

Determinants of Executive Salary in a Competitive Market

Jatinder Kumar Jha & Sunil Maheshwari

This study explored the impact of social networks on compensation level of managers as well CEOs. Our arguments are based on Vroom expectancy theory and Adam's equity theory. Social network with key personalities (political leaders, actors, cricketers etc.) adds to the prestige and power of the CEOs. Based on segmented labor market (SLM) theory, authors argue that wage differentials across the industries exist due to labor immobility. The paper explored factors contributing to labor immobility which include institutional factors (managerial rule, government and laws, etc.), union membership, and skill level. Inflow of migrant labor influences the wage rate across the industries.

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Introduction

The cost associated with losing employees and recruitment, selection and training new employees often exceeds 100 % of the annual compensation for the position (Cascio, 2006). Therefore it is very important to retain the key employees because of not only the financial loss but also the tacit or strategic knowledge loss that goes with the leaving employee. Work disruptions, loss of productivity, customer service and diversity are a few other consequences of resignation of an employee (Aleen, Bryant & Vardaman, 2010). Pay dissatisfaction is the major reason for job quitting. Compensation and benefits are great motivators so organizations need to focus on this strategic area for acquisition and retention of key employees. Pay is a strategic decision of the firm since acquisition and retention of the key employees depends

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up on the pay structure. Research has shown that market survey reflects the external worth of jobs and job evaluation reflects its internal worth (Remick, 1981). Pay satisfaction is the positive or negative feeling of the employee for his/her pay (Miceli & Lane, 1991). There are number of factors that influence the pay satisfaction. Perceived pay fairness is one of the determinants of pay satisfaction (Berkowitz et al., 1987; Dyer, Schwab & Theriault, 1976; Folger & Knonovsky, 1989). Fisher and Govindarajan (1992) found positive relationship between age, tenure, experience and years of education of profit centre managers with compensation. They further found that profit centre manager gets higher compensation with increase in its size. Rouzies et al. (2009) found that variable to fixed pay ratio of sales professional depends up on tax regime (tax burden on employee & employer) and complexity of task. Challenging job is difficult to evaluate; so fixed component dominates the variable part. After extensive review of the existing literature on wage determination we came up with a conceptual framework that explains how labor immobility influences the wage rate in competitive labor market. We have further explored the factors contributing to labor rigidity including union membership, institutional factors, inflow of migrant workers and skill level. We have drawn our argument on Segmented Labor Markets (SLM) Theory that emphasized on the existence of dual labor market (primary and secondary sectors) with some institutional barriers that prohibits the labor mobility across the segmented markets (Dicken & Lang, 1985; Doeringer & Piore, 1971). We

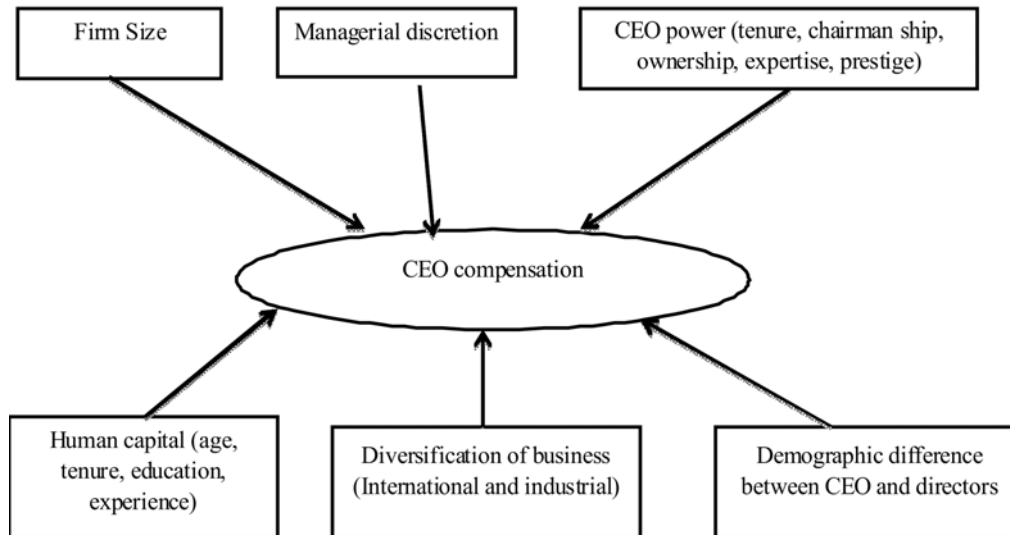
have studied the impact of social networks on the compensation level of managers and CEOs. While studying the determinants of wages our major focus was on exploring the factors influencing the labor mobility across the industries. We have discussed the determinants (fig. 1) of executive salary/ CEO salary and have synthesized the existing literature under relevant subheadings (factors). We then explore the literature on determinants of wages and proposed the conceptual framework (fig. 3).

