



# Pay inequalities and managerial turnover<sup>☆</sup>



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## ABSTRACT

We study how pay inequalities affect (i) a firm's rate of voluntary non-CEO manager (VP) VP resignations, and (ii) the likelihood that an individual VP will voluntarily resign. We consider pay inequalities that a VP faces relative to (i) the CEO in her own firm, (ii) other VPs in the firm, and (iii) VPs in benchmark firms. We use a unique hand-collected dataset of over 1000 voluntary managerial resignations and find that pay inequality is an important determinant of managerial turnover. We find that managers are more likely to resign when their pay relative to their peers in the firm and outside the firm is lower; and firms with greater levels of pay inequality and greater pay inequality relative to benchmark firms experience higher VP turnover.

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## 1. Introduction

In an interview with the *Wall Street Journal*, the CEO of *Biomet Inc.* contends that narrow pay differentials at the top of Biomet's corporate hierarchy has helped retain almost all its top executives for several years.<sup>3</sup> Academic research has also started to examine on how notions of fairness, inequity aversion, altruism, and similar “other-regarding” preferences affect agent actions

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<sup>3</sup> *Biomet Inc.*, a successful medical-device manufacturing company, maintains a narrow pay differential among its top management team; in 2005, the annual cash compensation among the top twenty managers in the firm ranged from \$517,200 to \$575,800. Further, in the last several years, only one member of the *Biomet's* top management team left the firm—he retired. (*Wall Street Journal* (April 11, 2005)).

(e.g., Bellemare et al., 2008; Bolton and Ockenfels, 2000; Demougin et al., 2006; Fehr and Schmidt, 1999, 2005; Fehr et al., 2007). The common underlying premise in these theoretical and experimental studies is the inclusion of others' wealth/pay in addition to the agent's own wealth in her utility function. These studies help reconcile some of the anomalies (e.g., the "ultimatum" game) documented in experimental studies that are hard to explain using purely "self interest" frameworks. The predictions from frameworks that investigate inequity aversion, fairness, etc. are generally examined using controlled experiments.<sup>4</sup> We, on the other hand, study how pay inequalities faced by non-CEO managers (VPs) in large corporations affect both the likelihood that an individual VP will leave voluntarily as well as the turnover rates among a firm's VPs. To our knowledge, our study is among the first to examine the effects of "other-regarding" preferences on agent actions in a non-experimental real-world setting.<sup>5</sup>

A recent global survey of over 800 Chief Executive Officers (CEOs) by *The Conference Board* reveals that managerial talent retention is the top issue facing Asian CEO's and ranks sixth and seventh among European and U.S. CEOs, respectively. There are a number of theoretical and empirical studies on how the magnitude and structure of managerial (or economic agent's) pay affect managerial effort, firm performance, and investment and financial policies (e.g., Coles et al., 2006). There is, however, little empirical work on how the level and structure of managerial pay influence managerial retention.<sup>6</sup> Our study attempts to fill this gap by examining the effect of a specific aspect of compensation, pay inequality, on managerial retention.

The effect of the level of VP pay on turnover depends on (i) the absolute level of the pay, (ii) how the pay level compares to that of other VPs in her own firm and in benchmark firms, (iii) how it compares to her CEO's pay level, and (iv) how the inequalities she faces in her firm compare with those in benchmark firms. At the firm level, firms that are better paymasters, that is, VPs' pay is typically higher than in benchmark firms, should have lower turnover rates. Thus, on the one hand, higher pay should induce the manager to stay with the firm. However, if the VP's pay also serves as a signal of her ability, then, consistent with the "play me or trade me" explanation in Lazear (1999), a higher-paid manager is more likely to leave because she will have better outside employment opportunities.

