Executive Compensation, Profit-Sharing and Firm Performance

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Abstract

This study examines the relationship between executive compensation, mandatory worker profit-sharing, and firm productivity using panel data from Ecuador's large private enterprises over 2019-2023. Leveraging Ecuador's universal 15% profit-sharing requirement as a natural experiment, I employ dynamic System GMM estimation to address endogeneity concerns. The analysis yields striking null results: neither top management team compensation nor mandatory profit-sharing demonstrates significant associations with firm productivity, and their interaction shows no evidence of complementarity or substitutability. These findings remain robust across alternative productivity measures and firm characteristics. The dominant role of productivity persistence (59% carry-over between periods) suggests that firm performance is primarily driven by deep organizational capabilities rather than annual compensation adjustments. The results question the economic rationale for mandatory profit-sharing schemes and challenge conventional wisdom about compensation effectiveness in emerging markets.

Executive Compensation, Profit-Sharing, Firm Productivity, Emerging Markets, Ecuador, Panel Data

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1 Introduction

The design of compensation systems that align managerial and employee incentives with firm objectives represents a fundamental challenge in corporate governance. While extensive research examines executive compensation (Murphy, 1999) and employee profit-sharing mechanisms (Kruse, 1993) separately, their interaction remains underexplored, particularly in emerging market economies where institutional mandates often require firms to implement profit-sharing regardless of managerial preferences.

This study examines how top management team (TMT) compensation and mandatory worker profit-sharing jointly determine firm productivity. I leverage Ecuador's institutional setting, where a legally mandated 15% worker profit-sharing requirement creates exogenous variation in employee incentive intensity. This context enables identification of how managerial and worker incentive mechanisms influence organizational performance while avoiding selection bias that complicates voluntary profit-sharing studies.

I address three fundamental questions: First, what are the independent effects of TMT compensation and worker profit-sharing on firm productivity? Second, do these compensation mechanisms operate as substitutes or complements? Third, how do firm characteristics moderate these relationships? Understanding these relationships is crucial for emerging markets, where underdeveloped equity markets necessitate greater reliance on cash-based compensation.

Ecuador provides an ideal empirical setting for testing theoretical predictions about compensation effectiveness. As a dollarized economy, exchange rate volatility is eliminated while preserving emerging market characteristics. The universal profit-sharing mandate eliminates selection bias inherent in voluntary schemes, while comprehensive firm-level data from the Structural Business Survey (ENESEM) covering 2019-2023 provides detailed compensation and performance measures for large private enterprises.

The findings challenge fundamental assumptions about compensation effectiveness in emerging market contexts. Despite comprehensive analysis across multiple specifications, neither TMT compensation nor mandatory worker profit-sharing demonstrates significant associations with firm productivity. The interaction between these mechanisms shows no evidence of complementarity or substitutability, decisively rejecting both theoretical predictions. Instead, firm performance appears primarily driven by persistent organizational capabilities, with approximately 59% of productivity advantages carrying over between periods.

These null results contribute important evidence questioning conventional wisdom about incentive system design. The absence of compensation effects suggests that agency theory predictions developed for developed markets may not generalize to emerging market contexts. The dominant role of productivity persistence indicates that sustainable performance advantages arise from deep structural capabilities rather than annual compensation adjustments.

From a policy perspective, the results question the economic rationale for mandatory profit-sharing schemes while highlighting the importance of policies that build long-term firm capabilities. For corporate practice, the results indicate that firms seeking productivity improvements might achieve better outcomes by investing in capability-building activities rather than focusing primarily on compensation design.

2 Theoretical Framework

The interaction between managerial and employee compensation systems draws from agency theory and optimal contracting models. This section develops theoretical predictions regarding how TMT compensation and mandatory worker profit-sharing jointly influence productivity.

2.1 Agency Theory and Managerial Incentives

The fundamental agency problem arises from the separation of ownership and control, creating potential conflicts between shareholder objectives and managerial actions (Jensen and Meckling, 1976). Optimal contracting theory provides the framework for understanding how compensation design can mitigate these conflicts by aligning managerial incentives with firm value maximization (Holmström, 1979).

