

The Executive Wage Disparity and Corporate Performance

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Abstract. The connection between executive salary disparity and corporate yield has garnered a lot of attention since the continuous development of China's economic marketization, and some researchers have found a variety of economic consequence theories on the relationship between the two, however, there is still a lack of unified explanation between different theories. Therefore, by summarizing the three different theories on economic consequences in the existing studies, this paper analyses the differences in their contradictory points, and accordingly explores the connection between the executive pay disparity and company success. The analysis finds that the "inverted U-shaped" theory is more supported from the point of overcoming the contradictions, i.e., the tournament theory and the behavioural theory have different scopes of application, so that both positive and adverse correlations between the executive wage difference and business performance exist, and the application of which should focus on the important moderating and intermediary variables in the relationship between the two to determine what stage it belongs to. This is a reminder that pay formulators need to work closely with the characteristics of the company to develop the pay gap that best suits them.

Keywords: Executive pay gap; corporate performance; Tournament Theory; Behavioural theory; Inverted U-shape theory.

1. Introduction

In the new century, the rapid development of various industries and changes, many companies start from the pay structure, widen the pay gap to obtain higher performance, but between 2004 and 2007, the absolute salary disparity between executives and staffs of state-owned companies increased from 160,000 to 290,000, nearly doubled in just four years![1], In some enterprises, the pay differential between executives and workers has increased by 100 times, and executives have been exposed to millions of annual salaries, triggering great controversy in society. Although the government issued a salary limitation order in 2009, stating that the annual remuneration of state-owned company leaders should not be more than 20 times the average employee wage, which prevented executive salaries from continuing to soar, the gap between executive salaries has continued to widen in recent years [2]. The highest gap in 2023 is still 288 times.

Does a widening pay gap really promote future corporate performance? Academics have not reached a consensus on this issue, and there are three main types of views: according to academics that subscribe to the tournament hypothesis, the executive pay disparity can improve business performance, scholars who support the behavioural theory believe that the executive pay difference can induce a feeling of injustice within the firm and adversely affect corporate performance, and scholars believe that both theories are applicable and that there is a curvilinear connection between the executive pay discrepancy and business performance [2]. This study starts from the contradictory points of the two theories supported by the existing literature, combines with the traditional Chinese culture and special institutional background, discusses the rationality of the different theories and the root of the contradictions, differentiates and analyzes the theoretical ways to deal with the contradictions, speculates on the theory that more truly reflects the connection between the executive pay discrepancy and firm performance, and explores the connection between business performance and the executive pay discrepancy and its inner mechanism from the important influencing factors.

This paper may theoretically help subsequent studies to directly address the limitations of the existing literature and identify research deficiencies; practically, it is beneficial to the government's

macro-control and corporate performance growth by formulating a reasonable pay structure and related policies through the connection between the two and controlling the salary disparity and its economic consequences.

2. Relevant Theories and Definitions

2.1. Variable Definition

2.1.1. Executive pay gap

According to China's corporate Law, executives include corporate managers, deputy managers, financial officers, the board secretary of a listed business, and other employees as specified in the articles of association. Some researchers have divided the corporate executive pay gap into the internal pay disparity of executives, the salary difference between managers and workers, and the external wage discrepancy of executives between different companies, with different gaps having different relationships with corporate performance [3]. The measurement of pay gap in more literature uses relative gap because absolute gap is prone to endogeneity problem [2, 4], which defines the internal pay gap of executives as the rate between the top three executives', directors', and supervisors' average salaries and the average executive salary.

2.1.2. Corporate performance

There are various indicators to measure corporate performance, such as financial indicators like ROA (total profit to average assets as a ratio) and ROE (net profit to shareholders' equity as a ratio), as well as market indicators like EPS (ratio of profit after tax to total equity) and Tobin's Q referred to market value divided by book value. However, ROA and ROE, as accounting profit indicators, are affected by accounting phasing and manipulation by executives, and are significantly unfavorable for measuring corporate performance [5], and Western scholars believe that Tobin's Q value better reflects the growth in corporate value and market performance, and should be chosen to measure corporate performance [6].

2.2. Economic Consequences of the Pay Gap

2.2.1. Tournament Theory

Tournament theory suggests that when monitoring can be trusted, pay is determined by marginal contribution, and since absolute values may be difficult to quantify, promotion decisions are made through marginal contribution ranking [7]. This sorting also triggers spontaneous monitoring within the organization, which reduces the cost of monitoring, and at the same time encourages employees to continuously put in greater effort, not by virtue of one credit once and for all, and thus improves the performance of the organization.

