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The Effect of Outside Directors' Equity Compensation on Labor Investment Efficiency

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ABSTRACT

This study is motivated by two strands of the literature: corporate labor investment efficiency and director equity compensation. Labor cost is economically significant, and inefficiency in labor investment harms firm financial performance. Although outside directors play an important role in monitoring and advising labor investment, there is relatively scant literature on how they affect labor investment efficiency. Outside directors' equity compensation has increased substantially since the adoption of the Sarbanes–Oxley Act (SOX); whether equity compensation can improve outside directors' governance performance remains controversial. My research aims to fill in this gap by examining the effect of outside directors' equity compensation on corporate labor investment efficiency.

Drawing on the literature, I argue that equity compensation can incentivize outside directors to provide both monitoring and advisory roles in a way that increases the efficiency of labor investment. However, outside directors are also agents, and equity compensation may incentivize them to collude with self-serving executives who have incentives to deviate from the optimal labor investment level for their private benefits, e.g., rent seeking and empire building. As a result, the relationship between outside director's equity compensation and labor investment efficiency is ex ante unclear, and I empirically examine this research question.

I use a sample of U.S. firms during the period from 2006 to 2019 for my analysis. I find that a higher proportion of equity compensation in outside directors' total compensation is associated with a smaller absolute difference between the actual and expected net hiring, i.e., higher efficiency in labor investment. The result is economically significant. A one standard deviation increase in outside director's equity compensation is associated with a decrease in inefficient labor investment of 5.11%. My findings are robust to alternative proxies for outside directors' equity compensation and labor investment efficiency, alternative explanations, and endogeneity tests. Moreover, firms with a higher proportion of equity compensation for outside directors reduce both overinvestment (over-hiring) and underinvestment (over-firing and under-hiring) in labor.

I also incorporate directors' characteristics by using new measures of weighted average of outside directors' equity compensation. Although the incentives, capabilities, and effectiveness of outside directors on monitoring and advising can vary with their individual characteristics, I provide evidence that equity

compensation for outside directors can improve labor investment efficiency when directors' characteristics are incorporated in the weighted measures.

In addition, I provide results that support the substitution hypothesis of alternative governance mechanisms. Although outside directors' equity compensation can mitigate labor investment inefficiency, the impact is less pronounced for firms with greater institutional ownership or CEO ownership. The impact of outside directors' equity compensation is stronger for firms operating in human-capital-intensive industries than in other industries, suggesting that outside directors' equity compensation plays a significant role in improving labor investment efficiency for the firms with keen labor competition and high labor adjustment costs. I also find that the negative effect of outside directors' equity compensation on labor investment inefficiency is more pronounced for complex firms that require a higher level of monitoring than for other firms.

Finally, I provide evidence that equity compensation incentivizes outside directors to cut labor costs and employees in response to economic downturns. Overall, my findings contribute to the debate on the effectiveness of director equity compensation by showing its non-trivial benefits.