TMT compensation serves multiple functions beyond effort provision. Higher compensation attracts superior managers whose skills enhance strategic decision-making (Gabaix and Landier, 2008). Performance-contingent compensation creates direct incentive alignment by linking managerial rewards to firm outcomes (Murphy, 1999), while compensation levels signal commitment to retaining effective leadership, reducing turnover costs.

When significant firm profits are predetermined for employee distribution through mandatory profit-sharing, the design space for managerial contracts becomes constrained, potentially requiring adaptation in how firms structure TMT incentives.

2.2 Employee Incentives and Profit-Sharing Theory

Worker profit-sharing schemes address agency problems at the employee level by creating direct financial stakes in firm performance. The primary economic mechanism operates through effort provision: when employees receive compensation contingent on firm-wide performance, individual incentives align with collective outcomes (Weitzman and Kruse, 1990).

Secondary mechanisms include improved information sharing and participatory decision-making. Profit-sharing creates employee interest in firm-wide outcomes, encouraging information flow that enables better operational decisions. The shared financial stake reduces adversarial labor-management relationships, facilitating implementation of efficiency-enhancing organizational changes.

The mandatory nature of Ecuador's profit-sharing scheme eliminates selection effects that complicate analysis of voluntary programs. Firms cannot choose whether to implement profit-sharing based on expected effectiveness, ensuring that observed relationships reflect true causal mechanisms rather than selection bias.

2.3 Interaction Effects: Theoretical Predictions

Two competing hypotheses emerge regarding how TMT compensation and worker profit-sharing jointly influence firm performance.

2.3.1 Substitution Hypothesis

Under the substitution hypothesis, managerial and employee incentive mechanisms serve similar functions in addressing agency problems, making them partial substitutes. If worker profit-sharing effectively aligns employee effort with firm objectives, the marginal benefit of high-powered managerial incentives may diminish. Budget constraints may force trade-offs between compensation mechanisms, as mandatory profit-sharing reduces distributable cash flows available for managerial compensation.

2.3.2 Complementarity Hypothesis

The complementarity hypothesis suggests that TMT compensation and worker profit-sharing mutually reinforce each other's effectiveness. Effective profit-sharing implementation requires sophisticated managerial skills in system design, communication, and performance measurement. Higher TMT compensation attracts managers with these capabilities, enhancing profit-sharing effectiveness through superior implementation.

Information and coordination arguments also support complementarity. Profit-sharing creates employee incentives to share productivity-relevant information with management, while effective TMTs utilize this information to design better strategies.

Based on this analysis, I derive the following hypotheses:

Hypothesis 1: TMT compensation is positively associated with firm productivity, reflecting its role in attracting effective management and providing incentive alignment.

Hypothesis 2: Worker profit-sharing is positively associated with firm productivity through enhanced employee motivation and organizational alignment.

Hypothesis 3a (Substitution): The positive association between TMT compensation and productivity weakens as worker profit-sharing intensity increases.

Hypothesis 3b (Complementarity): The positive association between TMT compensation and productivity strengthens as worker profit-sharing intensity increases.

3 Literature Review

3.1 Executive Compensation and Firm Performance

The relationship between executive compensation and firm performance has generated extensive empirical research with mixed conclusions. Early studies found weak correlations between CEO pay and performance (Jensen and Murphy, 1990), leading to debates about compensation effectiveness as an incentive mechanism.

Methodological advances have refined these findings. Hall and Liebman (1998) demonstrated that stock option valuations create stronger pay-performance sensitivities than previously recognized, while Core et al. (2003) showed that comprehensive compensation measures produce more robust performance relationships. However, Rönkkö et al. (2023) highlight identification problems in estimating CEO effects, demonstrating that inadequate controls for autocorrelation can produce spurious results.

3.2 Employee Profit-Sharing and Productivity

Research demonstrates generally positive effects of profit-sharing on firm performance. Kruse (1993) provides comprehensive evidence that profit-sharing firms exhibit higher productivity growth, while Freeman et al. (2010) synthesize international evidence showing consistent positive associations.

