You scratch his back, he scratches mine and I'll scratch yours: How unethical behaviour can inflate executives' pay

April 9 2015

If you have a strong network of business colleagues who sit on each other's board, your pay can be a lot heftier —- but often at the expense of your shareholders, according to a new study by Ted Rogers School of Management at Ryerson University and University of Toronto's Rotman School of Management.

The researchers were interested in testing the theory that business executives, who have strong networks among their peers, are more likely to inflate their colleagues' pay because they believe it will be reciprocated.

"There's a great deal of research trying to understand how a chief executive officer's pay is determined," says Professor Fei Song, Ted Rogers School of Business Management and the study's co-lead author. "One school of thought is that their pay is determined by a corporation's board of directors. However, people who make up these boards are often CEOs of other companies themselves and are more likely to receive higher compensation packages because of this exclusive network."

But what happens when CEOs are paid more? "If executives of corporations receive a higher compensation, they may be taking the company's revenue from the shareholders' pockets and paying it to themselves," says Song, whose research area is unethical behavior in business settings.

The researchers conducted three studies with 520 undergraduate commerce students from University of Toronto and Ryerson University. In the first study, the students were split into two groups: proposers (e.g. business executives) and responders (e.g. shareholders). Each student in the proposer group was then assigned as A or B. The A and B students were told they worked for each other but did not know who the other person was and did not speak to them. The researchers then instructed each proposer that they had a certain amount of money to divide between the other person they "worked for" and the outside responder. The actual amount of money was only known to the proposer side and not known to the responder side.

In the first study, the researchers found that the proposers who worked for another person were more likely to give more money to their "work" colleague and less to the outside responder.

The second study was similar to the first one, but this time, instead of teams of two, there were larger proposer networks of 20. Again, the proposers opted to deceive the outsider students by under-claiming the amount of money there was to be divided.

In the third experiment, all the students in the proposer network "worked" for each other except for one student who broke the link. In this scenario, the researchers found the broken loop curbed the tendency for proposers to deceive the responders.

"Indirectly reciprocal networks are often overlooked and difficult to track. Imagine three CEOs from company A, B, and C where A sits on B's board, B sits on C's board, and C in turn sits on A's board. In this example, there is no direct conflict of interest because A does not benefit him or herself by inflating B's salary and the same applies to the other two CEOs. Nevertheless, our findings suggest that everyone in the network is likely to inflate salary for each other. Now imagine this

network consists of hundreds of CEOs," said Professor Zhong, Rotman School of Management, co-lead author of the study.

While Song says it's difficult for shareholders to see the circle of reciprocity among CEOs, "as a start, giving shareholders more powers to monitor board meetings would help."

Provided by University of Toronto

Citation: You scratch his back, he scratches mine and I'll scratch yours: How unethical behaviour can inflate executives' pay (2015, April 9) retrieved 25 April 2024 from https://phys.org/news/2015-04-ill-unethical-behaviour-inflate.html

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