Fat Cats and Thin Followers: Excessive CEO Pay May Reduce Ability to Lead

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Fat Cat Thursday: Top bosses earn workers' salary by lunchtime. (Neate, 2018)

In 2018, as in previous years, disclosures of the pay of public company chief executive officers (CEOs) have been accompanied by widespread media coverage, political condemnation, and public outrage. The main talking point is a simple one: while the typical worker continues to see little improvement in their pay, CEOs continue to do exceedingly well. For instance, in Australia, CEOs of large public companies are estimated to earn between 15 and 106 times the salary of the average worker (Walker, 2016). In the United Kingdom, CEOs of FTSE 100 companies receive about 120 times what the typical worker does (CIPD, 2018). And in the United States, CEOs currently earn around 271 times what their workers do (Mishel & Schneider, 2017). This state of affairs is relatively recent, as in the middle of the twentieth century, US CEOs earned about 20 times the amount of the typical worker. This means that over the last half century, CEOs have seen their pay rise by almost 1000% while their workers have had a paltry rise of just 11% (Mishel & Schneider, 2017). The enrichment of CEOs and (to a lesser extent) other member of the executive class has had measurable societal consequences. In particular, it has increased the concentration of societal income among those at the very top of society, and may be one of the most important factors in the increase in income inequality in the United States in the past 50 years (McCall & Percheski, 2010; Piketty, 2014).

Understandably, the public discourse around CEO pay has focused on its implications for society broadly (see also Bratanova, Vauclair, Liu, & Summers, chapter "A Rising Tide Lifts Some Boats, but Leaves Many Others Behind: The Harms of Inequality-Induced Status Seeking and the Remedial Effects of Employee Ownership"). Somewhat overlooked is the possibility that high levels of CEO pay may also have negative implications for the functioning of their organizations. In

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this chapter, we explore the implications that CEO pay may have for the CEOs' most important function: their capacity to lead their organization. Drawing on the social identity approach to leadership (Haslam, Reicher, & Platow, 2011), we argue that high pay is likely to erode CEOs' capacity to create a shared social identity (or sense of "us") with their workers, and thereby weaken their ability to influence them to work toward their organization's goals. If true, it suggests that in setting CEO pay, organizations need to consider a wider range of outcomes than is suggested by dominant economic models of leader remuneration. This is because in setting CEO pay, organizations shape the motivation and behavior not only of their CEO but also of their workers. Indeed, in designing compensation packages that attempt to ensure that CEOs do the right thing by shareholders, organizations may be driving a wedge between CEOs and their workers.

In what follows, we will summarize models that account for CEO pay (including determinants of their rising pay) as well as the theoretical and empirical bases for our argument that high CEO pay may erode their ability to lead. In the process of revising the literature, it becomes apparent that the changes in CEO pay over the past 50 years not only have harmed the well-being of individuals and groups in society but may also have reduced the capacity of firms to create prosperous and just societies.

Understanding CEO Pay

In this section, we explore some of the factors that have been implicated in the recent historical rise in CEO pay. Setting the pay of CEOs and other members of the top management team is one of the most important functions of an organization's board of directors. This is because the nature of a CEO's compensation package (i.e., its size and structure) is seen to be the main instrument that a board has to motivate their CEO so that she or he pursues (and achieves) high levels of organizational performance. This instrument is seen as necessary to deal with the moral hazard that is introduced by the fact that within organizations there is typically some separation of ownership and operational control. In particular, there is the risk that those who have operational control (e.g., CEOs) will run the organization in ways that satisfy their own personal interests (i.e., allowing them to extract undeserved "rents") rather than the collective interests of the firm's owners (i.e., maximizing value for shareholders).

According to agency theory (Fama & Jensen, 1983; Garen, 1994), this moral hazard can be minimized by setting up appropriate contracts that specify the relationship between the outputs of a CEO's effort and their compensation. The optimal contract is often related to the organization's performance, insofar as it can be attributed to factors within the CEO's control (Hölmstrom, 1979). In addition to specifying some relationship between organizational performance and CEO pay, boards can seek to further align the interests of CEOs and their shareholders by including shares as part of the CEO's compensation package (thereby making them owners

too). The extent to which compensation packages of CEOs (but not other workers) are made up of shares can account for the relative increase in CEO (and executive) pay in comparison with other workers. This is because shares have, like other forms of capital, historically attracted higher rates of return than labor has.

