

Rank Order Tournaments and Incentive Alignment: The Effect on Firm Performance

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Abstract

While the CEO of a typical firm faces only performance-based (alignment) incentives, firm VPs face both performance- and promotion-based (tournament) incentives. We investigate the effect of alignment incentives in the case of CEOs and alignment and tournament incentives in the case of VPs on firm performance. Consistent with the extant literature, we find that both CEO and VP alignment associate positively with firm performance. We also find that tournament incentives, as measured by the pay differential between the CEO and the median VP, relate positively to firm performance. We show that the effect of tournament incentives on firm performance is more pronounced when the CEO is close to retirement and is weaker when the incumbent CEO is in her first year of service or when the CEO is also the Chair of the Board. Our analysis also suggests that the marginal effect on the market value of the firm's equity is greater when additional compensation to the CEO is in the form of short-term compensation rather than long-term compensation. For VPs, an additional dollar in the form of long-term compensation raises equity value more than a dollar increase in short-term compensation.

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