International evidence on mandatory profit-sharing remains limited. Nimier-David et al. (2023) exploit a 1990 French regulatory change to demonstrate that mandated profit-sharing increases labor share by 1.8 percentage points while reducing profit share by 1.4 percentage points, with no significant impact on firm productivity.

3.3 Emerging Market Corporate Governance

Emerging market corporate governance structures present unique institutional contexts that differ fundamentally from developed market frameworks. The predominance of concentrated ownership, family control, and underdeveloped institutions creates distinct agency problems and optimal contracting solutions (Claessens et al., 2000).

Iwasaki (2022) analyze 4,425 estimates from 204 studies across emerging markets, finding that the overall linkage between ownership and performance is significantly weaker than in developed economies. This suggests that management discipline by investors operates less effectively in emerging market contexts, potentially increasing the relative importance of alternative governance mechanisms.

4 Institutional Context

Ecuador is a middle-income Latin American nation with GDP of approximately $108 billion and per capita income of $6,345 in 2019. The economy is dominated by small and medium enterprises, with 89.2% of formal firms employing fewer than 50 workers. Ownership is typically concentrated, with family-owned enterprises constituting 67% of all registered companies.

4.1 Mandatory Profit-Sharing Framework

The centerpiece of Ecuador's institutional framework is the mandatory worker profit-sharing scheme codified in Article 97 of the Labor Code. This regulation mandates that all profit-generating enterprises distribute 15% of annual pre-tax profits to employees, creating a universal incentive mechanism linking worker remuneration to firm success.

The distribution follows a specific formula: 10% is distributed among all workers based on days worked during the fiscal year, and 5% is allocated proportionally based on family burden. The mandatory nature eliminates self-selection bias inherent in voluntary profit-sharing studies, while the uniform 15% rate provides standardized treatment intensity across firms.

Ecuador's capital markets remain underdeveloped, with the Quito Stock Exchange listing only 47 companies as of 2019. This limited development significantly constrains the use of stock-based compensation instruments for executives. Consequently, cash-based components of executive pay constitute the primary financial incentive tools for top managers in Ecuador,

making their study particularly relevant for understanding incentive provision in emerging markets.

5 Data and Methods

5.1 Data Source and Sample

I use data from Ecuador's Structural Business Survey (ENESEM), conducted annually by the National Institute of Statistics and Census (INEC). ENESEM represents a comprehensive census of formal businesses with 10 or more employees, providing detailed financial statements, employment records, and compensation data at the firm level. All monetary variables are deflated to 2023 constant dollars using Ecuador's Consumer Price Index.

I apply several data filters to construct the analytical sample. First, I exclude observations with missing or negative values for key financial variables. Second, I trim observations in the top and bottom 1% of the distribution for TMT compensation and productivity measures. Third, I restrict attention to large private enterprises, defined as firms with at least 200 employees and majority private ownership. This sample selection ensures that compensation decisions reflect economic efficiency considerations rather than political objectives.

5.2 Variable Definitions

Executive Compensation is operationalized as TMT Compensation per Manager, capturing the total annual cash compensation paid to the firm's top management team. This measure encompasses base salaries, performance bonuses, and other regular cash payments.

Profit-sharing per Worker quantifies the firm's mandatory profit-sharing distributions divided by the total workforce, reflecting the extent to which firms provide performance-based compensation to employees.

Firm Performance is assessed using Value Added per Worker as the primary measure, computed as the difference between total revenue and intermediate costs, normalized by employment levels. Revenue per Worker serves as a robustness check.

Control Variables include firm size (log of total employees), firm age (years since establishment), capital intensity (fixed assets to sales ratio), and financial leverage (total debt to assets ratio). Industry and year fixed effects control for unobserved heterogeneity.

5.3 Descriptive Statistics

Table 1 presents summary statistics for the key variables. TMT compensation varies widely across firms, with a mean of \$52,950 and standard deviation of \$45,880. Profit-sharing shows substantial variation, with most firms providing \$720 per worker. Revenue per worker averages \$192,250, with high variation indicating significant productivity differences across firms.

