

# Does Salary Gap Really Have Incentive Effect

Yalin Wang

Management College, Jinan University, Guangzhou, China

Email: [406857562@qq.com](mailto:406857562@qq.com)

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## Abstract

The salary gap is an important content in the design of salary system inside enterprises. The effect of salary gap on recipients and performances can totally be explained by the tournament theory and the behavioral theory. This paper concludes relative theories and previous empirical studies so that we hope it will make a contribution to prospective researches and salary practice in our country.

## Keywords

Salary Gap, Tournament Theory, Behavioral Theory

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## 1. Introduction

In a recent survey by the American media, the salary gap has become a worldwide problem and has a tendency to gradually expand. Now it is the most serious in China that executive pay on average, is 12.7 times more than employees compensation. In different industries, the pay gap is not the same. The pay development report was made public, showing the specific data in the following chart. Such situation caused the attention and question of the society from all walks of life.

Industries	Salary gap
Real estate	13.4
Wholesale and retail	5.5
Science and technology	4.44
Architecture	4.23
Manufacturing	2.94
Agriculture, forestry, animal husbandry and fishery	3.96
Finance	2.74
Information	2.57

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Pay gap has a very important practical significance. To corporations, the appropriate compensation gap is conducive to ease the contradiction between executives and employees, to reduce the liquidity of staff, and to strengthen the emotional bonds. Everyone in any position will spare no effort to contribute to enterprises development. To the social, solving this problem will reduce contradictions in the society, promote social harmony and stability, and provide a good external environment for enterprises.

In academia, scholars launched a fierce discussion on the two basic views: tournament theory and behavior theory. These two views are opposite, supporting the positive incentives of salary gap and the negative incentives. A large amount of researches have been carried out at home and abroad that obtained different empirical results.

## 2. The Positive Effect of Salary Gap and the Mechanism

Tournament theory supports the viewpoint that the salary gap has a positive incentive effect. The theory from the perspective of individual, regards the gap as bait in group competition, only through the efforts to win in the competition of talents. Using this to motivate employees to work hard, so as to improve business performance.

### 2.1. Tournament Theory

Tournament theory was put forward by Lazear and Rosen (1981) [1] in that the absolute value of the individual marginal output is considered to be difficult to confirmed due to the increased difficulties of monitoring and the cost increase, but the relative ranking in the organization is easy to obtain. Enterprises as a workplace where employees are competing against each other, when employees win in the competition, they will get extra pay, the gap appearing. So tournament theory holds that the salary gap will have a positive effect on the staff motivation. According to the theory, the salary structure of enterprises should be designed as the employee's position rises, the pay gap is widening. It is that use the gap as the incentive to stimulate work enthusiasm, so as to improve the performance. Later, Mclaughlin [2] extended the existing model, he thought that if the number of the competitors and external uncertainty increased, the contestants would be aware of the smaller possibility of winning, thus slack off. So in order to encourage participants, the pay gap must be increased as a trigger.

### 2.2. Relative Researches

A lot of research results support tournament theory. Jensen (1976) [3] the first discussed the pay gap, he believed the salary should be along with the rise of administrative levels increased, while increasing the gap between adjacent levels that played a role of tournament theory. Ehernbegr and Bognanno (1990) [4] using the sports samples, based on the study of the European men's golf game, found that giving excellent players more lucrative bonuses would make players more efforts to get good grades. Eriksson's research (1999) [5] on the change of demand or cost as a proxy variable of environmental uncertainty, found that of companies the bigger the change was, the greater the pay gap was, in order to induce competitors to redouble their efforts.

In the domestic, it is relatively late for scholars to explore the topic. Taking half a year as a cycle, Lin, Huang (2003) [6] verified that the salary gap between the CEO and other senior executives pay gap exists positive correlation to the company's future performance by using the absolute and the relative data. Subsequent inspection found the main factors were not from the outside but their own operating characteristics, affecting the wage gap in our country. Chen, Zhang (2006) [7] agreeing upon the viewpoint of Baker, Jensen (1988) [8] that growth determined the running of promotion system, analyzed data from the fastest growing industry and the slowest one, then by comparison made a conclusion that for high growth firms, the increase of the gap between executives mostly depended on the number of competitors, the developed degree of location and the scale of expansion; while for low growth firms, only the first two factors can increase the gap. Regardless of high-growth or low-growth companies, senior managers' salary gap was positively correlated with performance in the same period.

Liu Chun (2010) [9] for the first time provided the direct empirical evidence of the relationship between the pay gap of executives and employers and the performance in state-owned enterprises, confirming the tournament theory. Considering the regional and annual differences, the result showed although the salary gap in the coastal areas was greater than that in the central and western regions, the relativity of the latter was significantly more sensitive. In depth, the incentive was diminishing marginally with the passage of the year. The conclusion is consistent with Backer, etc.

### 3. The Negative Effect of Salary Gap and the Mechanism

Behavioral theory supports the salary gap is negative incentive factor. It is from the perspective of the overall organization that the salary gap can damage the unity and cooperation relationship, and interfere with the collaborative atmosphere, which is harmful to the personal efficiency and organizational performance.

