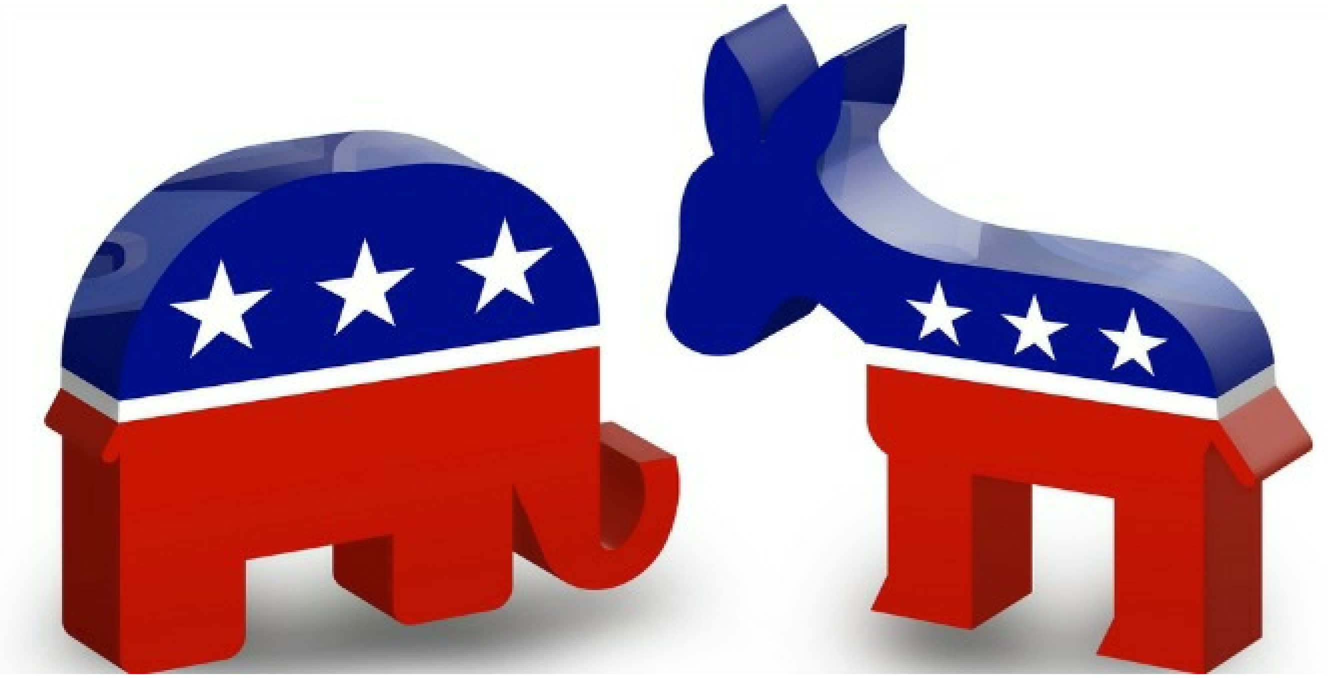
The elephant (and the donkey) in the boardroom

blogs.lse.ac.uk/businessreview/2017/02/07/the-elephant-and-the-donkey-in-the-boardroom/

2/7/2017



Firms governed by politically conservative boards of directors pay their CEOs more money than do firms with more liberal-leaning (the ideological left in the US) boards. That's the conclusion of our new study on the impact of political ideology in the boardroom. We also find an ideological disparity in the degree to which directors weigh recent firm performance when deciding upon CEO pay. Relative to their liberal counterparts, conservative-leaning boards tie CEO pay more closely to firm performance. They offer bigger financial rewards after periods of strong earnings or stock returns, and impose harsher penalties after periods of weak performance.

How much is a CEO worth to an organisation?

It's a hotly debated question in American fiscal discourse, especially as the pay gap between chief executives and front-line workers grows ever vaster. Of course, this debate is largely academic for all but the few whose votes really matter: the corporate directors who set compensation packages for their firms' senior leaders.

Boards have a fiduciary responsibility to ensure that CEOs are paid the appropriate amount to serve the best interest of shareholders. But what's "appropriate" is highly subjective, and might be directed by political beliefs. Given that pay is the most observable manifestation of directors' biases about how much CEOs matter to the success of their organisations, we wondered whether corporate boards' ideological leanings may affect decisions about CEO pay.

To find out, we tracked the pay and performance of more than 4,000 CEOs of S&P 1500 firms from 1998 to 2013. We also tallied donations by those firms' corporate directors to political parties and candidates over the same period, establishing an ideology score for each board along the left-right political spectrum. To create an apples-to-apples comparison of CEO pay, we controlled for firm size, age, industry, sales growth and other factors in compensation decisions. This allowed us to isolate the relative effect of political ideology on CEO pay across a wide range of public companies.

After levelling the landscape, we found that conservative boards, on average, paid their CEOs four percent more money than liberal boards paid theirs. This translates to approximately $140,000 in additional compensation for the typical chief executive. This pay differential equals more than three times the median income in the United States.

When we factored recent firm performance into the equation, we found that good times brought an even bigger premium in compensation. After a period of strong earnings or increased market capitalisation, conservative boards paid their CEOs 18 per cent more than CEOs who report to liberal boards. The difference in CEO pay across liberal and conservative boards was much smaller, however, following poor performance. Our findings indicated that the poorest performing chief executives fared more or less the same in terms of their pay, regardless of whether their boards were conservative or liberal.

What's going on here?

Our findings suggest that there may be differences in the way that liberals and conservatives view the impact of individual leaders. While it would be ideal to examine these differences by collecting primary data through surveys, we were unable to do that. Instead, we drew from prior psychological research that has shown that conservatives are more likely to make internal (as opposed to external, or situational) attributions for outcomes.

This logic suggests that directors' political ideologies may shape their perceptions of how much — or how little — CEOs matter to a firm's profitability and survival. According to our theory, conservative boards will be more inclined to believe that the fortunes of an organisation hinge on the actions of its CEO. And this higher assessment of CEO impact translates into higher CEO pay. In contrast, liberal boards are more likely to attribute firm performance to social structures, market conditions and broader environmental factors, resulting in lower CEO pay.

What does it mean?

For practitioners and astute observers of business, our findings suggest that the criteria for evaluating corporate governance may be less objectively clear-cut than previously thought. Instead, opinions about whether governance practices are good versus bad may be in part driven by the politics of the beholder. For instance, conservative directors could reasonably argue that higher CEO pay is good governance. After all, it is their responsibility to recruit and retain uniquely talented CEOs, a task that takes on heightened importance when CEOs matter — or are perceived to matter — a great deal to the organisations they lead.

For corporate directors, it may be beneficial to have the awareness that their political beliefs are shaping their views and influencing their approaches to corporate governance. Political biases may creep into these really important decisions. To understand that this is happening is informative. However, the question is: if you knew about your biases, would it make you more reflective? Would it alter your behaviour?

- *You may also want to read how liberal-leaning companies engage in more corporate social responsibility than conservative ones: Red or blue? Political ideology and firms' corporate social responsibility*

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Notes:

- *This blog post is based on the authors' paper The Elephant (or Donkey) in the Boardroom: How Board Political Ideology Affects CEO Pay, in* Administrative Science Quarterly, Vol 62, Issue 1, 2017
- *The post gives the views of its author, not the position of LSE Business Review or the London School of Economics.*
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