Employee compensation means all types of pay given to the employees under their employment contract. Direct financial payment includes wages, salaries, incentives, commission and bonuses. On the other hand indirect financial payments comprised employer paid insurance, leave travel concession etc. Various legislations like Minimum Wages Act, 1948, Payment of Wages Act, 1936, and Equal Remuneration Act, 1976 etc. influence the structure, computation, and payment of wages. Pay Commissions in India give their recommendation to fix the salaries of government employees. Government forms wage boards to decide the salaries of various occupational groups. In India, apart from compensation legislations, unions also influence the pay plans through formal collective bargaining with the employers (Dessler & Varkkey, 2011).

Determinants of Executive (CEO) Salaries

Acquisition and retention of key employees is a very challenging job. In

Fig. 1 Determinants of CEO Compensation



today’s competitive job market talent management is really a big challenge for any organization. There are a lot of choices available for the job seekers. In order to attract the talented pool of employees, organizations are designing their compensation plans in such a way that would lure the potential candidates for joining their organizations. Compensation determines the employee attitude, motivation and behavior in the organization (Gerhart & Milkovich, 1992).

Human Capital

Human capital includes age, experience, tenure, and skills of an employee. Logic for positive relationship is that the managers who invested in acquiring job relevant skills should get the premium. Hambrick (1989) found that functional expertise /background and prior experience affect the compensation.

Firm Size

Research has found a relationship between firm’s size and executive pay (Rich & Larson, 1984). Job complexity refers to the magnitude of responsibility vested in the job. Gomez-Mejia et al. (1987) found that in management controlled organizations firm size predicts the total compensation, bonuses and base salary of executives. The relative size of profit centre (size of profit centre/ size of firm) is positively related to the salary and bonuses of the profit centre manager. As size of the firm increased complexity increases therefore executive with greater expertise is required (Becker, 1964). Fisher and Govindarajan (1992) in

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their study found that profit centre manager gets higher compensation with increase in profit centre size.

Managerial Discretions

Performance based pay (bonuses, stock options) would be effective if managerial discretion is high since high managerial discretion means many options available for decision making (few constraints), behavior and decisions are difficult to predetermine, impact of their decisions are unobservable or ambiguous and firm's performance is volatile. These discretions are stemming from a complex/diverse business strategy and uncertain (dynamic) environment (Rajagopalan & Finkelstein, 1992; Hambrick & Finkelstein, 1987). Finkelstein and Hambrick (1989) found managerial discretion increases with firm diversification. Magnan and Stonge (1997) found that high managerial discretion (whole sale customer, foreign, international business etc.) in banking industry leads to performance based compensation.

Diversity in Board

Power of the CEO influences the compensation positively by ignoring economic factors (firm specific factors, job etc.) (Brick, Palmon & Wald, 2006). Power of CEO is coming from his tenure (Shen, 2003), expertise and prestige (Finkelstein, 1992), equity ownership (Cannella & Shen, 2001) and chairmanship (Westphal & Zajac, 1995). Directors are representatives of shareholders and they have fiduciary duty to protect the interest of shareholders but power-

