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Social elites on the board and executive pay in developing countries: Evidence from Africa

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ABSTRACT

This study applies a new multi-focal actor-centered institution-theoretic approach to examine the association between executive pay and the recruitment of social elites to the board of directors in developing countries. We use a sample of 119 initial public offerings (IPOs) from 17 African stock markets to model this relationship. The results suggest that a higher proportion of elites on the board is associated with lower executive pay. This is moderated by institutional quality; that is, lower institutional quality is associated with more directors drawn from social elites and with higher pay, while the opposite is true in higher-institutional-quality environments. Our findings confirm the importance of the social environment within which governance is embedded.

1. Introduction

Prior research on the determinants of executive and CEO salary has been overwhelmingly dominated by the adoption of either an agency-theoretic or a neoclassical lens. The former focusses on incentive alignment between shareholders and their managerial agents (Jensen & Meckling, 1976) as well as insider self-reward or appropriation tendencies (e.g. Doidge, Karolyi, & Stulz, 2007). The latter focusses on the pay-performance relationship (e.g. Buck, Liu, & Skovoroda, 2008; Liu, Lu, & Chizema, 2014) as well as salary premiums attributable to the supply or demand-side schedules of the managerial labor market (e.g. Oxelheim & Randoy, 2005). Both assume market-intermediated arms-length transactions and third-party contracting in the provision of resources, including capital and labor, to the firm. However, there is a lack of research focussing on the role of the underlying political economy in the determination of optimal executive salary levels. This is of particular importance in developing economies, where firms and their transactions are contextually embedded in institutional frameworks that promote extended socially conditioned relational contracting (Acquaah, 2007).

We follow North (1989), North (1991)'s intuition that, in developing countries with weaker aggregate formal institutional quality, polities are demographically narrower and controlled by empowered special interest groups, or social elites, with considerable vested private benefits of control. These actors have a lack of incentive to initiate more equitable reforms in formal institutional frameworks, resulting in stagnation. However, while they usurp hegemonic control over the national polity, they are drawn from the underlying society, and in the case of much of the developing world this is based on extended clan and ethnic lineage rivalries that in effect form the underlying social fabric of emerging nation states. Our model extends the actor-centered institution-theoretic model of Aguilera and Jackson (2003), Aguilera and Jackson (2010) to a developing context. This involves considering the interrelationship between the different stakeholders within the organizational structure of the firm, each having socially constructed preferences shaped by the prevailing institutional framework within the society from which they are drawn. In this way, our model accommodates a firm's active management of its legitimacy strategy (Suchman, 1995), which leads it to co-opt environmental contingencies arising from the demographic shape of polity, through the recruitment of social elites to nonexecutive board roles. This legitimacy is essential in the acquisition of resources (Pfeffer & Salancik, 1978). However the recruitment of elites also introduces institutionalized incongruities into the firm through a conflict of their socially constructed norms and

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preferences with those of other stakeholders such as management, labor, suppliers and customers, these being unequivocally shaped by the underlying clan or ethnic lineage governance framework within the society. Following Aguilera and Jackson (2003), we argue that salary is a natural mechanism used to stabilize the firm's governance structure when otherwise irreconcilable tensions arise due to institutionalized incongruities between elites and management drawn from the underlying informal societal framework.

Using a unique sample of 119 initial public offering (IPO) firms from 17 African stock markets, we find that elevated proportions of social elites on boards of directors are associated with lower average executive salaries. We argue this is due to a tempering effect of all the powerful ethnic lineages and extended clan governance frameworks from which all stakeholders are drawn. This supports relational contracting and effectively reigns in appropriation motivations associated with social elites. Furthermore, this association is positively moderated by formal institutional quality. Consequently, in low formal institutional quality environments, higher proportions of social elites are associated with higher executive salaries, while the opposite is true in high formal institutional quality jurisdictions. Our findings and new theoretical approach yield valuable insights into the determinants of executive salaries in developing economies – where national governance frameworks can be very different from their counterparts in advanced economies. This also makes a valuable contribution to international business theorizing, in terms of underscoring the importance of explanations based on the contextual embeddedness of governance arrangements and utilizing under-used institution-theoretic approaches as opposed to notions of governance emanating from convergence processes and competitive efficiencies at a national level.

The paper is structured as follows. In Section 2, we outline our model and derive the theoretically framed arguments underpinning our hypotheses. The following section discusses the appropriateness of the African context for this study, explains the characteristics of the sample, describes the structure of the variables used in the estimation and presents some descriptive statistics. The estimation results are reported and discussed in section 4, and the final section summarizes the conclusions of the paper, lists the limitations of the study and suggests some avenues for future research.

