RESEARCH BRIEF

Center for Executive Succession

Performance Consequences of CEO Pay Compared to the Pay of Other Executives

Research in the *Strategic Management Journal* offers some useful insights into executive pay. There are two theories about what happens when a CEO makes substantially more than others in the top management team. One suggests that relatively high CEO pay represents a prize for which others compete, motivating them to perform better. The other predicts that differences will be demotivating if they are seen as unfair by lesser-paid executives. The authors showed that firm performance is higher when differences are small or large, and firms with moderate differences in pay between the CEO and other executives perform worse.

Key Takeaways:

- Differences in pay between CEOs and other executives can impact their motivation to perform.
- Large and small disparities in pay lead to improved performance, and moderate disparities are associated with worse performance.
- If firms have an heir apparent, bigger discrepancies are more uniformly harmful to performance.

The researchers argued that both theories of pay disparity could be right. Moderate differences in pay can breed comparisons that seem unfair, but not be especially motivating. Very large differences will be motivating, and also make other executives see the CEO as so separate from themselves that they won't make the comparison at all. They looked at the compensation patterns of 227 firms from the Fortune 500 over four years, and found that pay disparities that were very high or very low resulted in better firm performance. The average CEO's total compensation was about 3.12 times the average of the next four top managers. Exceptions were found in firms with an heir apparent to the CEO position, and in firms with particularly powerful CEOs. In those firms, higher disparity between CEO and other executive pay more uniformly hurt performance.

The findings suggest that firms should consider their pay policies in light of the overall context. For instance, firms with strong succession planning and powerful CEOs may see less benefit in large pay gaps between CEOs and other top team members.

Ridge, J. W., Aime, F., & White, M. A. (2015). When much more of a difference makes a difference: Social comparison and tournaments in the CEO's top team. *Strategic Management Journal, 36: 618-636.*