ful CEO appoints passive directors (Zajac & Westphal, 1996). Moreover directors who are CEOs in other firms also support high compensation level of CEO. Resource dependence theory expects professional and demography heterogeneity in the board for better compensation decision. Since directors from same demographic category have similar belief, there is fair chance of group outcome. Professional homogeneity is the result of directors in compensation committees of other firms (Vafeas, 2000). Professional homogeneity leads to imitation of inter organizational practices (Haunschil, 1993:589) which inhibits the effective processing of information since search of other alternatives is rare and there is poor evaluation of each alternative (Turner & Pratkanis, 1998: 781). Powerful CEO appoints directors who do not want authority due to their personality traits (Westphal & Stern, 2006). That helps the CEO in dominating in his compensation decision. Information regarding the CEO job and other firm related characteristics play a vital role on the determination of compensation, so director of the firms should have access to all relevant information. Another problem with homogeneous group of directors is "Group Think" in compensation related decisions. It is a dysfunctional mode of group decision making characterized by a reduction in independent critical thinking and a relentless striving for unanimity among members." (Eorbes & Milliken, 1999:496). Information is not processed properly and there is fair chance of poor decision. Similar group of people do not challenge each other's decisions (Turner

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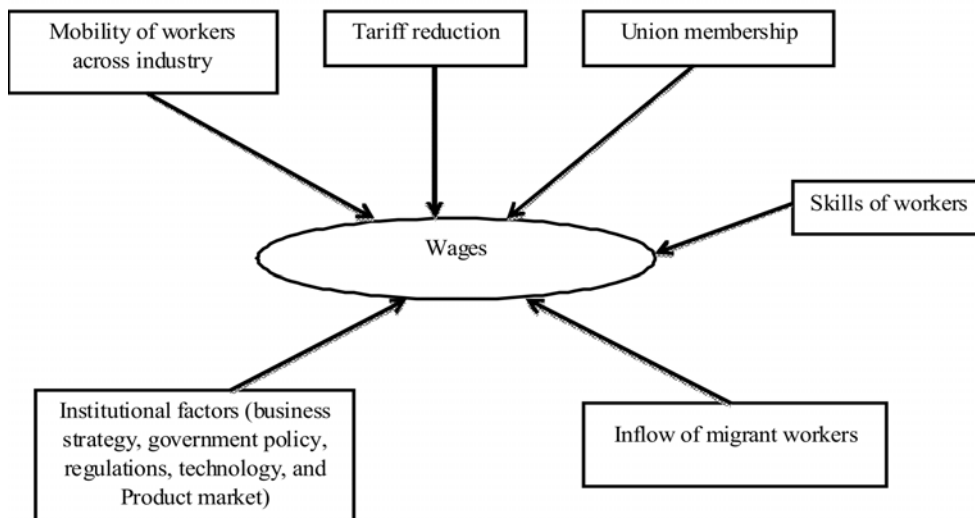
&Pratkanis, 1998). Professional and demographic homogeneity inhibits the information flow and compensation fixed by them is not optimal for the firm.

Diversification of Firm Business

Diversification of the firm’s business is another factor that influences the CEOs compensation. Deckop (1988) found higher international diversification, accounting earnings, investment opportunities and firm size positively influencing the CEOs compensation. With increase in portfolio of business due to international expansion (dispersion of sales, assets, and personnel) information processing becomes difficult for boards

(Draft, 1992). Monitoring of executive becomes a costly affair, hence agency cost increases (Roth & O’ Donnell, 1996). With diversification of business, complexity in managing the business increases (Duru&Reeb, 2002). Firm size affects the diversification (Kim, Kim &Pantzalis, 2001) and positively influences the CEOs compensation (Sanders & Carpenter, 1988). With increase in the size of firm responsibility of CEO increases and requires greater ability and knowledge to manage the complex firms, so they are paid higher compensation for their efforts (Gaver&Gaver, 1995; Rosen, 1982). Sales volume (Newman & Banister, 1998) and total sales (Useng et al., 2000) are two ways to measure firm size. International diversification, firm size and accounting earnings are positively related to CEOs compensation. Large sized firm has more international investment opportunities and this international diversification leads to firm profits and CEOs are being paid higher.