Another perspective on the rise in CEO pay is provided by neoclassical economics. The standard neoclassical model of labor markets is one in which workers are paid the value of their additional contribution to firm output. In a model of this kind, payments to the CEO reflect such factors as leadership capacity and decision-making ability. These may be measured by credentials of various kinds, including past experience. In this framework, the increase in CEO pay may be seen as the result of organizational changes that have increased the importance of managerial skills and thus the value of the CEO's contribution. It may also be seen as the result of the gradual removal of the constraints on CEO pay that were in effect during the mid-twentieth century and that meant that CEOs were previously underpaid relative to the value of their contribution. An alternative account within the neoclassical tradition is provided by models of class conflict. These models also assume that a CEO's pay depends on their contribution to the firm's profits, although this is primarily achieved by repressing wages rather than increasing the value of the firm's output. From this perspective, the increased pay accruing to CEOs is directly linked to the declining share of income going to labor.

A final model of CEO pay relates to the impact that paying CEOs more than they are worth may have on other workers. In particular, tournament models (Rosen, 1986; see also Connelly, Tihanyi, Crook, & Gangloff, 2014; Faleye, Reis, & Venkateswaran, 2013) suggest that boards may use CEO pay to extract higher effort from the company's employees. According to these models, CEOs are paid more than the value of their contribution to the firm (and other workers less than their value) because high payments to CEOs elicit greater effort from senior managers who aspire to occupy their position (see also Walasek & Brown, chapter "Income Inequality and Social Status: The Social Rank and Material Rank Hypotheses"). Although this means that individual managers do not receive payment that is commensurate with their individual contributions, with some few receiving more than they should and the rest receiving less, at the group level, payments equal to contributions.

Whether these "rational" factors associated with material inventives can indeed account for the increased rise in CEO pay is still an open question. The empirical literature is vast and contradictory. On one hand, the neoclassical model receives some support from an analysis of pay during the global financial crisis (2007–2009), when average firm value decreased by 17%, and CEO pay fell by 28% (Gabaix & Landier, 2008), and immediately after it (2009–2011), when firm value increased by 19% and CEO pay rose by 22% (see also Edmans, Gabaix, & Landier, 2008; Falato, Milbourn, & Li, 2012). At the same time, however, longer term trends are less supportive. Over the period beginning in the 1970s, CEO pay rose rapidly (along with corporate profit and profit sharing with shareholders), while wage growth of workers was weak in most developed countries, and almost nonexistent for large segments of the US workforce. Growth in employment, output, and productivity has

also been weaker than that in the previous decades following the World War II. Overall, these trends are inconsistent with the standard neoclassical model, leading scholars such as Finkelstein, Hambrick, and Cannella (2009) to argue that there is a great deal of heterogeneity in CEO pay that is not accounted for by economic fundamentals, such as the size of the organization or the macroeconomic conditions. Another notable trend is a steady increase in the proportion of CEOs hired from outside the organization (Falato et al., 2012). This does not follow straightforwardly from the tournament model, namely that the higher the reward for the CEO, the stronger should be the preference for an internal candidate (Agrawal, Knoeber, & Tsoulouhas, 2006).

If the rise in CEO pay cannot be wholly attributable to such compensation models, then what is responsible for it? The literature points to two factors: the ability of CEOs to set their own pay and biases on the part of the board. Rent-seeking models (Bebchuk, 1994; Bebchuk & Fried, 2004) suggest that CEOs do not act in the interests of the firm, however defined. Rather, they use their positions of power to create an environment in which they can enrich themselves at the expense of both workers and shareholders. Indeed, CEOs who have occupied their role for a long time possess large shareholdings in the company and high levels of control of the top management team and are likely to have a great deal of control over their compensation. Equally, although members of the board are supposed to base their decisions around CEO compensation on economic fundamentals, they typically have a large degree of discretion in the way in which they do this (e.g., by choosing which peers to benchmark against; Bizjak, Lemmon, & Nguyen, 2011). This means that boards are relatively free to act on their personal biases or to pursue their career-related or reputational self-interest (Murphy & Sandino, 2010). Supporting this point, Gupta and Wowak (2017) found that board member ideology affected CEO pay, as boards whose members made more donations to conservative causes paid their CEOs more, and based their pay more strongly on organizational performance, than boards whose members made more donations to liberal causes. At the same time when boards agree to award CEOs high salaries, this may enhance their own standing in the CEO's eyes and thereby advance the shared interests of managers more generally—and in ways that they themselves benefit from in the future.

