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

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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.

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

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

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tournaments and doubles the tournament prize and tournament likelihood, respectively. 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 current positions before finding new job opportunities, 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.

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. 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

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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).

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