Fig. 2 Determinants of Wages



In India after 1990 various trade reforms took place following the liberalization of its economic policies. These trade reforms like reduction or removal of various tariffs, de-licensing etc. affected the different industries differently at different periods of time. This differential growth stemming from trade reforms led to differential wages across the industries (Chatterji & Choudhury, 2013). Krueger & Summers (1987) found that industry affiliation of the worker is an important factor in wage determination which may be due to imperfect competition and immobility of industry specific skills. Effects of reforms like lay-off of employees, outsourcing, subcontracting were seen in India very late after 2002 (Dutta, 2007). This industry affiliation influences the wages of workers negatively in the absence of their mobility across industry and geographical localities. Chatterji & Choudhury (2013) found that Indian labor market could not respond to the reforms due to structural bottlenecks in the labor market. There is rigid labor market in India (Dutt, 2003). Various labor laws like Industrial Disputes Act, 1947 that secures employment security by prohibiting lay-offs of employees (in enterprises having more than 100 employees) without prior permission from government, and other laws pose labor inflexibility. Varying union bargaining power across the industry that has been

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decreasing (Dutt, 2003), also influences the wage differential across the industry. Due to multiplicity of unions its power is decreasing in India. Any seven people association can be considered as Union under Trade Union Act, 1926. Trade unions secure higher wages for its members without losing employment (Krueger & Summers, 1988). Kumar and Mishra (2008) in their study found that trade policy reforms (tariff reduction) has created the wage differential in India across industry. Since tariff reduction happens substantially in unskilled labor industry so now wages are high in those industries. Tariff increases the productivity and that leads to higher wages. So trade reforms (reduction in tariff) increased the wages of unskilled workers as compared to skilled workers. Argument for high wages is that liberalization influences productivity positively and that is passed onto industry wages. And liberalization has effected more in those industries where tariffs were high, high share of unskilled workers and low wages (Goldberg & Pavcnik, 2005).

Mincer (1974) attributed the difference in investment on development of worker skills or education level (human capital) for the wage differential. Workers' individual differences in terms of skills and education create wage differences in labor market. Segmented Labor Markets (SLM) Theory emphasized on the existence of dual labor markets (primary and secondary sectors) with some institutional barriers that prohibits the labor mobility across the segmented markets (Dicken & Lang, 1985; Doeringer & Piore, 1971). Primary sector

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jobs are characterized by high wages, good working conditions, and good career growth opportunities. Discriminant group (women, immigrants, blacks), usually find difficulties in getting jobs in this sector (Dicken & Lang, 1985). This segmentation of job market is done by the institutional factors like internal managerial rules, business strategies, product markets, technological conditions, power of trade unions, regulations and government policies. Migrant workers often are employed in secondary market and they are exposed to poor working conditions and low wage jobs (Hammar, 1985; Piore, 1979). Migrant or foreign workers are assumed to affect the employment and wage rate in host countries. Inflow of migrant workers influences the wage rate in host country.

Determinants of Salary: Propositions

Salary expectation depends up on the reference points (Adams, 1963). People used to compare their salary with other persons in their occupational field (Scholl, Cooper & McKenna, 1987). We have proposed job seekers having more social ties would have more referents and they will have more information related to salary levels for given jobs. A social network is formed between two participants based on mutual trust. Social capital is based on the assumption that “mutual

relationship would help me” (Cross & Cummings, 2004; White, 2002:260), so it is all about entering in to relationship for achieving some goal or tangible/intangible benefits. Social capital theory emphasises on the relationship for personal tangible and intangible benefits. Trust, norms, and networks improve the efficiency of social organizations by facilitating coordinated action (Putnam, 1993). Individual having more social networks would have more information regarding the salary offered by other companies for similar job position so he/she would negotiate or expect higher salary. Their networks help them in information gathering quickly. Also individual having more social ties would have many job options through reference of their social networks. This would give them confidence in negotiating higher salary levels. A highly socially connected individual will always compare his salary with individual in their networks. Social comparison is very common for socially connected individuals. Berkowitz et al. (1987) found social comparison influences the pay satisfaction of an employee.

Proposition 1a: Individual with large social networks negotiate/expect higher salary.

Proposition 1b: Individual with small social networks negotiate/expect lower salary.