Table 1: Summary Statistics (2019-2023)

Variable	N	Mean	Std. Dev.	P25	P50	P75
TMT Compensation per Manager	11,111	52.95	45.88	24.00	42.74	69.24
Profit-sharing per Worker	12,327	4.16	40.14	0.15	0.72	2.25
Revenue per Worker	12,327	544.84	2,107	94.50	192.25	394.53
Value Added per Worker	12,327	70.08	405	17.47	28.13	49.71
Firm Size (Employees)	12,544	212	523	30	75	195

Notes: All monetary variables in thousands of 2023 USD.

5.4 Empirical Strategy

My baseline specification employs a dynamic panel framework to address productivity persistence and compensation endogeneity:

$$\begin{aligned}\ln(\text{VA/L})_{it} = {} & \alpha + \rho \ln(\text{VA/L})_{i,t-1} + \beta \ln(\text{TMT Comp})_{i,t-1} \\ & + \gamma \ln(\text{Profit Share})_{i,t-1} + \delta[\ln(\text{TMT Comp})_{i,t-1} \times \ln(\text{Profit Share})_{i,t-1}] \\ & + \mathbf{X}'_{i,t-1}\boldsymbol{\phi} + \mu_i + \lambda_t + \varepsilon_{it}\end{aligned} \tag{1}$$

where $\ln(\text{VA/L})_{it}$ denotes log value-added per worker for firm i in year t, $\ln(\text{TMT Comp})_{i,t-1}$ is log TMT compensation per manager, $\ln(\text{Profit Share})_{i,t-1}$ is log profit-sharing per worker, $\mathbf{X}_{i,t-1}$ includes predetermined controls, μ_i captures time-invariant firm heterogeneity, and λ_t represents year effects.

The lagged dependent variable controls for productivity persistence, addressing methodological concerns about spurious regression in performance studies (Rönkkö et al., 2023). The interaction coefficient δ tests the central hypothesis regarding complementarity or substitutability between compensation mechanisms.

5.4.1 System GMM Estimation

I employ the system GMM estimator of Blundell and Bond (1998) to address three sources of endogeneity: simultaneity bias (compensation decisions may respond to productivity shocks), dynamic panel bias (lagged dependent variable correlates with the error term), and omitted variable bias (unobserved firm capabilities jointly determine compensation and productivity).

The system GMM approach combines first-differenced and levels equations, using lagged levels as instruments for the differenced equation and lagged differences as instruments for the levels equation. For endogenous variables (TMT compensation, lagged productivity), I use instruments dated $t-2$ and earlier. For predetermined variables (profit-sharing, controls), I use instruments dated $t-1$ and earlier.

I employ specification tests for GMM validity: the Arellano-Bond test for second-order serial correlation and the Hansen test of instrument validity. Following Roodman (2009), I limit instrument proliferation by collapsing the instrument matrix and restricting instrument lags.

6 Results

6.1 Main Results

Table 2 presents the central empirical findings using System GMM estimation. The results reveal substantial productivity persistence, with the lagged dependent variable coefficient of 0.587 ($p<0.01$), indicating that approximately 59% of current productivity differences persist into the following period. This validates the dynamic specification and suggests that firm-specific capabilities represent the dominant driver of performance differences.

Table 2: Executive Compensation, Profit-Sharing, and Firm Productivity

	Dependent Variable: Log Value-Added per Worker			
	System GMM		**Fixed Effects**	**OLS**
	Interaction	No Interaction	Baseline	Comparison
	(1)	(2)	(3)	(4)
Productivity$_{t-1}$	0.587***	0.601***		
	(0.153)	(0.151)		
TMT Compensation$_{t-1}$	−0.425	0.198	−0.011	0.165***
	(0.574)	(0.113)	(0.049)	(0.044)
Profit-Sharing$_{t-1}$	−0.915	−0.022	−0.068	0.210***
	(0.822)	(0.034)	(0.070)	(0.064)
TMT × Profit-Sharing$_{t-1}$	0.082		0.006	0.010
	(0.075)		(0.006)	(0.006)
Capital Intensity$_{t-1}$	0.204***	0.195***	0.015	0.212***
	(0.049)	(0.051)	(0.019)	(0.015)
Leverage$_{t-1}$	0.023***	0.022***	0.002	0.017***
	(0.007)	(0.007)	(0.003)	(0.005)
Observations	4,203	4,203	4,205	4,205
Firms	1,816	1,816	1,816	1,816
AR(1) test (p-value)	0.000	0.000		
AR(2) test (p-value)	0.247	0.253		
Hansen test (p-value)	0.210	0.184		

Notes: Standard errors in parentheses. *** $p<0.01$, ** $p<0.05$, * $p<0.10$. System GMM specifications include firm and year fixed effects. Control variables (firm size, age, capital per worker) included but not reported.