2. Theory and hypotheses

There is a considerable literature on executive and CEO pay, although the overwhelming majority of it is informed by a narrow set of theoretical perspectives. Most studies focus on a small group of developed nations, principally the US (e.g. Core, Guay, & Larcker, 2003; Core, Guay, & Larcker, 2008), UK (e.g. Conyon & Murphy, 2000), Japan (e.g. Abe, Gaston, & Kubo, 2005), and Scandinavia (Oxelheim & Randoy, 2005), and this is largely the reason for the limited range of theoretical applications, given that these countries all have institutional frameworks that extensively support external market intermediation of capital, managerial labor and products (Aguilera & Jackson, 2003; Hoskisson, Yiu, & Kim, 2004).

Neoclassical theory is fundamentally based on notions of efficient markets. For managerial labor, this implies the equating of supply of and demand for executive talent (Conyon, 2006). In this scenario, the marginal return on executive performance is equal to the marginal product (Mirrlees, 1976). This has led to a host of studies focussing on pay that is related to individual performance (e.g. Buck et al., 2008), as well as the association between pay and firm performance (e.g. Buck et al., 2008; Carpenter & Sanders, 2002; Conyon, 2006). Agency theory extends this economic perspective by viewing pay as a form of incentive alignment between shareholder principals and their managerial agents (Jensen & Meckling, 1976). This has more recently evolved into tournament theory (Conyon, Peck, & Sadler, 2001; Main et al., 1993), relating to competition in internal labor markets, and CEO power theory (Ryan & Wiggins, 2004) that focusses on the self-reward tendencies of dominant CEOs.

However, a limitation of such neoclassical and agency perspectives regarding pay and governance is the exclusive focus on bilateral contracts between principals and agents, since notions of agency costs are based solely on differences in utility. While this has been argued to be akin to a form of *dyadic reductionalism* (Aguilera & Jackson, 2003: 449), it also lacks any consideration of the social context within which business activities are embedded. A further limitation of such perspectives is their exclusive focus on external market intermediation. This severely curtails their application to emerging and developing economies, in which markets tend to be both inactive and segmented (see Hearn & Piesse, 2013; Hearn, 2014) and relational contracting is commonplace. Ownership structures also differ significantly from the traditional Berle and Means (1932) view of diversification as the sole means of achieving separation of ownership from control, which is a fundamental condition of agency theory (Aguilera & Jackson, 2003; Aguilera & Jackson, 2010). Furthermore, agency theory has a restricted view on board composition in terms of the board's ability to monitor. Thus, interlocking directorships and the recruitment of directors from other backgrounds, while potentially beneficial for the firm, are generally viewed negatively in terms of their "*busyness*" that may inhibit effective monitoring (Fich & Shivdansani, 2006). Conversely, resource dependence theory is preoccupied with the social capital and networks that directors bring to the firm in terms of additional resources and information, which can be linked to higher performance (e.g. Pfeffer & Salancik, 1978). Hillman and Dalziel (2003) were the first to provide a theoretical integration of resource dependency's boundary-spanning directors and the incentives of executives, although this has not been developed further.

A recent study of the political economy related determinants of executive salary in Chinese listed firms, by Chizema, Liu, Lu, and Gao (2015), utilized social comparison theory where higher numbers of government officials as nonexecutives on boards of directors were found to be associated with lower executive salaries. Theoretically, the egalitarian nature of socialist government officials co-opted to boards of directors was argued to exert anti-inflationary pressure on executive self-reward tendencies. However, this perspective is very limited in its lack of consideration of the wider political economy within which all aspects of the firm's functioning are inextricably embedded. Given these constraints within prior theorizing, we propose an extension of the institutional actor-centered model of Aguilera and Jackson (2003), Aguilera and Jackson (2010). This is sociologically orientated and assumes the firm's organizational structure and boundaries are transcended by a number of distinct stakeholders, each with their own socially constructed preferences. The emphasis on social construction of preferences underscores the importance of institutions in forming these, while at the same time underlining their importance in shaping overall firm strategy. Aguilera & Jackson's model assumes three principal stakeholder groups, namely those of capital, management and labor. These groups are in dynamic coalition and conflict with each other, owing to potential institutionalized incongruities, while at same time conceding concessions when conflicts arise between capital and management – over the design of management compensation, for example – in order to maintain the stability and integrity of the firm as a governance structure.

The model flexibly accommodates incongruities, deemed to arise through institutionalized differences in rationality (Lepsius, 1990). In this way, if capital, as a stakeholder group, takes the form