In sum, although the evidence in their favor is mixed, mainstream economic models offer a range of accounts that explain why the increase in CEO pay relative to workers that has been observed in the last 50 years may be justified as rational. And even if CEOs are overpaid, tournament models suggest that this may have beneficial consequences, increasing the extent to which those who aspire to be CEOs are prepared to exert effort in spite of their relatively low pay to beat their peers to the ultimate prize. At the same time, however, there has long been a recognition within management and economics (e.g., as expressed in equity and cohesion theories; Adams, 1963; Levine, 1991) that pay dispersion within organizations has the potential to yield negative outcomes too (Siegel & Hambrick, 2005). Extending this point, in this chapter we argue that high CEO pay may have negative implications for what can be seen as CEOs' core function: their capacity to lead.

The Social Identity Approach to Leadership

Our expectation that CEO pay can affect the ability of CEOs to effectively lead their organizations is grounded in the social identity tradition (Tajfel & Turner, 1979; Turner, 1991; Turner, Oakes, Haslam & McGarty, 1994). A central claim of social identity theory is that people's self-concept, or sense of who they are, is derived not only from their sense of who they are as an individual "I" (a person with unique attributes, values, and goals), but also from their sense of who they are as a collective "we" (as a member of a group with shared attributes, values, and goals). Importantly, when individuals internalize their membership of a given group, their behaviors will be directed towards enacting the attributes and values that characterize it as well as realizing its goals. They will also have a heightened attentiveness to, and desire to coordinate with, the behaviors of other group members. In other words, according to this theorizing, shared social identities provide a basis for collective action and social influence (Turner, 1982, 1991). This claim is borne out by an extensive body of research that has shown that shared social identity is a basis for a broad range of important organizational phenomena including cooperation and extra-role behavior (Blader & Tyler, 2009; van Dick, Grojean, Christ, & Wieseke, 2006), motivation and performance (Haslam, Powell, & Turner, 2000; Ellemers, de Gilder, & Haslam, 2004), and leadership and followership (Turner & Haslam, 2001; van Knippenberg & Hogg, 2003; for a review, see Lee, Park, & Koo, 2015).

In their *New Psychology of Leadership*, Haslam et al. (2011) argue that leaders will be more effective to the extent that they are able to cultivate and tap into a social identity that they share with followers. This is because leaders who can *create* and *represent* a shared social identity should be better able to accomplish the essential task of leadership: the mobilization of followers towards the achievement of collective goals (Haslam, 2004; Rast, 2008). In line with this claim, there is evidence that group members who are seen to represent a group's identity—both by embodying what it stands for and by working hard on its behalf—are particularly likely to be a point of reference for other members of their group and therefore to be influential in shaping their thinking and behavior and to be endorsed as leaders (Haslam & Platow, 2001; Platow & van Knippenberg, 2001; Ullrich, Christ, & van Dick, 2009; for recent reviews, see Barreto & Hogg, 2017; Hogg, Van Knippenberg, & Rast, 2012; van Knippenberg, 2011). In one particularly striking example of this point, Steffens and Haslam (2013) showed that contenders for the position of Prime Minister in Australia since 1903 were much more likely to be successful if they evoked a shared national identity through references to "we" and "us" in their campaign speeches (with the candidate who used these terms most going on to win 80% of elections). Furthermore, in a longitudinal study of leadership in the Royal Marines, Peters and Haslam (2018) showed that trainees who expressed a greater concern with helping their group to succeed (rather than with rising to the top) at the start of their training were more likely to be perceived as leaders by their peers 1 year later.

CEO Pay and Shared Identity

On the basis of the foregoing arguments, we can expect that the ability of CEOs to create and represent a shared social identity with their workers will affect their ability to lead. Importantly, then, this suggests that CEO pay may matter for leadership if it affects their ability to create and represent a shared social identity. So is there any evidence that pay may have identity implications? In fact, there are at least two reasons for expecting that high CEO pay will undermine worker perceptions that they share a social identity with their CEO. First, there is evidence that people are highly sensitive to interpersonal comparisons in relation to pay, and that perceptions that one is underpaid relative to other organizational members tends to undermine a person's sense of being valued, as well as their motivation and effort (Goodman, 1974). Second, where a CEO's pay is more contingent on company performance than workers' pay (and CEO bonuses and stock options ensure that this is almost always true) then the divergent pay outcomes of CEOs and many of their workers is likely to erode a sense of shared fate. This divergence may be particularly salient in times of organizational success, as CEOs may be perceived to reap all the rewards of the efforts of all organizational members. Together, this suggests that contemporary forms of CEO compensation are likely to undermine shared social identity.