The results provide no support for significant compensation effects. The TMT compensation coefficient is −0.425 with a large standard error (0.574), rendering it statistically insignificant. Similarly, the profit-sharing coefficient of −0.915 (0.822) lacks statistical significance. Most importantly, the interaction term coefficient of 0.082 (0.075) is not statistically different from zero, providing no evidence for either complementarity or substitutability between compensation mechanisms.

Column (2) examines whether removing the interaction term reveals independent effects. TMT compensation shows a coefficient of 0.198 (0.113), which approaches but does not achieve conventional significance levels, while the profit-sharing coefficient remains insignificant. These results suggest that compensation effects are not robust across specifications.

The System GMM diagnostics strongly support the validity of the identification strategy. The AR(2) test produces a p-value of 0.247, validating the use of lagged instruments. The Hansen test yields a p-value of 0.210, providing no evidence against instrument exogeneity.

While compensation variables show no explanatory power, several firm characteristics demonstrate significant associations with productivity. Capital intensity exhibits a robust positive coefficient of 0.204 ($p<0.01$), while financial leverage shows a small but significant positive coefficient of 0.023 ($p<0.01$).

The comparison with alternative estimators reinforces these findings. Fixed effects estimates produce small and insignificant coefficients for all compensation variables. While OLS estimates show larger and significant coefficients, the substantial differences between OLS and System GMM estimates highlight the importance of controlling for endogeneity.

6.2 Robustness Checks

Table 3 presents robustness checks using alternative productivity measures and econometric specifications. The analysis employs revenue per worker as an alternative productivity measure, total factor productivity estimated using the Levinsohn-Petrin method, and longer lag structures.

Table 3: Robustness Checks

	System GMM Estimates		
	Revenue/Worker	TFP (LP)	Longer Lags
	(1)	(2)	(3)
$\text{Productivity}_{t-1}$	1.365***	0.955**	0.634***
	(0.274)	(0.478)	(0.242)
$\text{TMT Compensation}_{t-1}$	−0.365	0.480	−0.201
	(1.168)	(1.610)	(0.305)
$\text{Profit-Sharing}_{t-1}$	−0.489	0.380	−0.456
	(1.639)	(2.522)	(0.462)
$\text{TMT} \times \text{Profit-Sharing}_{t-1}$	0.041	−0.050	0.040
	(0.150)	(0.237)	(0.043)
Observations	4,203	4,205	2,727

Notes: Standard errors in parentheses. *** $p<0.01$, ** $p<0.05$, * $p<0.10$.

The robustness analysis provides strong confirmation that the null compensation effects are not dependent on specific productivity measures or econometric specifications. Across all three alternative approaches, neither TMT compensation nor profit-sharing demonstrates significant associations with firm performance, and all interaction terms remain statistically insignificant.

6.3 Heterogeneity Analysis

I examine whether compensation effects vary across firm characteristics by partitioning the sample by size and export orientation. The results show that null compensation effects are robust across firm size categories (Large: 200-499 employees, Very Large: 500-999 employees, Mega: 1000+ employees) and export orientation (domestic vs. export-oriented firms with >10% export share).

Across all subsamples, neither TMT compensation nor profit-sharing demonstrates significant associations with productivity, and all interaction terms remain statistically insignificant. This pattern contradicts theoretical predictions that compensation effects should be strongest among large firms or export-oriented firms facing competitive pressures.

Productivity persistence remains strong across all subsamples, ranging from 56% to 82%, reinforcing the conclusion that firm-specific capabilities rather than annual compensation adjustments drive performance differences.

7 Discussion

The empirical findings present a striking departure from conventional wisdom regarding compensation effectiveness in emerging market contexts. The complete absence of significant compensation effects challenges fundamental assumptions in agency theory and optimal contracting literature.