As size of the firm increased complexity increases therefore executive with greater expertise required (Becker, 1964). Firm size affects the diversification (Kim, Kim & Pantzalis, 2001) and positively influences the CEOs compen-

sation (Sanders & Carpenter, 1988). With increase in size of firm responsibility of CEOs increases and requires greater ability and knowledge to manage the complex firms so they are paid higher compensation for their efforts (Gaver & Gaver, 1995; Rosen, 1982). Fisher & Govindarajan (1992) in their study found that profit centre manager gets higher compensation with increase in profit centre size. Increase in firms size leads to higher managerial discretion. These discretions are stemming from complex/diverse business strategy and uncertain (dynamic) environment (Rajagopalan & Finkelstein, 1992; Hambrick & Finkelstein, 1987). Larger the firm more options available for the manager to choose, so managerial discretion increases with firms size. Larger firms has all resources (finance, market expertise, human resource) so they have more diversification options. Since managerial discretion is high in larger firms, there is high probability of diversification. Finkelstein and Hambrick (1989) found increased managerial discretion with diversification of the firm. Hence they are paid high. We are proposing managerial discretion influences the diversification of firms business. With diversity it becomes very difficult to evaluate the performance of managers/executives so firms go for variable pay.

Proposition 2a: Managerial discretion positively influences the diversification of firm.

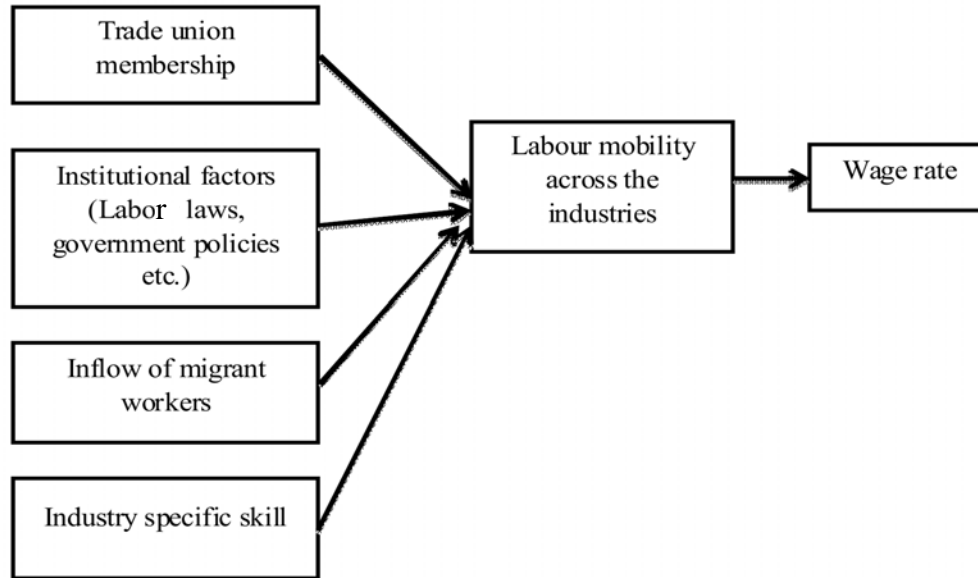
Proposition 2b: Diversification is positively related to compensation of executive/managers.

Power of CEO influences the compensation positively by ignoring economic factors (Job, firm specific factors, etc.) (Brick, Palmon & Wald, 2006). Power of CEO comes from his tenure (Shen, 2003), expertise and prestige (Finkelstein, 1992), equity ownership (Cannella & Shen, 2001) and chairmanship (Westphal & Zajac, 1995). CEOs having more social networks with key personals like politicians, film stars, cricketers (known sports persons), chairmanship or membership in national and international organizations score high on prestige power. Just having directorship in any firm or having social networks with any person won't impact the firms profitability and hence the compensation of the CEOs. Only those social ties would lead to increase in CEO power and hence CEO compensation which have potential to benefit the firm.

Proposition 3: Social ties of CEO are positively related to his/her compensation.

Krueger and Summers (1987) found that industry affiliation of worker is the important factor in wage determination which may be due to imperfect competition and immobility of industry specific skills. Effects of reforms like lay-off of employees, outsourcing, subcontracting were seen in India very late after 2002 (Dutta, 2007). This industry affiliation influences the wages of workers negatively in the absence of their mobility across industry and geographical localities. Chatterji and Choudhury (2013) found that Indian labor market could not respond to the reforms due to structural

Fig. 3 Framework for Wage Determinants



bottleneck in the labour market. Labor mobility in India was very low. Skill level of workers or industry specific skills of workers was one of the reasons for the industry affiliation or poor labor mobility across the industries. This led to poor wages in particular industries where labor mobility was low. Industry level skills restrict the labor mobility across the industry and hence it leads to low wages. Highly skilled workers have more mobility across the industries so they get good wages. Trade unions do not want to lose its members, so they discourage labor mobility. This mobility would also elimi-

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nate their importance since wages would be decided on the demand and supply of labors and not on the bargaining power of unions. Varying union bargaining power across the industry (that has been decreasing (Dutt, 2003)), also influences the wage differential across the industry. But unions try to protect the interest of the workers against non-union workers, union workers are paid more. Mincer (1974) attributed the difference in investment on development of worker's skills or education level (human capital) for the wage differential. Workers' individual differences in terms of skills and education create wage difference in labor market. Highly skilled workers get higher wages.

