



Contents lists available at ScienceDirect

Journal of Corporate Finance

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

Executive labor market segmentation: How local market density affects incentives and performance[☆]

Hong Zhao

Department of Finance, NEOMA Business School, 59 Rue Pierre Taittinger, Reims 51100, France



ARTICLE INFO

Article history:

Received 19 July 2017
 Received in revised form 27 February 2018
 Accepted 1 March 2018
 Available online 6 March 2018

JEL classification:

G30
 G34
 J4

Keywords:

Executive labor market
 Geographic segmentation
 Local market density
 Non-compensation incentive
 Firm performance

ABSTRACT

I study how the density of executive labor markets affects managerial incentives and thereby firm performance. I find that U.S. executive markets are locally segmented rather than nationally integrated, and that the density of a local market provides executives with non-compensation incentives. Empirical results show that in denser labor markets, executives face stronger performance-based dismissal threats as well as better outside opportunities. These incentives result in higher firm performance in denser markets, especially when executives have longer career horizons. Using state-level variation in the enforceability of covenants not to compete, I find that the positive effects of market density on incentive alignment and firm performance are stronger in markets where executives are freer to move. This evidence further supports the argument that local labor market density works as an external incentive alignment mechanism.

© 2018 Elsevier B.V. All rights reserved.

1. Introduction

Recent empirical findings suggest that geographic factors play an important role in managerial compensation schemes. Francis et al. (2016) find a positive relation between the size of the city in which a firm is headquartered and its CEO's compensation. Bouwman (2013) shows that CEO compensation is highly influenced by the average compensation level of other CEOs in the local area. However, it is unclear whether geographic factors also affect executives' non-compensation incentives.

Previous literature shows that non-compensation incentives, including dismissal threat and promotion based tournament, are important sources of managerial incentive alignment. For example, Jenter and Lewellen (2014) document a strong relation between firm performance and CEO turnover and indicate that nearly 40% of turnovers are performance induced. Nielsen (2017) finds that dismissed CEOs experience a 40% annual income decline in the five years following turnovers. With respect to

[☆] I am grateful to my dissertation committee—Michael Hertzler (Chair), Ilona Babenko, Jeffrey Coles, and Luke Stein—for guidance and support. For helpful comments, I thank an anonymous referee, George Aragon, Shantanu Banerjee, Hank Bessembinder, Sudipto Dasgupta, Mohamed Ghaly, Stuart Gillan (the editor), Jarrad Harford, Laura Lindsey, Patrick McColgan (discussant), Salvatore Miglietta, Grzegorz Pawlina, Ran Tao, Jessie Jiaxu Wang, Rong Wang (discussant), and seminar participants at Arizona State University, BI Norwegian Business School, Goethe University, Lancaster University, NEOMA Business School, the 2015 China International Conference in Finance, and the 2015 FMA Annual Meeting. All errors are my own.
 E-mail address: hong.zhao@neoma-bs.fr.

tournament incentives, a survey by [Graham et al. \(2005\)](#) shows that 75% of executives agree that their desire to meet earnings targets is more driven by upward mobility in labor markets than short-term compensation schemes. Moreover, both theoretical and empirical studies show that these non-compensation incentives have positive effects on firm performance ([Lazear and Rosen, 1981](#); [Kale et al., 2009](#)).

In this paper, I study how one specific geographic characteristic – local labor market density – affects managerial non-compensation incentives. In denser labor markets, executives might face stronger dismissal threat because of local competition, and stronger tournament incentives because of outside opportunities. At the same time, market density might disincentivize executives by providing more backup options in the event of dismissal. The primary goal of this paper is to test empirically the existence or non-existence of the above channels and examine how market density affects firm performance through managerial incentive alignment.

One condition necessary for local market density to be important is the presence of geographic segmentation in executive labor markets.¹ If executives tend to move within one large national market rather than many small local markets, then all executives will face the same labor market conditions. To examine whether there is geographic segmentation in U.S. executive labor markets, I use a sample of executive job changes covered by the BoardEx database, and regard a job change (i.e., a hiring) within 60 mi. as local. If markets show national integration and firms hire executives randomly from a nationwide pool, then on average, local hirings should account for only 5% of the hirings in the sample. However, the data show that the realized local hiring percentage is 34%, indicating a large bias in local hiring, rejecting the nationwide market hypothesis at the 1% level. This local hiring bias remains large and significant even after adjustment for industry clustering.