The null results for both TMT compensation and profit-sharing effects contradict the extensive theoretical framework suggesting that properly designed incentives should align behavior with firm objectives. More importantly, the insignificant interaction effects decisively reject both complementarity and substitutability hypotheses, indicating that these compensation mechanisms operate independently.

These findings align with recent methodological critiques in the compensation literature. The high productivity persistence coefficient (0.587) suggests that firm performance is primarily driven by deep structural capabilities that evolve slowly over time, consistent with resource-based view arguments about sustainable competitive advantages.

The null compensation effects stand in marked contrast to much of the developed market literature, which typically finds positive associations between executive pay and firm performance. However, the findings are consistent with recent studies that employ rigorous identification strategies and find weak relationships between compensation and performance.

7.1 Policy Implications

The null results carry significant implications for compensation policy in emerging markets. Ecuador's mandatory 15% profit-sharing requirement appears to generate no measurable productivity benefits, questioning the economic rationale for such policies. For corporate governance policy, the results suggest that regulatory efforts might be more effectively directed toward building institutional infrastructure that supports firm capability development rather than mandating specific compensation structures.

The findings also have implications for executive compensation regulation. Given the absence of significant TMT effects, policies focused on constraining executive pay levels may

have limited impact on firm performance. Instead, regulatory attention might focus on improving governance mechanisms that support long-term capability building.

7.2 Limitations and Future Research

Several limitations should be acknowledged. The focus on large private enterprises may limit generalizability to smaller firms or state-owned enterprises. The five-year panel may not capture very long-term compensation effects. Additionally, the analysis focuses on cash-based compensation measures in a context where equity markets are underdeveloped.

Future research should extend this analysis to other emerging markets with mandatory profit-sharing schemes to test the generalizability of these findings. Investigation of the specific organizational capabilities driving productivity persistence could inform more effective policies for promoting firm growth.

8 Conclusion

This study provides novel evidence on the relationship between executive compensation, worker profit-sharing, and firm productivity using comprehensive panel data from Ecuador's large private enterprises. Leveraging Ecuador's mandatory profit-sharing requirement as a natural experiment and employing dynamic System GMM estimation, the analysis yields striking null results that challenge fundamental assumptions about compensation effectiveness in emerging markets.

The central finding is the complete absence of significant relationships between compensation mechanisms and firm productivity once proper econometric controls are implemented. Neither TMT compensation nor mandatory worker profit-sharing demonstrates measurable associations with performance, and their interaction shows no evidence of complementarity or substitutability.

This study makes three principal contributions. First, it provides the first rigorous examination of compensation-productivity relationships in an emerging market context with universal mandatory profit-sharing, eliminating selection bias. Second, it demonstrates the critical importance of controlling for productivity persistence in compensation studies. Third, the comprehensive null findings challenge the generalizability of agency theory predictions developed primarily in developed market contexts.

The dominant role of productivity persistence suggests that firm performance is primarily driven by deep organizational capabilities that evolve slowly over time rather than respond to annual compensation adjustments. This finding aligns with resource-based view arguments about sustainable competitive advantages while contradicting optimal contracting theory predictions.

The policy implications are significant for emerging market governments considering mandatory profit-sharing schemes or executive compensation regulation. The absence of productivity benefits from Ecuador's profit-sharing requirement questions the economic rationale for such policies. For corporate governance policy, the results suggest that regulatory efforts might generate greater productivity gains by focusing on institutional infrastructure that supports long-term capability development.

The findings also carry important implications for corporate practice in emerging markets. Rather than focusing primarily on compensation design, firms seeking productivity improvements might achieve better results by investing in technology adoption, human capital development, and organizational learning that contribute to persistent performance advantages.

This study's null results represent an important contribution to understanding compensation effectiveness in emerging market contexts. By demonstrating that neither executive compensation nor mandatory worker profit-sharing significantly influences productivity when properly identified, the findings highlight the central role of persistent organizational capabilities and challenge both policymakers and managers to focus on building long-term competitive advantages rather than relying primarily on compensation design to drive performance improvements.

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