2.2.2. Behavioural theory

Behavioural theory suggests that teamwork is the main way to generate performance, and that managers and employees often perceive whether they are being treated fairly through pay comparisons. If the pay gap widens, those who are lower will feel dissatisfied and believe that their inputs are not rewarded, resulting in negative behaviours such as slacking off, striking or jumping ship, or even not caring about the corporate goals, which reduces the cohesion of the company and affects the performance of the company [8].

3. Theoretical Analysis

3.1. The Connection between Executive Salary disparity and Enterprise Performance

As known in the previous section, the pay discrepancy categories are to be examined here. First, the internal gap in executive pay, more literature empirically proves an important positive correlation

between the two, supporting the tournament theory [9, 10], but Zhang's experimental data gives the opposite conclusion, suggesting that the pay gap undermines cooperative behaviours and is detrimental to the prospective profits of the firm, supporting the behavioural hypothesis [11]. Secondly, the internal salary difference between executives and workers, many papers focusing on SOEs have concluded that there is a positive relationship between the internal wage disparity and the prospective performance of the business, suggesting that the wage difference has an motivational effect on the firm's performance, thus supporting the tournament theory [1, 4, 12, 13]; however, there are also studies that support the behavioural theory [11]. In addition to this, there are also a part of studies that suggest that the connection between internal salary gap and company profits is complex and probably not linear, and the two theories should be considered together. Research has demonstrated an "inverted U-shape" between the two, i.e., when the pay gap is insufficient (before the inflection point), increasing the pay gap creates incentives but is not so serious as to create a sense of unfairness, and the tournament theory dominates; meanwhile, when the salary discrepancy is too large, the behavioural hypothesis is the dominant factor, and the two theories are negatively correlated [2, 5, 14, 15]. Thirdly, existing research illustrates that the relation between the executive external salary disparity and company performance is transitioning from tournament theory to managerial market theory [3], which is not the focus of this paper and will not be described here.

3.2. Analysis of Tournament Theory and Behavioural Theory Differences

3.2.1. Analysis of the contradictory status of Tournament theory and Behavioural theory

The existing tournament theories and behavioural theories have validity. Objectively, the pay gap has an impact on human psychology and behaviour, which may indeed increase motivation while creating an unfair corporate climate, and each has a theoretical basis in psychological principles that cannot be refuted. However, the existing literature is not justified by the opposite correlations obtained from the data, thus supporting the different theories. Firstly, these studies have selected different company industries, some focusing on manufacturing [5] and some using data only from the service sector [14], considering that the service sector dominates the GDP in recent circumstances. These industry-different data are themselves biased towards different theories. For example, technology development talents in manufacturing industry have a pivotal role within the industry, so their higher pay is easily accepted by the public, and the pay gap they can afford is naturally higher, and these industries themselves will have a bias towards theories. Secondly, the study of absolute value is neglected. Whether it is tournament theory or behavioural theory, it is believed that the behaviour and psychology of employees in the whole process of pay gap increase is unchanged, which only conforms to one theory. However, in reality, the two theories should be considered together in the process, comparing the magnitude of the utility they produce and observing the dominant utility. Third, the existing literature proves that there are many mediating and moderating variables between the wage gap and enterprise yield and play a significant role [2, 4, 16], different theories do not comprehensively control the significant variables in the process of exploration, and there may be a natural positive relationship between the wage difference and enterprise achievement [17], these indistinguishable correlations lead to empirical correlation coefficients of inaccuracy, and may also result in contradictions in theories. . Fourth, the theory itself does not adapt to certain practical situations, for example, the pay gap may arise from managerial power, is opportunistic behaviour does not have incentive utility, but the empirical results will wrongly support the behavioural theory.

3.2.2. The end of the conflict and the scope of application of the theory

When considering the two theories together, when the pay gap is very small, an appropriate increase in the gap will not produce a strong sense of unfairness, at which time the incentive utility dominates, and an increase in the wage discrepancy is conducive to business performance, and the tournament theory is used; whereas, when the pay gap is large enough to exceed the normal level, the impact of its destructive cooperation is greater than the incentive effect, and thus the behavioural

theory is applied [5]. According to this reasoning, it can be seen that the study should use both theories together to explain the connection between wage discrepancy and company yield.