According to equity theory (Adams, 1963; Wallace & Fay, 1988), whether workers are satisfied with their pay is determined by their perception that the ratio of their own effort to their pay and that of others is fair. If a worker believes that he or she is exerting more effort for their pay than others are, they should seek to rectify this by reducing their effort or seeking a pay rise. Importantly, it has been suggested that pay disparity (and perceptions that it is or is not equitable) has implications not only for how much effort a worker is prepared to exert but also for their relationships with their colleagues (Levine, 1991). Specifically, when pay disparity is perceived to be unfair, worker cohesion is likely to break down. In social identity terms, pay dispersion (especially when it is perceived to be unfair) should erode a sense of shared identity (Jetten et al., 2017). Furthermore, as suggested earlier, when the basis for CEO and worker pay differs such that a CEO's pay is more closely connected to their organization's performance than the worker's is, this is likely to undermine perceptions of shared fate. According to Deaux (1996; see also Jackson & Smith, 1999), shared fate is one of the major mechanisms of social identification. To the extent that CEO pay affects shared identity in these ways, workers should be less inclined to prioritize the needs of their organization and the interests of the collective over their own personal needs (see also Greenberg, 1990).

In line with these suggestions, there is a large body of work that suggests that unequal pay can have a range of negative effects in organizations. Much of this work has been conducted in sports teams, because the public nature of pay and the accessibility of (and consensus around) performance metrics simplifies this analysis. Although the results are somewhat mixed, perhaps reflecting the different production functions that underlie performance in the different sports (e.g., Frick, Priz, & Winkelmann, 2003), there is evidence that higher levels of team pay inequality

are associated with poorer team performance over time in soccer and baseball (Coates, Frick, & Jewell, 2016; Frick et al., 2003). These results have also been shown to hold in a nonsporting domains. For instance, Pfeffer and Langton (1993; see also Bloom, 1999) found that salary inequality within 600 academic departments was negatively associated with current and long-term research productivity, job satisfaction, and research collaboration.

There is also evidence that high disparity in pay between CEOs and other members of their organization can have negative outcomes. For instance, Cornelissen, Himmler, and Koenig (2011) found that workers who perceived their CEO's compensation as unfair (in relation to job demands) reported levels of absenteeism that were 20% higher than would be expected on the basis of individual-level factors, such as physical health. Negative outcomes have also been observed within top management teams (Bloom, 1999; Carpenter & Sanders, 2002; Hayward & Hambrick, 1997; Siegel & Hambrick, 2005; Pfeffer & Langton, 1993). For instance, Ou, Waldman, and Peterson (2018) found that greater pay disparities between CEOs and other top executives were associated with lower perceived team integration and poorer financial performance. Furthermore, Wade, O'Reilly, and Pollock (2006) examined a sample of 120 firms over a 5-year period and found that if lower-level managers were underpaid relative to their CEOs, they were more likely to leave the organization. Finally, Haß, Müller, and Vergauwe (2015) found evidence that greater pay disparity between the CEO and other executives was associated with a greater likelihood that executives would engage in fraud (Haß et al., 2015).

Importantly, in line with the expectations of equity theory, there is evidence that the extent to which pay disparity is likely to have negative effects will be determined by workers' perceptions that it is (or is not) fair. For instance, Fredrickson, Davis-Blake, and Sanders (2010) found that the negative association between CEO–executive pay disparity and the performance of a random sample of S&P 500 companies was weaker in the presence of factors that might justify this pay disparity (e.g., CEO tenure, ownership position). An implication of this is that workers may in some circumstances tolerate the high pay of their CEOs (e.g., when they believe that a CEO's high pay is commensurate with their skills and effort). In addition, consistent with tournament theory, workers may be more tolerant of high CEO pay if they believe this has positive implications for their own future financial prospects. Speaking to this point, Cullen and Perez-Truglia (2018; see also Faleye et al., 2013) found that while workers who believed that they were paid less than peers exerted less effort and performed more poorly (as measured by hours worked, e-mails sent, and sales), those who believed that they were paid less than managers worked harder and performed better. They were able to show that these effects were driven by workers' beliefs about the future implications of others' pay. In particular, highly paid peers were seen to indicate that one's own future earnings prospects were poor, while highly paid managers were seen to indicate the opposite.

