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Does CEO pay dispersion matter in an emerging market? Evidence from China's listed firms

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ABSTRACT

This paper examines how the institutional features of emerging economies (i.e., government ownership, political connections, and market reform) influence CEO pay-dispersion incentives. Consistent with our expectation, we find that CEO pay dispersion generally provides a tournament incentive in China's emerging market, as it is positively associated with firm performance. In addition, tournament incentives are weaker where firms are controlled by the government and where the CEO is politically connected, but it became stronger after the China's split-share structure reforms. Further, we find that in state controlled firms the satisfaction gained by meeting multiple economic and social goals largely reduces the effectiveness of tournament incentives, while the managerial agency problems inherent in private firms might mitigate them.
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1. Introduction

Executive pay dispersion, defined as the pay differential between the CEO and other executives, has implications for the inner workings of the top executive team, and for overall firm performance (Bebchuk et al., 2011). While many studies examine the level and structure of executive compensation and its relationship with performance (Jensen and Murphy, 1990; Yermack, 1996; Core et al., 1999; Murphy, 1999), controversy remains about how executive pay differentials arise and affect firm performance (Kale et al., 2009; Bebchuk et al., 2011; J. Chen et al., 2011). Since the emergence of the global financial crisis, the media has been critical of the large gap in pay between CEOs and employees in most countries, and of the

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resulting severe agency problems and inequality. While many governments have tried to reduce the gap by restricting ever-higher CEO compensation,[1] public anger and resentment of it have not ceased.

The extant literature tends toward two views regarding the optimal (or appropriate) level of pay dispersion. The *tournament* viewpoint sees the pay differential in the corporate hierarchy as defining an arena where individuals compete for promotion and rewards. High-performing executives with considerable managerial potential win promotion and commensurate compensation. A large spread of compensation across corporate hierarchical levels attracts talented and venturesome participants to compete in the managerial tournament by providing extra incentives to exert effort. This viewpoint supports the view that a large pay dispersion is necessary to provide appropriate incentives for executives to perform (Main et al., 1993; Eriksson, 1999; Kale et al., 2009).[2] The *entrenchment* viewpoint sees the large pay gap between the CEO and other executives as giving an indication of CEO power (Lambert et al., 1993), since powerful CEOs are entrenched and find it easier to expropriate shareholder wealth. Empirical studies show that the excess executive-pay gap might reflect agency problems and reduce firm value and performance (Adams et al., 2005; Landier et al., 2008; Bebchuk et al., 2011).

Evidence from emerging markets such as China has only recently started to appear. J. Chen et al. (2011) document that managerial powers are positively related to executive remuneration, and organizational levels and contestant numbers have positive effects on pay differences between executives. They provide preliminary evidence that the pay gap has a positive effect on firm performance, and that this effect is stronger in firms that are relatively less controlled by the government. Lin and Lu (2009) also find that the pay gap is positively related to firm performance, and that this relationship is more significant with higher managerial power (defined as larger managerial ownership and longer tenure of the CEO). Although the evidence for pay dispersion's positive effect on performance has been established, there is no comprehensive analysis showing *how* it affects firm performance and by what mechanism.

This paper extends the existing literature by examining the channels through which the institutional features of emerging markets shape executive pay dispersion, and how they affect tournament incentives in China's listed firms. Specifically, it identifies the institutional features that can affect pay dispersion and the relationship between pay dispersion and firm performance, including state ownership, CEO political connections and reform of the split-share structure. Moreover, in contrast to Lin and Lu (2009), this paper follows Bebchuk et al. (2011) in treating managerial power as an entrenchment, and investigates its impact on the association between pay dispersion and firm performance.

The institutional background of China's listed firms encompasses several important features that shape executive pay dispersion, and which may differ from those in the U.S. and other countries. First, while CEO compensation has been increasingly important, and more related to firm's profits since China's economic reform of executive compensation (Groves et al., 1994; Kato and Long, 2005; Firth et al., 2006a; Zheng et al., 2008; Cao et al., 2011a), the executive pay dispersion remains constrained by the dominance of state ownership and government intervention. In addition to the goals of maximizing shareholders' value, the state owner (in other words, the government) also has non-economic goals of maintaining social equality and harmony. Due to these non-economic goals, the pay differential in the corporate hierarchy, especially in SOEs, would attract close political scrutiny because it is a potential point of conflict. Furthermore, the competition for completion of these non-economic goals does not necessarily lead to an improvement in performance (Jensen, 2001). Independent from the incentives provided by executive compensation, performance improvement in SOEs could be related to policy support obtained from the government. Secondly, an implicit incentive scheme such as perquisites, political promotion, chasing personal fame and other “grey” income on the position seems to be prevalent, but not directly observable, in China's emerging market (Chen et al., 2010; Cao et al., 2011b). In such an economic environment, which lacks a functioning external labor market, the complexity of executive incentive casts doubts on the value of

[1] These governments include the U.S., Germany, the U.K., France, Sweden, China and some others. Specifically, the U.S. Department of the Treasury has announced a $500,000 cap on top-paid executives for the most distressed financial institutions, and the German government places a €500,000 cap on top executives in banks in financial distress.

[2] Empirical evidence is mixed on the tournament viewpoint. For example, O'Reilly et al. (1988) do not find support for the tournament argument in a sample of 105 Fortune 500 firms, and Conyon et al. (2001) report that variation in executive compensation is not associated with enhanced firm performance in a sample of 100 UK firms in 1997.

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