A VP faces pay inequalities relative to her peers in the firm as well as to those in benchmark firms. Pay inequality aversion suggests that VP turnover at both individual and firm levels will be increasing in these inequalities. How the extent of pay inequalities in her current firm compare with those in benchmark firms will also be a factor for inequity-averse managers; for example, firms that have lower pay dispersion (e.g., Biomet) will likely have lower VP turnover. Finally, promotion-based tournament incentives (Lazear and Rosen, 1981) also create pay differentials. The pay difference between a CEO and a VP is typically used as a measure of tournament incentives in recent empirical research (e.g., Kale et al., 2009), which shows that the CEO – VP pay gap has a positive association with firm performance. Higher tournament incentives, by design, also create greater pay inequalities between the CEO and firm VPs. We expect that greater tournament incentives will discourage (inequity-averse) managers from remaining with the firm.

We examine the effects of a VP's pay level and the pay inequalities that she faces on the (voluntary) turnover of VPs in a sample of non-financial and non-utility S&P 500 firms over the period 1993–2004. Managerial turnover may be due to several reasons such as retirement, death, acquisitions, etc. We identify 2956 executive turnovers, and can clearly classify 2169 (73%) of these as voluntary, that is, resignations and retirements. To ensure that we isolate the effect of pay inequality-related turnovers, we also conduct all our analyses only on the sample of 1007 (34%) voluntary resignations. We examine VP turnover at two levels—the VP turnover rate at the firm level and the likelihood of resigning at the individual VP level. The firm level analysis focuses on *how many managers* leave the firm, whereas the individual VP-level analysis relates to *which manager* leaves the firm. The rationale underlying the firm-level analysis is that firms likely choose levels of pay inequality to create (e.g., tournament) incentives to improve firm performance knowing that these inequalities may increase employee turnover. Thus, a value-maximizing firm optimally chooses both the level of pay inequality in the firm and the turnover rate by trading off the performance benefit with the cost of turnover. The VP-level analysis, on the other hand examines the importance of pay inequality as a determinant of the VP's decision to leave the firm.

From the firm level analysis, we find that firms with larger pay inequalities, both within the firm and relative to benchmark firms, are associated with higher VP turnovers (and resignations). Further when the firm is a good paymaster, VPs in the firm have greater equity ownership, the CEO is older, VP is younger, the firm is profitable, and firm risk is low, VP turnover is lower. When firms have a designated successor, or have a new CEO in place, VP turnover is higher. When the firm has a CEO succession plan, or the CEO is new, or the CEO is highly aligned with shareholders, the pay disparity between the CEO and the VP is unlikely to result in strong tournament incentives (Kale et al., 2009). We expect that in these cases, the positive effect of CEO–VP pay inequality on VP turnover will be stronger and our empirical findings support these predictions. We then consider situations where VPs may be more concerned with the notion of fairness, namely, in riskier firms or in firms where human capital is more important. Since CEOs are compensated with more options than VPs, they stand to gain more when the firm performance is good, but bear the same risk as VPs in bad times. Therefore, VPs in riskier firms are less likely to tolerate compensation inequalities with their CEOs.

<sup>4</sup> An experimental study published in the journal *Nature* (Brosnan and de Waal (2003)) with female capuchin monkeys as subjects reports that these monkeys exhibited high participation rates when each monkey was rewarded (equally) with cucumbers. However, the participation rates of monkeys receiving cucumber rewards plummeted when they observed that some monkeys were receiving grapes (a more favored snack) for the same job. The rates declined even further when some monkeys received grapes without "doing any work." Thus, in an experimental setting, monkeys expressed dissatisfaction by refusing to "work" when faced with "pay" inequality.

<sup>5</sup> Kuhn and Niessen (2012) also use executive compensation data to examine whether public negativity toward income/pay inequality influences firms' compensation policies. We complement their work by examining how pay inequalities faced by VPs affect VP turnover.

<sup>6</sup> Chang, Dasgupta, and Hilary (2007) examine the relation between CEO pay relative to other managers and stock price effects around CEO turnover announcements.

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