

The Effect of Executive Pay Incentives on Firm Outcomes

Md Reiazul Haque

BBA (Hons) and MBA in Accounting & Information Systems

University of Rajshahi, Bangladesh

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Statement of Originality

I hereby certify that the work embodied in the thesis is my own work, conducted under normal supervision. The thesis contains no material which has been accepted, or is being examined, for the award of any other degree or diploma in any university or other tertiary institution and, to the best of my knowledge and belief, contains no material previously published or written by another person, except where due reference has been made. I give consent to the final version of my thesis being made available worldwide when deposited in the University's Digital Repository, subject to the provisions of the Copyright Act 1968 and any approved embargo.

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Acknowledgement of Authorship

I hereby certify that the work embodied in this thesis contains unpublished papers of which I am a joint author. I have included as part of the thesis a written declaration endorsed in writing by my supervisors, attesting to my contribution to the joint unpublished papers.

Md Reiazul Haque

By signing below we confirm that Md Reiazul Haque contributed the idea development, literature review, research model and methodology development, and data collection and analysis to the papers entitled (1) Tournament incentives and firm performance: Does gender matter? (2) Pay disparity and firm operational efficiency, and (3) Rethinking the measurement of pay disparity and its effect on firm outcomes.

A/Professor Doowon Lee

Dr Bobae Choi

Professor Sue Wright

Statement on the Unpublished Papers Contained in this Thesis

The chapters presented in this thesis are largely a series of the following unpublished papers that I have completed during this PhD.

1. Haque, M. R., Lee, D., Choi, B., & Wright, S. (2020). Tournament incentives and firm performance: Does gender matter? This paper is based on Chapter 2 of this thesis.
2. Haque, M. R., Lee, D., Choi, B., & Wright, S. (2020). Pay disparity and firm operational efficiency. This paper is based on Chapter 3 of this thesis.
3. Haque, M. R., Lee, D., Choi, B., & Wright, S. (2020). Rethinking the measurement of pay disparity and its effect on firm outcomes. This paper is based on Chapter 4 of this thesis.

My co-authors certify that I am the primary contributor to each of the papers listed above. I initiated the research ideas, undertook the literature review, performed the data analysis, and wrote the first draft of all of these papers. My co-authors provided me with guidance regarding the topics, literature, and methodology, reviewed drafts of each paper, and provided feedback.

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Abstract

The gap in compensation ('pay gap') between the chief executive officer (CEO) and other executives (VPs) in a firm's top management team is often studied yet its overall effect on firm outcomes remains ambiguous. According to tournament theory, this pay gap creates motivation among the VPs to become the future CEO, leading to an extended effort and better firm performance. In contrast, equity theory posits that pay gap creates a perception of unfairness among the VPs, resulting in less effort and low firm performance. Empirical evidence on the association between pay gap and firm performance is also mixed and inconclusive. In this thesis, I conduct three studies to shed light on these theoretical and empirical debates concerning how pay gap impacts firm outcomes.

The first study considers VPs' gender composition and examines the impact of the pay gap on the firm's financial performance in two scenarios: when VPs are gender homogenous and when not. In line with gender role theory, I argue that male and female VPs show different outlooks on the pay gap, and thus its effectiveness on firm performance in the above scenarios would be different. Consistent with this prediction, the results show that the pay gap is positively associated with a firm's financial performance only when the VPs are gender homogenous. This finding implies that the 'extended effort' provision of tournament theory applies to specific settings only.

The second study examines the association between the pay gap and firm operational efficiency. Given the evidence in prior research that the accounting- and market-based performance proxies are affected by earnings management and forces beyond executives' control, respectively, they may not fully capture the impact of the pay gap on VP behavior. Thus, I employ frontier-based operational efficiency, which largely avoids the limitations of accounting- and market-based performance measures. The result shows a negative association

between pay gap and efficiency, supporting equity theory's view that the pay gap is counterproductive.

The third study separates the pay gap into explained (determined by economic factors) and unexplained (not determined by economic factors) components and examines their association with firm's financial performance and operational efficiency. I predict that VPs perceive the explained pay gap as fair and equitable, resulting in better firm performance and greater efficiency. In contrast, I expect VPs to perceive the unexplained pay gap as unfair, leading to a counterproductive effect on performance and efficiency. My results support both predictions, suggesting that CEO's and VPs' compensation should be mainly based on economic attributes to achieve optimal financial and operational outcomes.

Overall, findings in this thesis contribute to the extant literature and advance our understanding of how the pay gap impacts firm outcomes. The pay gap is an effective motivational mechanism for VPs when they are from a single-gender group and when economic factors determine the size of the gap. These findings have implications for those who design executive compensation and consider the pay gap in their decision-making.