



# Social pay reference point, external environment, and risk taking: An integrated behavioral and social psychological view



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## ABSTRACT

Compensation studies traditionally draw from behavioral agency model to explore how CEO pay influences risk taking, yet this literature has generated mixed results. Integrating behavioral agency model and social comparison theory, we develop a more complete theoretical model that shed light on the equivocal findings. We introduce the concept of social pay reference point that explains risk taking in response to the underlying behavioral and social-psychological mechanisms through which CEOs compare and frame their pay relative to social peers' pay. In addition, we establish theoretical boundary conditions of the hypothesized baseline effects by considering the moderating effects of environmental munificence and dynamism. We test our hypotheses on 545 manufacturing firms across 2878 firm-year observations spanning time period from 1994 to 2006. Our hypotheses receive considerable empirical support.

## 1. Introduction

Scholars have long sought to understand what drives risk taking behaviors. This question has conceptual and practical importance because risk taking can help firms create shareholder value (Datta, Iskandar-Datta, & Raman, 2001) and achieve competitive advantage (Shapira, 1995). Why managers engage in risky but value-enhancing investments with positive net present value has performance implications (Rajgopal & Shevlin, 2002), making this topic worthy of further investigation.

Wiseman and Gomez-Mejia's (1998) behavioral agency model (BAM) was originally conceptualized to explain the relationship between executive pay and CEO risk behavior by explicating how behavioral factors such as risk bearing and framing of reference points shape perceptions and behaviors (Larrazza-Kintana, Wiseman, Gomez-Mejia, & Welbourne, 2007; Lim & McCann, 2013, 2014; Lim, 2015, 2016; Zhang, Bartol, Smith, Pfarrer, & Khanin, 2008). This perspective predicts that accumulated CEO pay creates risk bearing (pay-at-risk), which exerts a negative effect on risk taking. While theoretically valuable, behavioral agency research has provided little explanation for how social pay comparisons affect choice decisions. Although Wiseman and Gomez-Mejia (1998, p. 149) did note that “within BAM, peer salary levels would influence executive aspirations for compensation (i.e., a compensation reference point),” the authors did not advance formal propositions nor has empirical BAM research tested this concept. Behavioral agency studies typically formulate propositions about risk taking without any consideration of the social comparison process

through which CEOs frame negative or positive pay deviation relative to a salient comparison group. This is curious because social comparison theory argues that CEOs are likely to compare their pay with peer CEOs within the industry (Fredrickson, Davis-Blake, & Sanders, 2010; Main, O'Reilly, & Wade, 1993). Scholars assert that “pay is first and foremost a measure of comparative success [...],” (Fredrickson et al., 2010, p. 1033; original italics). Importantly, Bizjak, Lemmon, and Nguyen (2011, p. 542) observed that “in most firms, [...] total compensation are in some form anchored to the peer group. Firms typically target the various components of pay at the median pay level of the comparator group [...] A natural source for compensation peers are firms in the same industry” (new emphasis).

Earlier behavioral agency studies assume CEOs frame pay contexts as potential losses or gains through comparisons with the firm's stock price or historical pay, thereby largely ignoring pay comparisons with social peers. This stream has generated mixed findings. For example, Larrazza-Kintana et al. (2007) showed that positively-valued CEO unexercised options (resulting from stock price above option exercise price) negatively influence risk taking. Devers, McNamara, Wiseman, and Arrfelt (2008) found that positively-valued CEO unexercisable and exercisable options generally exhibit positive relationships with firm strategic risk. Martin, Gomez-Mejia, and Wiseman (2013) demonstrated that CEO current wealth has a negative impact on risk taking. Zhang et al. (2008) showed that CEOs with lower stock ownership and more out-of-money options (arising from stock price below option exercise price) are likely to manipulate earnings. Lim (2015) found that CEO restricted stock deviating negatively from prior values increases R & D

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investment but positive pay deviation decreases this risky activity. Lim (2016) showed that CEO current and future wealth below historical pay reference point raises risk tendencies; although CEO current wealth above the reference point lowers risk taking, CEO future wealth above this point elicits risky behaviors. While this body of work has advanced our knowledge of the pay/risk taking link, the equivocal results call for new thinking on the topic.

In response to empirical challenges with earlier BAM studies, recent research has begun to shift beyond traditional frameworks to suggest that social pay comparisons (Fong, Misangyi, & Tosi, 2010; Fredrickson et al., 2010; Seo, Gamache, Devers, & Carpenter, 2015; Wade, O'Reilly, & Pollock, 2006) including feelings of inequity and norms of fairness (Trevor & Wazeter, 2006) affect strategic outcomes. However, this nascent stream has mostly focused on the extent of CEO underpayment or overpayment based on residuals statistically derived from CEO wage equations. While this small but growing body of work has enriched our knowledge of social pay comparisons, we lack understanding of how framing of CEO pay during social comparisons with peer CEOs' pay drives risk preferences (Wiseman & Gomez-Mejia, 1998, p. 149).

The current study shed light on the aforementioned mixed findings and more effectively explain the different results in the extant literature by building on the behavioral agency model (Wiseman & Gomez-Mejia, 1998) and social comparison theory (Festinger, 1954) to advance a theoretical framework that offers an integrated behavioral and socio-psychological theoretical explanation of risk taking, which we define as investments in uncertain projects with the potential to generate high returns but might lead to negative outcomes (Palmer & Wiseman, 1999). We do so by conceptualizing *social pay reference point* which we define as the median pay of CEO referents within the same industry representing a targeted benchmark against which focal CEOs compare their framed pay contexts.