Based on the evidence of geographic segmentation, the main analysis addresses the way in which local labor market density affects executives' non-compensation incentives, with market density measured as the number of firms within 60 mi. of a firm's headquarters. The first channel of managerial incentive alignment I test is performance-based dismissal threat. As firms tend to hire executives locally, a denser market provides firms with more local outside candidates, thereby allowing them to make more credible dismissal threat to their incumbent executives. Consistent with this hypothesis, empirical results show that CEO turnover-performance sensitivity is significantly higher in denser labor markets, implying stronger dismissal threat for executives therein. In addition, when replacing incumbent executives, firms in denser markets are more likely to hire outsiders rather than promote insiders. This result offers further support for the argument that convenient access to external candidates is the reason for higher turnover-performance sensitivity in denser markets.

In addition to the threat of dismissal, outside tournament opportunities are another potential source of executives' non-compensation incentives. As potential outside job advancements are more plentiful in denser markets, they should offer executives higher tournament incentives. To capture tournament incentives, I consider both the size of the tournament prize, i.e., the expected compensation increase when an executive moves to another local firm, and the likelihood of tournament, i.e., how often tournaments occur in a local market. Empirically, the results show that both the prize and likelihood of local outside tournaments are significantly higher in denser labor markets. All else equal, an interquartile increase in market density almost triples and doubles the tournament prize and tournament likelihood, respectively.

Both dismissal threat and outside tournaments work as channels through which market density improves managerial incentive alignment. However, there might also exist a channel of incentive misalignment, if executives in denser markets have more backup options in the event of dismissal. To test for this concern, I construct a sample of executives who lost their jobs and examine their subsequent employment outcomes in a three-year window based on news articles. Regression results indicate that dismissed executives in denser markets do not find new jobs more easily, obtain positions with higher compensation, or experience shorter unemployment durations. One possible explanation is that dismissed executives are forced to leave their local markets as reputation spreads locally. I find empirical evidence supporting this explanation. Compared to executives who change jobs voluntarily, dismissed executives are significantly less likely to find their next job in the local market.

Given that market density improves executive incentive alignment, a natural question is whether density also enhances firm performance. The empirical challenge here is that market density could have an effect on performance through various channels, so a simple positive correlation between these two variables does not suffice.² The method I adopt is to interact market density with executives' career horizons. The logic, as argued in [Gibbons and Murphy \(1992\)](#), is that executives with shorter career horizons (i.e., those closer to retirement) should be less responsive to dismissal threats and tournament incentives. Using age as a proxy of career horizon, I find that the coefficient of the interaction term between market density and executive horizon is significantly positive in performance regressions. In other words, the positive effect of market density on firm performance is stronger for firms with younger executives. In terms of economic magnitude, firms with market density in the top quartile and executive age in the bottom quartile have a 0.27 (0.016) higher industry-adjusted Tobin's Q (ROA) than do those with market density in the bottom quartile and executive age in the top quartile. These results support the argument that executives in denser markets exert more effort in response to stronger non-compensation incentives, thereby leading to higher firm performance.

As the effects of market density on incentive alignment and firm performance hinge on executives' movements within local labor markets, the effects will be weaker if executives cannot move freely. Restrictions on executive local mobility will shrink the

¹ The U.S. executive labor markets are commonly viewed as very mobile. [Kedia and Rajgopal \(2009\)](#) write "it is difficult to argue that top executives are geographically immobile" (p. 125). Yet, some recent empirical findings challenge this view. See, for example, [Ang et al. \(2013\)](#), [Bouwman \(2013\)](#), [Yonker \(2016\)](#), and [Francis et al. \(2016\)](#).

² See [Marshall \(1920\)](#), [Duranton and Puga \(2004\)](#), and [Rosenthal and Strange \(2004\)](#) for economic foundations of the effects of geographic clustering on firms.

Download English Version:

<https://daneshyari.com/en/article/7357112>

Download Persian Version:

<https://daneshyari.com/article/7357112>

[Daneshyari.com](https://daneshyari.com)