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Geographical relationships and CEO compensation contracts

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ABSTRACT

In this paper, we empirically analyze the effects that the geographical relationships between chairman and CEO have on the latter's compensation contracts, based on samples of listed A-share private firms from 2005 to 2014. We find that geographical relationships are related to lower pay–performance sensitivity, and that the correlation mainly exists in poor performance periods, suggesting that geographical relationships weaken the effectiveness of compensation contracts. We also find that geographical relationships can be substituted by external formal institutions.

1. Introduction

CEO compensation contracts lie at the core of firm governance. Effective contracts relieve the agency problems that stem from a separation between ownership and management (Jensen and Meckling, 1976; Jensen and Murphy, 1990). However, the compensation contract is not a perfect tool for situations involving information asymmetry and limited rationality. CEOs tend to take opportunistic actions in their pursuit of private benefits, and shareholders rarely know that it is happening. From a Western perspective, agency problems are thought to be solved by external institutions. Yet while perfect property protection systems and legal mechanisms can improve contract enforcement (Williamson, 1985), emerging and transitioning environments such

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as China cannot provide complete external institutional control, which can lead to inadequate property protection and legal penalty mechanisms (Chalos and O'Connor, 2004). As such, some studies treat social relationships as an alternative mechanism, as they provide motivation and reduce information asymmetry. The possible positive effects of social relationships are referred to as the substitution hypothesis (Wang, 2005; Zhao and Lv, 2015). Other research finds that social relationships reduce boards' supervision effectiveness. The possible negative effects of social relationships are referred to as the weakening hypothesis (Core et al., 1999; Hwang and Kim, 2009). In this paper, we test which of the aforementioned hypotheses is deterministic.

This paper focuses on representative social and geographical relationships to test their effects on compensation contracts. Geographical relationships are generated by one's proximity to another. From a sociological perspective, Chinese society is constructed through classifications and relationships. Classifications are the most fundamental informal social construct upon which relationships are built (Pan, 2000). "Countryman" is a common classification. As Fei (1948) says, Chinese social relationships form concentric circles, with home in the center. In addition to genetic relationships, geographical relationships and clanship are also important in China (Ma, 2008). In contrast to Zhao and Lv (2015), who focus on genetic relationships, we doubt the universality of altruism in genetic relationships (Wang et al., 2014; Wei and Chen, 2015). Compared with academic and colleague relationships, for which there is relatively little information, the effects of geographical relationships on contracts have been recorded (Cai et al., 2008) and are common in practice (Lu and Hu, 2014). Some studies find that geographical relationships influence economic behavior. For instance, informal financial organizations in Wenzhou built a credit network using geographical relationships to ultimately lower credit rates (Guo and Liu, 2002). However, geographical relationships can also increase firm risk (Lu and Hu, 2014) and reduce the effectiveness of internal control (Yu et al., 2017). Thus, the effects of social relationships on compensation contracts deserve to be explored.

We empirically analyze the effects of geographical relationships on the effectiveness of compensation contracts (compensation–performance sensitivity, also known as pay-performance sensitivity). We show that the sensitivity is lower in firms with geographical relationships. To distinguish between the substitution hypotheses and weakening hypotheses, we test the compensation stickiness and performance. According to the weakening hypothesis, geographical relationships can increase compensation stickiness. If geographical relationships act as umbrellas for CEOs' self-serving behavior, then compensation–performance sensitivity should only decrease in declining performance periods. According to the substitution hypothesis, CEO supervision does not rely on compensation contracts, and as such the reduction in compensation–performance sensitivity should be bi-directional. Our empirical result shows that the weakening effects of geographical relationships are only significant in declining periods, which supports the weakening hypothesis. We also test for the cross-sectional differences in institutions and find that the weakening effect is only significant in poor external institutions, indicating that governing by relationships may not be as powerful as doing so by institutional constraints. The abovementioned results remain robust after eliminating alternative mechanisms and endogeneity.

Our research makes several contributions to the literature. First, it supplements the relevant work being conducted in emerging and transitional markets. Studies on the effects of social relationships on compensation are largely based on developed markets (Core et al., 1999; Hwang and Kim, 2009; Fracassi and Tate, 2012). We also distinguish between two possible hypotheses and show how geographical relationships weaken CEO supervision. Second, unlike the research that focuses on clanship (Zhao and Lv, 2015), we explore geographical relationships to achieve a more universal conclusion. Finally, we emphasize the effectiveness of formal institutions to help guide regulators.

The remainder of this paper is organized as follows. The second section features a literature review, the third presents our theory and hypotheses, the fourth covers the research design, the fifth shares the empirical results and the final section concludes the paper.

2. Literature review

2.1. Board of directors and manager compensation

Early research is characterized by its focus on the effect of board structure on compensation contract effectiveness (Cyert et al., 1997), with board size as a deterministic factor of CEO variable compensation. When the