Workplace Inequality in the US and Managerial Rent Extraction: Evidence from Pay Growth Gaps

By Jie He, Lei Li, Tao Shu

Discussion by
Mireia Giné
IESE, WRDS, ECGI

ECGI Oxford
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Overview

Big question: What are the drivers of workplace inequality?

- Optimal contracting (Gabaix, Landier 2008; Terviö 2008): size increases profitability of firm: makes managers more valuable as it increases their marginal product.
- Rent extraction: compensation for non-performance, hidden pay, pay practices related to poor governance.
- Institutional setting: taxation of top executives, regulation, pay advisors – from cash to options to performance-based rewards.

Interesting paper

- New granular data LEHD from Census Bureau + Capital IQ → **Pay growth Gap**
- Decomposition of returns: systematic (luck) & idiosyncratic (skill)
- Insights from relation between **Pay Growth Gap & Firm Performance**.

Overview

Results

R1: Higher pay growth for managers than other employees: 16.5% vs 5%
Positive association with both systematic & idiosyncratic return.

R2: Assymmetry: executives rewarded for good idiosyncratic performance BUT only weakly penalized for bad performance. 1st dev increase in idiosyncratic returns is ass. 4.7% vs -1.6%

Stronger when governance is weaker.

R3: Results are most consistent with rent extraction rather than optimal contracting.

Comment 1: Why Pay Growth Gap?

Are concerns on level-gap relaxed if we look at growth-gap?

- *Ongoing* improvement in **investment opportunities** (Frydman & Papanikolau 2017)→ attract and retain skilled managers → executive pay rises → growth

- As firms **change corporate structure**: *ongoing* outsourcing of low-wage workers, *ongoing* automation → change in the base of file-and-rank employees → changes in average growth

- Changes in **pay-performance sensitivities** in the contracts: high pay-performance sensitivity leads to high pay if performance is high. → potentially less changes

Comment 2: Asymmetry & Contract Design

What is the contribution of Contract Design?

Avoid remuneration for luck.

CEO compensation with stock options is convex payoff - Holmström 1983

Asymmetric exposure to risk.

Top executive contracts will benefit from the positive outcomes (to take risk) but are insulated from bad outcomes – limited liability. Plus they get fired.

Would performance sensitivity generate this asymmetry.

How does this maps into Growth Gaps is less obvious?

Comment 2: Asymmetry & Rent Extraction

How large is the economic effect of the asymmetry?

- Song et al. (2019): employee salaries at the 90th percentile grew by 48% but only increased by 28% for the median employee from 1982 to 2013. (1.54% and 0.9% per year)
- Increase in level of inequality between employees and executives: 10.7% for Faleye et al (2013) and 9-19% in Frydman and Papanikolau (2018)

Rather than cross-section I am interested in the timeseries

Companies and labor markets are changing dramatically: the rise in intangibles, competition…

How these changes explain the gap? Learn about the evolution of the gap – rather than cross section with fixed effects.

Comment 3: Exploit Employee Heterogeneity

Given the granularity of the data, can we learn something about the different tiers of executives?

Distribution of executives and employees → hierarchy of corporation

When does it get flatter? Is it second-tier executives?

Pay dispersion for the CEOs has gone down as CEO compensation gets benchmarked by the industry and by size. Compensation practices get clustered: this might be affecting top executives.

Comment 4: Understand Firm Heterogeneity

How is the distribution of this Pay Growth Gap?

Is this driven by a handful of corporations?

Song et. al. (2019) The rise in US earnings inequality: 3 equally important drivers

- a rise in the sorting of higher-paid workers into higher-paying firms
- a rise in segregation: higher-paid workers work together in the same firms
- a rise in earnings inequality within firms.

Within-firm inequality is largely driven by mega firms: four times larger rise in within-firm inequality relative to all other firms. Accounts for 2/3 of within-firm inequality.

Comment 5: Mega Firms

Song et a. (2019)

top 50 (5) employees accounted for only 3% (1%) of the increase in within-firm inequality in mega firms.

the top-earning 10% of employees (wider group of managers, technicians, other highly paid individuals) account for 46% of the rise in within-firm inequality.

Comment 5: Where is the debate?

Two views: Optimal Contracting & Size vs Rent Extraction

Is the data giving us more insight into the weight of each view?

In particular, can we learn more about the role of Rent Extraction?

More generally,

To which equilibrium are we going and what are the main forces?

Technological change & rising returns to skills → Changes in the composition of workers

Within firm inequality is constraint by outsourcing

Cummulative effects of winner-take-most competition

Thank you!