Proposition 4a: Trade unions reduce the workers mobility across the industries.

Proposition 4b: Labor mobility across the industries is positively related to wages.

Proposition 4c: Union membership is positively related to wages.

Proposition 4d: Skill level of workers is positively related to wages.

Proposition 4e: Industry specific skill is negatively related to wages.

Segmented Labor Markets (SLM) Theory emphasizes on the existence of dual labor markets (primary and secondary sectors) with some institutional barriers that prohibits the labor mobility across the markets (Dicken & Lang, 1985; Doeringer & Piore, 1971). Primary sector jobs are characterized by high wages, good working conditions, good career growth opportunities and discriminant groups (women, immigrants, blacks), usually find difficulties in getting jobs in this sector (Dicken & Lang, 1985). This segmentation of job market is done by the institutional factors like internal managerial rules, business strategies, product markets, technological conditions, power of trade unions, regulations, and government policies. Migrant workers often are employed in secondary market and they are exposed to poor working conditions and low wage jobs (Hammar, 1985; Piore, 1979). Migrant or foreign workers are assumed to affect the employment and wage rate in host countries. Inflow of migrant workers influences the wage rate in host country. Institutional factors decide the inflow of migrant workers and labor mobility across the industries. If the labor laws are restrictive like in India then labor flexibility gets

reduced and wage differential across the industries becomes common. If migrant labor or unskilled labor are increasing then wages would go down due to excessive supply of labor.

Proposition 5: Inflow of migrant workers is negatively related to wages.

Discussion

We have presented the emergent framework after the extensive literature review that explains the determinants of wages in competitive labor market. We have proposed the impact of social network of an individual (as well CEO) on his/her compensation level. In compensation literature we could not find many empirical studies on this. This would be very interesting research for practitioners and academicians to explore the influence of social capital/network on pay satisfaction and compensation level. While reviewing the existing studies on determinants of wages we found that immobility of workers is major reason for the low wage rate in a few industries and wage differentiation across the industries. We further explored other factors of rigidity in labor market including union membership, institutional factors, skill gaps, inflow of migrant workers. We have drawn our argument on Segmented Labor Markets (SLM) Theory that emphasized on the existence of dual labor market (primary and secondary sector) with some institutional barriers that prohibits the labor mobility across the segmented markets (Dicken & Lang, 1985; Doeringer & Piore, 1971). Our findings can contribute substantially for the fu-

ture research in this direction. Researchers may further extend this query to explore the reasons for the skill gaps and labor rigidity in labor market. Social comparison is very common for socially connected individuals. Study done by Berkowitz et al. (1987) found that social comparison influences the pay satisfaction of an employee. Firm size affects the diversification (Kim, Kim & Pantzalis, 2001) and positively influences the CEOs compensation (Sanders & Carpenter, 1988). With increase in size of firm, responsibility of CEOs increases and requires greater ability and knowledge to manage the complex firms so they are paid higher compensation for their efforts (Gaver & Gaver, 1995; Rosen, 1982). Finkelstein and Hambrick (1989) found that managerial discretion increases with firm diversification. Social networks of the CEO enhance his prestige power since he gets more information related to the current business environment that helps him in managing the company efficiently. Power of CEO is coming from his tenure (Shen, 2003), expertise and prestige (Finkelstein, 1992), equity ownership (Cannella & Shen, 2001) and chairmanship (Westphal & Zajac, 1995). We have proposed social networks of the CEO would lead to higher compensation. Social network also influences the social comparison which is used by individuals which influences the pay satisfaction level. We have proposed individuals having more network would have more information regarding pay rate for given position and hence would negotiate or expect higher salary in comparison to others having less social networks.

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