

## Market competition and executive pay

### Increased competition affects the pay incentives firms provide to their managers and may also affect overall pay structures

Keywords: barriers to entry, entry costs, competition, executive compensation, performance-related pay

#### ELEVATOR PITCH

Deregulation and managerial compensation are two important topics on the political and academic agenda. The former has been a significant policy recommendation in light of the negative effects associated with overly restrictive regulation on markets and the economy. The latter relates to the sharp increase in top executives' pay and the nature of the link between pay and performance. To the extent that product-market competition can affect the incentive schemes offered by firms to their executives, the analysis of the effects of competition on the structure of compensation can be informative for policy purposes.

#### KEY FINDINGS

##### Pros

- + Regulatory changes aimed at easing the process of starting up a business are likely to foster output growth and employment at no additional expense to the public.
- + To motivate and elicit effort from their managers, firms design employment contracts that relate their pay to performance; executives' compensation schemes are also related to the levels of product-market competition.
- + Policies aimed at increasing competition in markets may help reduce inefficiencies associated with poor management prevalent in less competitive industries.

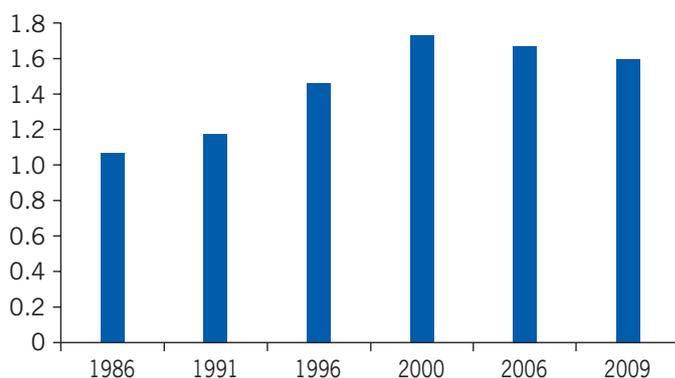
##### Cons

- Barriers to firm entry have negative effects on the economy (e.g. on competition, innovation, employment, and wages).
- While in most studies increased competition leads to stronger incentives provided by firms to their managerial workers, this is not necessarily always the case.
- As firms can substitute fixed for variable pay (and vice versa), the overall effect of changes in competition on executives' pay remains uncertain.

#### AUTHOR'S MAIN MESSAGE

Empirical evidence suggests that executive pay is related to the level of product-market competition. However, while most shocks or policy reforms that foster competition tend to strengthen the link between competition and performance-related pay, it can also be the case that increasing competition reduces incentives. Also, as firms may change their pay structures, the effect of changes in competition to CEOs' pay is uncertain. Therefore, policies aimed at reducing wage inequality should consider market idiosyncrasies as well as taking these different effects into account. Increased competition through, for example, deregulation does, however, have a potential to provide direct incentives for managers to perform well. This may help reduce inefficiencies associated with poor management.

Difference in log payment between CEOs and other workers



Source: Based on Figure 1.

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