Yet while this suggests that workers are likely to tolerate (and in fact approve of) some degree of pay disparity with CEOs, there is reason to believe that there are limits to this. Consistent with this possibility, Kiatpongsan and Norton (2014) surveyed more than 55,000 people in 16 developed countries and found that while there

was a consistent belief that CEOs should be paid more than the average worker, respondents believed that the ideal ratio of CEO-to-worker pay should be about 4.6:1 (a value that is less than half of their *estimate* of the actual ratio, and one-twentieth of the *actual* ratio). This in turn suggests that most workers (at least those in large, public organizations) are likely to believe that their CEOs are currently overpaid, and that this is neither fair nor indicative of their own future earning prospects.

While this work shows that pay disparity in organizations can have a range of negative implications for organizational performance, team functioning, and worker commitment—at least when this disparity is perceived as unfair rather than a signal for a worker's future earning potential—there is limited work which either (a) explains why these effects eventuate or (b) shows that they affect a CEO's ability to lead. These are gaps that our own recent research has attempted to fill. In line with social identity theorizing, we suggest that one important reason why CEO pay disparity matters is that it erodes shared organizational identity and therefore undermines a CEO's capacity to lead the organization. These are ideas that we have tested in both survey and field experimental research.

CEO Pay and Ability to Lead

In an initial study (Steffens, Haslam, Peters, & Quiggin, 2018), we tested the hypotheses that workers will identify less with CEOs who are very highly paid, and that this will reduce their perceptions that their CEO is an effective identity leader (i.e., one who creates, represents, advances, and embeds a sense of "us"; Haslam et al., 2011; Steffens et al., 2014) and has high levels of charisma (see Fig. 1).

The study recruited 590 adults to take part in a survey of perceptions of CEOs. Participants were randomly allocated to read one of two versions of a one-page description of Ruben Martin, the fictional CEO of a US technology company. This description covered Martin's background, his company's successes, and technological advances. Critically, the two versions of this study varied in their descriptions of Martin's pay, so that it was either higher or lower than that of most other US CEOs. This variation was highlighted by varying the title of the description (Ruben Martin:

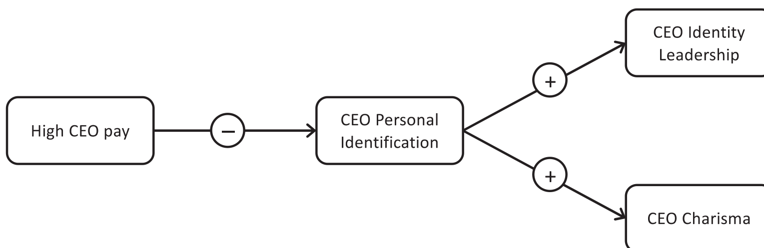

Fig. 1 Hypothesized effects of high CEO pay on worker's perceptions of the CEO

Big on Technological Advance, [Big/Small] on Salary) and the concluding sentence (Ruben Martin is [highly/moderately] paid for his role, being paid [more/less] than 97% of American CEOs.

After reading this description, participants were asked to indicate (a) their personal identification with the CEO (e.g., I identity with Ruben Martin), (b) the extent to which they thought he was an effective identity leader (e.g., Ruben Martin acts as a champion for the organization), and (c) their sense that he was charismatic (e.g., Ruben Martin is an inspiring person). As expected, participants identified less with the CEO when he was overpaid relative to other CEOs than when he was relatively underpaid. When the CEO was overpaid, participants also perceived him as being a less effective identity leader and less charismatic, and the results suggested that this was mediated through personal identification with the leader. The study thus provided clear evidence that perceptions of CEO pay can *cause* workers to relate to CEOs differently, and, more specifically, that when CEOs receive very high pay this reduces employees' identification with them and, as a result, leads them to be seen as less charismatic and less effective leaders of "us."

