Three Essays in Executive Compensation

by

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ABSTRACT

The first chapter entitled "Pay gap and total factor productivity" investigates the relationship between pay gap and total factor productivity in U.S. firms. If incentives created by tournament like pay structures motivate managers, then the gap in pay within a top management team should have a positive relationship with a firm's productivity. However, if tournament like pay structures encourage unproductive competition, then the pay gap can have a negative effect on productivity. I find that pay gap is negatively related to total factor productivity. The negative relationship between pay gap and productivity remains even after incentives created by managers' individual pay schemes and the likelihood of getting promoted are accounted for. Finally, after controlling for rent extraction by the CEO, corporate governance and other firm level factors, information risk is the largest determinant of pay gap.

Previous research links asymmetric benchmarking of CEO pay to CEO control over the pay-setting process. The second chapter – "The bright side of asymmetric benchmarking of pay: Evidence from top management team members" examines whether asymmetric benchmarking of pay exists for top management team members. The presence of asymmetric benchmarking of pay could, on one hand, suggest that managers are involved in skimming, or, on the other hand, could mean that firms insulate managers to prevent them from accessing outside opportunities. Using ExecuComp data for 1992-2007, I find that companies reward top management team members for good luck but do not penalize them for bad luck. Asymmetric benchmarking of pay for top management team members is, unlike CEO pay, consistent with the retention hypothesis rather than the skimming hypothesis. In particular, I find that asymmetric benchmarking of pay for top management team members has a positive relationship with firm value.

The third chapter, "Incentives and innovation: Empirical evidence", studies the relationship between compensation contracts of CEOs and innovation. I find that long term incentives in the form of options are positively related to patents and citations to patents, after controlling for conglomeration, capital structure and other variables known to impact innovation. I also find that pay for performance sensitivity has no relationship and golden parachutes also have a positive relationship with patents and citations to

patents. Overall, consistent with arguments of Manso (2007), the findings suggest that standard-principal agent contracts may motivate the managers to pass up innovative activities which are characterized by high riskiness, long gestation periods and a high rate of failure. Rather, incentive contracts that provide managers with long term commitment and protection for failure are more effective in motivating innovation.