

UNDERPAYMENT VERSUS OVERPAYMENT: HOW DOES CORPORATE GOVERNANCE QUALITY AFFECT CEO PAY?

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Abstract

Equity theory suggests that CEOs may be incentivised to pursue actions aimed at restoring equity when pay deviates from the predicted CEO labour market compensation rate. Using hand-collected data of 185 South African listed firms over a six-year period, this study investigates the effect of corporate governance (CG) quality on CEO pay deviation. Results suggest that whereas CG quality impacts negatively on total CEO pay deviation, this is only conspicuous when the CEO is overpaid. CG quality has no effect on CEO compensation when the CEO is underpaid. Also, CEO underpayment reduces firm value when the CG quality is poor. In contrast, CEO overpayment has no effect on firm value irrespective of the level of CG quality. The findings imply that recent CEO pay level agitations have resulted in the design of CG mechanisms that render CEO pay to be rigid upwards. The results are robust to alternative econometric techniques and endogeneity concerns.

Keywords: Pay deviation, executive compensation, equity theory, corporate governance

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