

Pay Equity in CEO Compensation and Agency Problems: Socio-psychological Framework of Agency Theory

Research question

While significant research attention has been paid to the determinants of CEO compensation, relatively less attention has been given to consequences of CEO compensation (Finkelstein and Hambrick, 1996; Miller, 1995; Gerhart and Milkovich, 1990). Many scholars who rely on behavioral theory cast doubt on the agency theory's mathematical model of deterministic prediction on the effect of incentive on managerial decision-making and behaviors (Wiseman and Gomez-Mejia, 1998; Tosi, Katz, and Gomez-Mejia, 1997). Finkelstein and Hambrick (1996:284), for example, maintained that the assumption made in agency theory about the incentive effects of compensation contracts is doubtful and it's not clear at all if compensation contracts can effectively align shareholder and managerial interests. Therefore, I attempt to examine the effectiveness of CEO compensation by addressing following question:

How CEO compensation contract should be designed? Under what conditions, CEO compensation contract will trigger CEO self-serving behaviors, instead of aligning interests of CEO and shareholders?

Theory development

According to social comparison theory, people tend to evaluate their opinions or value by comparing them with those of somebody else (Festinger, 1954). Equity theory recognizes that employee motivation is not a simple function of financial inducement but is influenced by social comparisons (Adams, 1963; Cowherd and Levine, 1992). That is, individuals perceive the existence of inequity, when the ratio of the outcomes he/she receives to the inputs they contribute doesn't equal the ratio of output-input of their comparison others (Adams, 1963). Equity theory predicts that perceived inequity will motivate individuals to strive to achieve equity or reduce inequity in various ways.

I integrate agency theory with equity theory (Baker, Jensen et al. 1988; Lazear 1991), to propose a socio-psychological agency theory framework. My theory assumes that CEOs are inequity-averse. It predicts that whether compensation contract can effectively prevent CEOs from engaging in self-serving behaviors largely depends on their *justice perception of the compensation contract* (Adams, 1963; Heneman and Judge, 2000).

I attempt to infer CEO justice perception of their compensation contract by examining diverse contexts in which comparisons of CEO compensation can be made. Inferred CEO perception of justice can be used to predict the degree of agency problem that will be materialized through their subsequent behaviors. In sum, I contend that inequitable compensation will trigger CEOs to engage in seemingly self-serving behaviors which aim to resort equity but can be seen as agency problem to the eye of shareholders. Specifically, underpaid CEOs will make efforts to increase their compensation, at least, to the level of equity. They will do this either by directly influencing board's compensation decision or by indirectly influencing various factors that are related to the level of compensation.

Hypotheses

My theory analyzes CEOs as an employee hired from either internal or external managerial labor market and thus assumes that CEOs will compare their compensation with those of other top executives both inside and outside the firm.

External pay equity. We assume that CEOs in the same managerial labor market (segmented by industry and size) have non-differentiable level of managerial capabilities. Therefore, comparisons of compensation level of CEOs (after controlling for variations in traditional economic factors such as firm size, firm performance, and human capital) who compete in the same managerial labor market will allow us to best infer their perceived degree of inequity. We will construct wage equations that consist of above-mentioned

variables. To measure the degree of pay inequity, we will run the equation for each managerial labor market for each year and take residuals.

Internal pay equity. We expect that within-firm wage differential between hierarchical levels should be similar at similar size firms in the same industry. We will obtain the ratio of CEO compensation to other top executives' compensation for each firm. Ratios will be compared among firms in the same managerial labor market. Relatively small ratio will reflect that focal CEO's relative superiority of managerial capability (to those of other top executives in his/her own firm) is less valued than it would be at other firms.

Influencing board's compensation decision. Underpaid CEOs may want immediate increase in compensation in the next year, to restore equity. It is attainable, since CEOs often have power to influence board's compensation setting decision for pay increase (Crystal, 1992; Finkelstein and Hambrick, 1989; Main, O'Reilly, and Wade, 1995).

H1: CEOs who are underpaid will receive larger pay increases.

Influencing organizational factors. Underpaid CEOs will engage in activities that can increase firm size, primarily through acquisitions (e.g. empire building strategy), since increasing firm size will (1) also increase CEO compensation while not necessarily increasing shareholder values (Amihud and Lev, 1981), (2) enhance the social prominence, public prestige, and political power of top executives (Jensen, 1989), and (3) increase the value of his/her specific human capital to the firm, enabling the themselves to negotiate a higher wage with the board of directors (Schleifer and Vishny, 1989).

H2: Underpaid CEOs are more likely to engage in size-increasing strategic actions, by pursuing (1) more acquisitions and (2) more diversifications.

Moderation effect of CEO power. The strength of CEO's influence over board's decision will vary depending on several socio-political variables and it will affect the degree of restoration of justice. When CEOs are powerful, they are likely to choose to affect

board's decision for pay increase. However, if CEOs expect that pay increase by influencing board's decision is not a viable option due to lack of power, they are more likely to engage in empire building strategy, since strategic decisions are more difficult for board to control (Eisenhardt, 1989).

H3: Support for H1 will be stronger in firms where CEO is powerful.

H4: Support for H2 will be weaker in firms where CEO is powerful.

Investment in Social Capital. Building more social capital might be an attractive strategy for individual CEOs for several reasons. First, social capital is not firm-specific assets (Geletkanycz et al. 2001) and thus CEO social capital can be transferred across firms and be paid off outside the focal firm. Second, social capital enhances the value of human capital by enabling the CEO to locate more opportunities (Burt, 1997). Therefore, having more directorships will enable the CEO to enter deep into the "inner group" (Useem, 1979) of business elite and promote his/her reputation in board director community, ultimately increasing outside employability. In addition, CEO social capital has been found to reduce the probability of replacement (Shleifer and Vishny, 1989; Rose and Shepard, 1997) but increase compensation (Belliveau, et al. 1996; Geletkanycz, Boyd, and Finkelstein, 2001).

H5: Underpaid CEOs are more likely to try to build more social capital (i.e., the number of directorship).

Turnover. Pay equity perceptions have an impact on voluntary turnover (Pfeffer and Davis-Blake, 1992). To the extent that the labor market is competitive and that board pays attention to competitive managerial labor market, deviation from market going rate will be transitory (Gerhart and Milkovich, 1990). However, if repeated underpayment is experienced by CEOs, they will interpret it as an outcome of board's policy or a reflection of board's consistent under-appreciation of their managerial capabilities (Gerhart and

Milkovich, 1990). In addition, they will perceive low possibility of future amelioration and thus their intention to leave will increase (Aquino, Griffeth, Allen and Hom, 1997).

H6: CEOs who are repeatedly underpaid are more likely to voluntarily leave the firm.

Hypotheses will be tested with longitudinal, unbalanced panel data that consist of variables for the S&P large, medium and small manufacturing firms in the U.S. over the year 1997-2004.

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