



**Equity Incentives, Pay Gap and the Cost of Equity Capital:
Evidence from Chinese Listed Companies**

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Abstract: This study explores the effects of equity incentives on the cost of equity capital from the perspective of pay gap, which has not received much attention in research on Chinese listed companies. We find that the implementation of the equity incentive plan has a significantly positive effect on the pay gap in enterprise. By dividing enterprise pay gap into the internal executive pay gap and the executive-employee pay gap, we find that under the influence of equity incentives, firms with large internal executive pay gap have a significantly lower cost of equity capital according to tournament theory; however, the executive-employee pay gap has a significantly positive effect with the cost of equity capital, which is consistent with behavioral theory's prediction. Furthermore, we find that the enterprises' ownership and regions' development level are playing an important role in the effect that equity incentives act upon the cost of equity capital. The findings make incremental contributions on studying the economic consequences of China's equity incentive plan, and we quest the implications of these findings for reforming Chinese

remuneration distribution system and adding some new empirical evidence for regulating pay gap theories applied in Chinese listed companies research.

JEL Code: G34, J31, J33, J38

Key Words: Equity Incentives; Pay Gap; the Cost of Equity Capital

1. Introduction

The question “Are you happy?” has recently become synonymous with people’s livelihood issues. The “2011-2012 Chinese Happiness Well-off Index” showed that income remains the most influential factor on public happiness and that higher wages have become the most effective way to raise public happiness. All above indicate that fairness and efficiency of income distribution is gaining more attention, in light of China’s multiple compensation system reforms and the introduction of the listed corporation equity incentive mechanism. Historically, China’s income distribution reform has moved from egalitarianism, to prioritizing efficiency and considering fairness, and finally to a focus on fairness. Lifelong job security and equal shares in state-owned enterprises (SOEs) began to disappear during the “Reform and Opening up” and the enterprise internal pay gap (the income disparity between workers) appeared from 1978.

In September, 1999, the Fourth Plenary Session of the Chinese Party’s 15 passed the “Central Committee of the Communist Party of China about the Reform of State-Owned Enterprises and the Development of Certain Major Issue Decisions,” which clearly put forward the idea of pegging income to the operating performance of enterprise managers. When “Interim Measures for Operating Performance Evaluation of Central Enterprise Managers” came into force on January 1, 2004, the yearly salary incentive method began for the executives of the central government’s directly controlled enterprises and a long-term incentive mechanism was introduced. The pay gap¹ therefore gradually expanded within enterprises. Table 1 shows that the absolute

¹ This paper combines the internal executive pay gap and in the term pay gap. The internal executive pay gap describes the income disparity between senior executives while the executive-employee pay gap depicts that