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# DOES MANAGERIAL COMPENSATION AFFECT WORKERS' EFFORT?

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We explore in a two-level gift-exchange experiment whether the managerial compensation influences workers' effort decisions. Firstly, we find that there exists a strong positive relation between own wage and effort levels for the workers, while the managers' effort reaches a maximum for intermediate wages and decreases for very high wages. Secondly, our data suggests that the managerial compensations are significantly negatively correlated with the workers' effort choices: the higher the manager's wage, the lower the effort level chosen by the workers.

*JEL classification codes*: C92, J33, M12, M52
*Key words*: managerial compensation, social preferences, laboratory experiment, gift-exchange, effort

## I. Introduction

We analyze in a two-level gift-exchange experiment the relationship between management compensation and workers' effort. The review of the relevant literature shows that 1) the broader public dislikes high managerial compensations,

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2) workers are inclined to make social comparisons with theirs equals and with their superiors, and 3) these social comparisons might affect their working performance. On the other hand, the effects of the perceived managerial compensation on employees' behavior at work are not tested for in experiments yet.

Opinion polls from various countries show that a significant majority of the people dislike high managerial compensations. According to a Bloomberg survey conducted in February 2006, about 81% of Americans say they think that the chief executives of large companies are overpaid — a percentage that changes little with income level or political party affiliation.[1] Data for the fairness perceptions in Germany is available from the Socio-Economic Panel (SOEP) conducted in 2005.[2] While 54% of the population think that their personal income is fair, only 25% think this way about the income of managers and 29% about the income level of the lowest-level employees. Accordingly, managers earn too much and the lowest-level employees earn too little in the eyes of the majority.

Many papers have shown that although effort at work is at least to some degree non-contractible, workers are more likely to perform above any minimum requirements if they feel fairly treated and have been paid a fair wage (Akerlof and Yellen 1990; Milgrom and Roberts 1992; Fehr and Gächter 2000). The own compensation is seen as the most important instrument to motivate employees to put forward an efficiency-enhancing effort level. However, as recognized by theories of distributive and procedural justice, employees' motivation is not only a simple function of financial inducement; it is also influenced by social comparisons and by the perception of causes and processes.

The research on social comparison theory shows that individuals in organizations tend to engage in vertical social comparisons with their superiors to see how well they are doing, whether their wage is fair, and how equitably they are being treated (O'Reilly et al. 2006). In this line of research, workers that feel their compensations are not equitable could respond with lower productivity and product quality, decreased morale, and increased turnover.

[1] Dash (2006). Bloomberg is the leading global provider of data, news and analytics.

[2] SOEP is a representative panel survey of the resident population of Germany. The 2005 wave of the survey includes 21.105 individuals from 11.453 households.