

## Pay Gaps Between Management and Workers: Causes and Consequences

Firms, workers, and policy makers are paying increasing attention to differences in pay between their executive leadership team (ELT) and lower-level employees. Recent research in the *Journal of Management* investigates the causes and consequences of such differences. They found that firms with investors who focus on the shorter-term tend to have larger pay gaps, while those whose investors have longer investment horizons tend to have lower pay gaps. Performance effects were consistent with investors' time horizons – firms' changes in pay gaps enhanced profit in the short term, but impaired longer-term profit performance trends.

### Key Takeaways:

- Short-term focused investors drive higher ELT-to-employee pay gaps, while longer time horizon investors promote smaller ELT-to-employee pay gaps.
- Firms that increase their pay gaps have better performance in the short term (within a year).
- Firms that increase their pay gaps have less favorable performance growth over the following 5 years.

The researchers studied publicly traded firms from the S&P 1500 and explored how the firm's institutional investor mix influenced pay gaps, which influenced subsequent company performance, measured by ROA. The average firm's ELT earned about 49 times the earnings of the average non-ELT worker. The researchers also examined institutional investors with more than 1%

ownership in the firm, classifying their investment horizon based on their portfolio's diversification, turnover, and trading sensitivity. They found that increases in transient (short-term) institutional investors were followed by larger ELT-to-worker pay gaps, better performance in a given year, and less favorable ROA trends over the next 5 years. The researchers note that higher TMT pay can attract better management talent, but increasing pay gaps can have unintended consequences. They suggest that managing pay gaps might help firms attract different types of investors. They recommend HR leaders attend to pay gaps because they may have substantial implications for recruiting, selecting and retaining the TMT and other workers, and may influence oversight from the board or regulatory bodies.

Source: Connelly, B. L., Haynes, K. T., Tihanyi, L., Gamache, D. L., & Devers, C. E. Minding the gap: Antecedents and consequences of top management-to-worker pay dispersion. *Journal of Management*, 42(4): 862-885. DOI: 10.1177/0149263135315.