#### 3.1. Behavioral Theory

Behavioral theory emphasizes the negative effects. Specifically, it can be explained by the four theories: relative exploitation theory, distribution preference theory, organizational politics theory and social comparison theory. Relative exploitation theory extended equity theory (Adams, 1963) that think employees will compare their income with that of higher level personnel. If they don't feel they deserve compensation, they will have the feeling of being exploited, indifferent to the goals of the organization, the negative behavior followed. As consequence, the cohesion of the enterprise will fall. According to distribution preference theory, the compensation should be determined by the interaction between the makers and the recipients. It should take a relatively equal pay in despite of the individual performance differences. In organizational politics theory, if benefits brought by efforts cannot make up for the loss of political action to undermine cooperation, must relatively reduce the pay gap between employees in order to promote effective collaboration. Social comparison theory was raised by Festinger (1954). It means people can evaluate themselves correctly and objectively and form the cognitive fairness through the comparison with other individuals, through social comparison form (Amrose, 1991).

#### 3.2. Relative Researches

Not a few studies support the theory of behavior. Deutsch's (1985) [10] conclusion was the same as Levine's (1991) [11]. That is in strong need of close cooperation, organization performance depends on the joint effort and the larger wage gap is not conducive to cooperation, even detrimental to performance. For Cowherd and Levine (1992) [12], it was found the lower-level employees were more sensitive to the fairness of compensation in order that distribution injustices would cause negative emotions, destroy emotional bonds between organizations, and reduce cooperation. Larger gap made product quality decline. Bolom (1999) [13] through the U.S. professional baseball league teams and players, found a big compensation gap tends to make individual and team performance poorer.

In China, fewer studies support behavioral research. Zhang (2007) [14] chose data of 264 listed companies, adopting two indicators the absolute and relative gap to measure wage gap between the general manager and the two other core members. Performance was measured by ROA and EPS, then the result conformed to the prediction of behavior theory. Adding the adjustment variable of team collaboration needs, the interaction between relative gap and financial risk had a negative effect on the performance of the two indicators. It was same to relative gap and technical complexity, partially supporting behavior theory. Namely behavioral theory has stronger applicability than tournament theory in the design of core executives compensation. Mainly taking the time differences of formulation, implementation and influence of compensation plan into account, Zhang (2008) [15] supposed the incentive of compensation gap was lagging behind, thus carried out an empirical test. There were two kinds of gap, internal management team and executive-employee. Obviously, the former was negatively related to the future performance significantly, while the latter showed negative only when the enterprise was ultimately under the control of state-owned shares.

### 4. The Dual Effect of Salary Gap and the Mechanism

We can find that the salary gap in different conditions, shows different incentive effect. That is in practice, tournament theory and behavior theory are not completely isolated. Often a single theory cannot well explain phenomenon. Essentially the emphasis of the two theories are different. Tournament theory focuses on studying economic factors, while behavior theory focuses on psychological factors.

#### 4.1. The Dual Effect

Lu (2007) [16] confirmed the degree of diversification would reduce the incentive of compensation gap. Accordingly she analyzed that inside the enterprise superior-subordinate supervision and peer-peer supervision exist

synchronously. When the environment works, these two kinds of supervision maybe change in different directions. So in the formulation of the remuneration plan, CEO and shareholders become more careful to recipients. Lu (2011) [17] verified as the risk was increasing, the influence of the senior management team salary gap on future performance changed from inhibition to promotion. The reason she guessed was that there were Checks and balances between top-down and parallel supervision. When choosing compensation mode, different levels may require a variety of solutions used interchangeably. Wang (2010) [18] based on the study of Chinese collectivism and hierarchy, found in constraints, the incentive effect of the pay gap between the different levels was in line with tournament theory and that of the same level was in line with behavior theory. Li, Hu (2012) [19] first clarified the mechanism how the executive-employee pay gap impacted performance in state-owned enterprises. Executives were not encouraged, to some extent reflecting the management power, but for employee motivation is more significant. Overall when the salary gap is small, tournament theory is set up, otherwise, the social comparison theory better explains.

## 4.2. U-Shaped Relationship

Also a type of research is agreed with the inverted “U” shaped relationship between pay gap and performance. Wang’s (2009) [20] result showed the two was not a simple linear relationship but the interval effect existed. Namely, the smaller pay gap has positive impact on performance, but expanded to a certain degree, it will have negative impact. On the basis of Lazear (1989) who put forward that employees were likely to make damage to opponent’s behavior for victory, Chen (2010) [21] joined the “destruction” factors in the model, observing that with the increase of salary gap the performance showed the change trend from increase to decrease, then this is the inverted U-shaped curve. Zhao (2012) [22] also observed the inverted U-shaped curve relationship and the relationship is not different due to the nature of corporate holdings and the region.

## 5. Conclusion

Combined with the above research and the practice of our country, I want to make some personal suggestions on the salary system of state-owned enterprises. I think state-owned enterprises should set up the appropriate salary gap, as an incentive to play its role in the tournament. It will improve the enthusiasm and efforts of executives and employees, and promote performance. In the design of the pay gap, not only external environmental factors (such as the industry, the region) must be taken into account, but also its own characteristics (such as risks, diversity). Moreover, in my opinion the staff is the motive force for enterprise development, so in the process of establishing, we must consider the feelings of employees, ask their views and create more opportunities for employees to participate. At the same time, the incentive system should be matched with individual incentive system and fair and reasonable performance management system. Finally, the design of the pay gap needs to guarantee the procedure fairness of the compensation decision. It is essential for open and transparent way of decision-making and implementation process. This can enhance the staff to pay the results of the fairness of recognition. For the company’s compensation disclosure system, it is of vital importance to carry out strict and transparent management. Ensure the whole procedure just and fair absolutely.

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