Our second study was designed to see whether these relationships hold when workers are asked to consider their actual (rather than fictional) CEOs. In this, 444 US-based adults who worked either full- or part-time were asked to participate in an online survey of perceptions of their CEO. To measure participants' perceptions of their CEO's pay relative to other CEOs, they were asked to indicate whether they thought that their CEO was one of the top-paid CEOs in the United States as well as how their CEO's pay ranked in comparison to other CEOs (from higher than 0% to higher than 100% of other CEOs). Participants then completed the same scales as in Study 1: their personal identification with their CEO, their perceptions that she or he was an effective identity leader and their perceptions that she or he was charismatic.

In line with the hypotheses, there was a significant negative association between employees' perceptions that their CEO was highly paid and their personal identification with him or her. And again too there was a negative association between perceptions that their CEO was highly paid and their perceptions that this leader was an effective identity leader. Although there was no significant negative association with perceptions of charisma, there was also the expected indirect effect from perceptions of CEO pay to identity leadership and charisma through personal identification. In this way, the study's findings reinforce those of Study 1 in showing that high CEO pay is associated with lower levels of personal identification with him or her on the part of employees, and that this in turn is associated with reduced perceptions of that CEO's identity leadership and charisma (see Fig. 1).

Interestingly, while both studies measured important dimensions of individual ideology—in particular, beliefs in meritocracy and social dominance orientation (SDO)—there was no evidence that these moderated the association between high pay and negative CEO perceptions. So while respondents who reported greater belief in meritocracy and higher SDO expressed higher levels of personal identification with their leader, controlling for these relationships did not weaken the association between high pay and personal identification. There was also no evidence that

these ideological beliefs moderated the pay–identification relationship. While this is inconsistent with our earlier argument that beliefs that CEO pay is (a) fair and (b) a prize awaiting oneself increases worker's tolerance for high pay, it may reflect our focus on CEOs' excessive pay relative to other CEOs. Ideology may play a more important role when workers consider whether their CEO's compensation is excessive relative to their own.

Conclusion

The way in which organizations have chosen to compensate their CEOs has allowed them to reap the benefits of strong organizational performance. While there are a number of neoclassical economic models that provide a strong justification for this state of affairs, there is increasing evidence that it may have negative consequences. In particular, there is some evidence that the enrichment of CEOs and the executive class is implicated in the increase in societal income inequality (especially in the United States). There is also a large body of work that shows that organizations with high levels of pay disparity between the CEO and other high-level managers or workers tend to have poorer outcomes. Indeed, it is rather remarkable to consider that CEO pay has continued to rise in the face of more than 40 years of evidence that it may be harmful for organizational performance.

In this chapter, we sought to extend this work by showing that high CEO pay may directly impair their capacity to perform their core function of leading their organization. Building on social identity theorizing, we presented the results of two studies that provided some quite compelling evidence that CEO pay has real and meaningful implications for workers. In particular, when a CEO is highly paid, it changes the relationship between workers and their CEO such that they perceive the CEO as "one of them" not "one of us," which in turn reduces their perceptions of the CEO as an effective and charismatic leader. Indeed, this may be a key reason for why other research has found negative effects of CEOs' very high pay on organizational performance (e.g., Hollander, 1995). Nevertheless, this was not examined in this research and remains an important question for future work to examine how CEO pay (and executive pay more generally) affects actual worker behaviors and leader's capacity to turn their vision for an organization into reality.

It is also an open question whether evidence of this kind is enough to arrest the rise in CEO pay and, potentially, shrink the gap between them and the typical member of their organization. In this regard, it is interesting to note that there are some moves to increase transparency about the disparity between CEO and worker pay. In particular, the United States requires that public organizations will publish the ratio of CEO to median worker pay from 2019; the United Kingdom will follow in 2020. The hope of legislators is that this visibility will shame organizations into designing more equitable compensation packages. However, historical precedent provides reason for skepticism. In particular, there is some evidence that Canadian legislation mandating that public companies declare their CEO's pay was actually

associated with an acceleration in the rise in CEO pay, arguably because this facilitated social comparisons between CEOs (e.g., Park, Nelson, & Huson, 2001; see also van Veen & Wittek, 2016). In light of evidence that workers underestimate CEO (and executive) pay by a factor of 20, one likely outcome of increased transparency around pay disparity is the further erosion of the connection between CEOs and their workers and the further spurring of public outrage and shareholder action. In other words, this issue is only likely to become a hotter one, and it is imperative to better understand how (and why) CEO pay affects the performance and well-being of workers, as well as the functioning of societies more generally.

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