3.3. An Exploration for the Connection between the Internal Disparity in Executive Compensation and Company Performance

3.3.1. Influence from multiple factors

Firstly, industry characteristics should be considered. For example, Li demonstrated that technology-intensive industries have a positive moderating impact on the relation between executive team level salary differences and company performance [4], and the connection between the two is also affected by asset size and number of employees [5]. Next is the risk factor, when the risk is high, supervision is more difficult, and the utility of increasing the pay gap to solve the supervision problem outweighs the disadvantage of undermining co-operation and contributes to firm performance. Therefore when external risk is high, firms should set a larger pay gap. Specific risks are business growth and customer demand uncertainty, etc., both of which positively regulate the connection between wage discrepancy and firm profits [2]. Secondly, when exploring the correlation between the two, the strategic factors of the enterprise cannot be ignored. Take the competitive strategy for example, enterprises adopting differentiation strategy focus on innovation and talent, pay levels are generally higher, there are excessive incentives, the phenomenon of pay gap is too large, which in itself is not conducive to business performance. Therefore, when exploring the relationship, it is important to gather industry characteristics and strategic choices to analyze that different strategies have naturally different pay gaps, which may be located in the two segments of an inverted U-shaped curve, making it easy to draw inconsistent conclusions. Finally, the nature of the enterprise's property rights has a significant role in the connection between the internal discrepancy in executive compensation and enterprise profits, state-owned companies non-state-owned enterprises from the structure of the management of the existence of essential differences, state-owned enterprises with high political relevance, itself is more likely to obtain excessive remuneration, resulting in detrimental to the performance of the enterprise's opportunistic behaviours, cannot be in the study of the leaf blind, ignoring the nature of the property rights to bring a series of potential impacts.

3.3.2. Intrinsic Mechanisms

Who does the internal pay gap actually benefit corporate performance by motivating? Wenjin Li explains the underlying mechanism and argues that the pay gap does not significantly motivate executives but rather employees, which enhances firm performance, whereas when the pay gap is too high, it undermines firm performance by generating greater unfairness to employees [18]. The study of the intrinsic mechanism greatly helps in the design of the pay structure.

4. Research Shortcomings and Future Research Directions

This study supports the "inverted U-shape" theory and demonstrates that the two theories work at different stages, but there are still research limitations. Firstly, it does not explore the specific value of the appropriate wage gap, i.e. the size of the inflection point, which restricts the actual design process of the enterprise's pay structure. Secondly, in the context of the rapid development of high-tech enterprises, this paper takes a more general view of performance, and does not distinguish between innovative performance and financial performance and so on. The internal mechanism of these different performance and pay gaps may be different, and the correlation relationship may also be different. Thirdly, in the analysis of the contradictory status quo, the psychological and influencing factors of the higher-paid are neglected because the intrinsic mechanism is discussed from the perspective of the lower-paid.

It is hoped that future research can pay attention to more important influencing factors, improve the adjustment mechanism of pay gap and enterprise performance, and make more research on the size of the inflexion point of the "inverted U-shape" theory.

5. Conclusions

By analyzing the contradictions in the existing literature supporting the tournament theory and the behavioural theory respectively, this study argues that the two theories should be used together to explain the connection between the executive salary difference and corporate performance, supporting the "inverted U-shaped" theory. In further exploring the relationship between the two, this paper summarizes the existing literature and finds that while applying the "inverted U-shape" theory, it is also vital to focus on the moderating factors, which are important moderating variables that may have a "qualitative" impact on the relation between the salary discrepancy and corporate growth. In addition, the paper also focuses on the underlying mechanisms of wage difference and firm performance to facilitate the understanding and application of the correlation in essence.

The paper's primary contribution is that it draws an "inverted U-shaped" conclusion from the contradictions of the existing theories, which helps academics to reach a unified viewpoint, and emphasizes the importance of relevant variables, which is conducive to the exploration of more factors in subsequent studies.

This paper makes some suggestions for the design of corporate pay structures: companies should take into account the characteristics of their industry, risk and strategy, etc., to determine the appropriate pay gap (inflection point) of the enterprise, deduce the stage at which the existing gap is, and make adjustments accordingly. Also, since the two theories jointly explain the impact of wage disparity on business performance, the intrinsic mechanism proves that the motivational effect of employees is larger than that of executives, and the company must take into account competition and fairness when designing the compensation system, and at the same time pay closer attention to the psychology and behaviours of the employees.

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