This concept is important to consider because it serves as the basis for explaining how and why behavioral framing of both negative and positive pay deviations relative to a salient comparison group influences risk preferences. Since CEO pay reflects status, prestige, and self-worth (Fredrickson et al., 2010), top executives are likely to compare their pay against a group of similar CEO peers such that distinct framed pay contexts will lead to differential risk taking tendencies. We are able to find only one study that investigated a similar social comparison relationship that we examine here, but it employed the CEO wage equation to examine the relationship between CEO relative pay standing and acquisition (Seo et al., 2015). To our knowledge no research has conceptualized and empirically tested the notion of social pay reference points. Yet, social pay reference points remain conceptually relevant because “decision-makers use [strategic reference point] in evaluating risky choices” (Shoham & Fiegenbaum, 2002, p. 128) and “managers first focus on social aspirations as this constitutes the baseline performance level (“how well they should perform”) before they attend to other performance benchmarks” (Kim, Finkelstein, & Haleblian, 2015, p. 1365). Our baseline theory accordingly suggests that CEO pay *below* the social reference point induces risk seeking because executives are interested to raise their pay to a level comparable with similar referents but CEO pay *above* the social pay reference point creates risk aversion because top executives seek to protect their pay values.

In addition, scholars have long acknowledged that the industry environment serves as an important source of key contingencies (Lawrence & Lorsch, 1969), rendering both external environment and managerial choice critical determinants of firm outcomes (Cyert & March, 1963). In his research, Greve reinforces the importance of considering both external conditions and managerial incentives within the performance feedback realm. Specifically, Greve (2003a, p. 14) explained that “the decision maker observes feedback from the environment and compares it with a goal, and starts searching for solutions if the goal is not met,” and that “performance feedback as an

incentive device relies on a theory of managers who are rational enough to know how to improve the organization, but will only do so if they are rewarded for it” Greve (2003a, p. 7). In this respect, incorporating environmental munificence and dynamism as moderators into our theoretical framework of social pay reference point is important as these factors are expected to extend our understanding of risk taking by modifying the veracity of fundamental behavioral assumptions.<sup>1</sup> Munificence reflects a resource-rich growth-sustaining environment whereas dynamism describes unpredictable rate of change in the industry environment (Dess & Beard, 1984). We postulate that a munificent environment attenuates the main effects such that high munificence suppresses managerial incentives to invest in risky projects during negative pay deviation while making executives act less conservatively during positive pay deviation because CEO pay value is perceived as more proximal to the benchmark. We predict that a dynamic environment leads to enhanced social comparisons with referent others such that CEOs become risk seeking during negative pay deviation and less risk-averse during positive pay deviation.

This study makes three important contributions. First, earlier behavioral agency studies primarily assess how CEO pay relative to stock price or historical pay impacts risk-related outcomes. To date, there is no investigation of social pay reference point effects on risk taking. This means we still have limited knowledge about the behavioral assessment of CEO framing of own pay relative to similar peers. Departing from research tradition, we conceptualize and empirically test *social pay reference point* as a theoretically relevant benchmark against which CEOs make social pay comparisons with referent CEOs. We offer a reference-based analysis of how social pay reference point induces differential risk preferences when negative and positive pay contexts are considered. Thus, our research creates value-added contribution over existing literatures by focusing on how risk-taking varies in response to CEO framing of relative pay.

Second, recent compensation research departs from traditional models by focusing on either behavioral explanations concerning endowment effect, loss aversion and historical reference point or social pay comparison explanations. We contribute to this growing stream by constructing a more complete theoretical framework, invoking *both* behavioral and socio-psychological theories to understand risk taking decisions in response to framing of CEO socially-derived relative pay. Accordingly, we built a more powerful, integrative framework with greater predictive power and texture to theoretical predictions regarding risk taking behaviors.

Third, we reason that contingencies will influence the baseline linkages because social pay comparison effects do not exist in a vacuum. Behavioral agency studies to date primarily focuses on exploring governance mechanisms *inside* organizations. Wiseman and Gomez-Mejia (1998, p. 149) acknowledged that “[b]y focusing on internal corporate governance, we ignore the potential role that external market factors may play in limiting our arguments.” We extend the behavioral agency model by developing a contingency theory that informs us how external environmental changes can strengthen or weaken risk taking in response to social pay reference points. An investigation of both *external* environmental factors and *internal* governance mechanisms is thus expected to advance our theoretical understanding of risk-taking behaviors.

<sup>1</sup> Dess and Beard (1984) proposed three dimensions - complexity, munificence, and dynamism. We excluded complexity for two reasons. First, complexity is less often linked to pay and/or *ex ante* risk taking in the literature than is munificence or dynamism, possibly because complexity is more tightly linked to changes in firm structure such as structural divisionalization required for decentralized decision-making (Bobbitt & Ford, 1980; Keats & Hitt, 1988). Second, the complexity variable constructed from Compustat-based industry concentration could suffer from empirical limitations. Ali, Klasa, and Yeung (2009, p. 3839) noted that “product markets research that uses Compustat-based industry concentration measures may lead to incorrect conclusions.”

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