executives. Second, high stock ownership helps to retain managerial talent (Balsam and Miharjo, 2007); for this reason, we expect executives with higher stock ownership to have lower employment mobility. Third, if a manager already receives a high level of compensation from her current employer, she is less likely to look for a new employer (*i.e.*, "job-hop") and thus has lower employment mobility. Fourth, managers usually have greater employment mobility in industries with a large number of companies, in industries engaging more in outside hiring, and in industries of high homogeneity (Deng and Gao, 2013; Cremers and Grinstein, 2013). Finally, when managers approach retirement or have stayed with a firm for a long period of time, they are less likely to look for new jobs and thus have lower mobility in the labor market (Balsam and Miharjo, 2007; Gibbons and Murphy, 1992). Based on these proxies for employment mobility, we find that, after losing executives, companies raise pay more aggressively for incumbent executives with higher mobility than for those with lower mobility.

The characteristics of the job-hopping executive (henceforth referred to as the "job-hopper") also play an important role in explaining the magnitude of the firm's pay raise to its remaining managers. We find that firms raise pay more aggressively for incumbent executives when they lose senior executives to other firms, and when they lose executives to companies that offer higher positions and/or greater compensation.

To further our understanding of the impact of job-hopping on executive compensation, we ask whether job-hopping firms generally under-pay their executives relative to their industry peers prior to job-hopping events. Does the job-hopping effect bring remaining executives back to a "normal" level of pay in the industry or to a greater level than the industry norm? We investigate these questions by comparing executive compensation between job-hopping firms and their industry peer firms. We find that, in the year prior to the job-hopping event, executives in job-hopping firms receive significantly lower compensation, especially lower equity-based compensation, than executives in their industry peer firms. However, in the year following the job-hopping event, there is no remarkable difference in executive compensation between the two groups. This result suggests that job-hopping events reduce the pay deficiency of job-hopping firms relative to their industry peers (*i.e.*, job-hopping firms "re-equilibrate" their pay practice after losing executives).

Finally, we investigate whether the job-hopping firm's subsequent pay raise indeed helps to retain its incumbent managers. We find that the pay raise is negatively associated with the likelihood of subsequent job-hopping by incumbent executives, which suggests that the raise in pay helps to prevent incumbent managers from moving to other firms.

This paper contributes to the literature on executive compensation in four ways. First, while most of the existing research on executive compensation has focused on the contracting problem between a firm and a manager in isolation (Edmans and Gabaix, 2009), a surging amount of literature has proposed that executive compensation is better understood in the context of the managerial labor market (Frydman, 2007; Murphy and Zábojník, 2004, 2007). However, given that the detailed firm-level executive hiring process is largely a black box (Oyer and Schaefer, 2011), many features of the managerial labor market are not sufficiently examined in the current empirical work. Our paper helps to fill this gap by empirically revealing the importance of executive job-hopping in the labor market on firms' compensation policies.

Second, much of the existing literature on the design of compensation contracts has concentrated on inducing optimal effort (see, for example, Holmstrom, 1979), leaving the role of the participation constraint (*i.e.*, the manager's reservation wage) relatively under-explored. From a theoretical perspective, Oyer (2004) points out that agency theory's often-overlooked participation constraint may be an important determinant of some common compensation schemes. Empirical evidence on this issue is, however, relatively scarce and has mainly focused on explaining the absence of relative performance evaluation (RPE) in executive compensation contracts. For example, Rajgopal et al. (2006) provide evidence supporting the view that the absence of RPE may be optimal if the manager's reservation wage varies with the economy's fortunes. In the context of CEO turnover, Eisfeldt and Kuhnen (2013) show that when industry conditions are correlated with managers' outside options, both the overall industry performance and the firm performance relative to their industry peers should be used in a CEO turnover decision. Complementing this line of research, our evidence suggests that managers' outside opportunities play an important role in increasing their compensation and especially their equity-based compensation.

Third, our study is also related to recent research that examines how an executive's personal connection influences her compensation. Hallock (1997) examines the relation between reciprocally interlocking boards of directors and executive compensation, and finds that interlocked CEOs earn significantly higher pay than non-interlocked ones. Hwang and Kim (2009) find that CEOs who have strong social ties with their outside directors are paid more. Engelberg et al. (2013) find that executives with stronger personal associations with other firms' executives or directors receive higher compensation. A common interpretation of these results is cronyism: these connections entrench the managers, weaken the board monitoring, and thus result in more rent-extracting behavior in the pay setting process (Brick et al., 2006; Fracassi and Tate, 2012). Our results suggest an alternative viewpoint: well-connected managers have better mobility in the labor market, and thus the firm has to pay more to retain them.