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Politically connected CEOs, firm performance, and CEO pay

Huiying Wu[a], Sihai Li[b,*], Sammy Xiaoyan Ying[c], Xuan Chen[b]

[a] School of Business, Western Sydney University, Sydney, Australia
[b] School of Accounting, Zhongnan University of Economics and Law, Wuhan, China
[c] Newcastle Business School, University of Newcastle, Sydney, Australia

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ABSTRACT

This study examines the role of executive political connections in shaping executive compensation strategies in private Chinese firms, given the importance of political connections in securing political legitimacy and government-controlled resources in China. Our results show that the political connections of CEOs have a positive impact on both firm performance and CEO pay, and that this impact is stronger in less-developed regions. Further analyses indicate that, for CEOs with local political connections, the positive impact is not affected by regional economic development. Our findings reveal the importance of CEOs' political connections and demonstrate that such connections play a role in determining executive compensation.

1. Introduction

The determination of management compensation has been the subject of extensive research in the strategic management literature, with a focus on the association between company performance and senior management pay (e.g., Buck, Bruce, Main, & Udueni, 2003; Conyon & Leech, 1994; Jensen & Murphy, 1990). However, much of the evidence from empirical research on the determinants of executive pay has failed to document a robust pay–performance link (Barkema & Gomez-Mejia, 1998; Conyon, Gregg, & Machin, 1995). Thus, research efforts have been increasingly directed toward seeking alternative social and political explanations for executive pay (Chhaochharia & Grinstein, 2009; Conyon & Peck, 1998; Finkelstein & Boyd, 1998; Finkelstein & Hambrick, 1989; Firth, Fung, & Rui, 2006; Henderson & Fredrickson, 1996; O'Reilly III, Main, & Crystal, 1988; Sanders & Carpenter, 1998). For example, O'Reilly III et al. (1988) document strong associations between CEO compensation and the compensation level of outside members of the board of directors, especially those who serve on the compensation committee, suggesting that social comparison has an importance influence on CEO compensation levels. Finkelstein and Hambrick (1989) find that CEO pay is linked to several factors such as firm size, operation complexity, financial performance, CEO power, board vigilance, and the CEO's human capital, indicating that CEO compensation is influenced by a complex web of market and political factors. These studies suggest that it is important to comprehend executive compensation from multiple perspectives, including economic, social, and political perspectives (Finkelstein & Hambrick, 1988).

Executives throughout the world have political connections (Boubakri, Cosset, & Saffar, 2008) and have a considerable impact on the operations and performance of firms (Faccio, 2006; Fisman, 2001; Hillman, 2005; Johnson & Mitton, 2003). As such, executive political connections may be an important determinant of executive compensation. However, the relationship between political connections and executive pay has received scant attention. We fill this void in the literature by examining the role of political connections possessed by chief executive officers (CEOs) in influencing firm performance and CEO pay.

This study draws on resource-dependence theory, which suggests that CEOs with political connections help a firm to secure resources and better manage a challenging environment (Pfeffer & Salancik, 2003). This perspective enables us to focus on the value of political connections in creating competitive advantages for firms in light of management and economic literature on the implications of political connections. We argue that CEO political connections are strategically important for firms to gain political legitimacy and acquire access to government-controlled resources and should therefore be an important determinant of CEO pay.

Using private Chinese firms listed on either the Shenzhen or the Shanghai stock exchange between 2005 and 2012, we find that the political connections of CEOs have a positive impact on both firm performance and CEO pay, and that this effect is stronger in less-developed regions. Further analyses indicate that, for CEOs with local political connections, the positive impact is not affected by regional economic development. These findings reveal the importance of the political connections of CEOs and show that such connections play a

* Corresponding author.
E-mail addresses: h.wu@westernsydney.edu.au (H. Wu), lshhhy0420@163.com (S. Li), sammy.ying@newcastle.edu.au (S.X. Ying), 494859298@qq.com (X. Chen).

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role in determining executive compensation.

Our study extends earlier research on executive pay but also differs from it in several important respects. First, our study provides an understanding of the effects of executives' political connections on executive pay. Prior studies have examined the influence of various characteristics of executive directors, such as social capital (Belliveau, O'Reilly, & Wade, 1996), executive power (indicated by tenure and shareholding), and human capital (Finkelstein & Hambrick, 1989). Little is known about the relationship between executives' political capital and executive compensation despite the fact that the effect of political ties on firm value has been widely documented in the literature. Second, this is the first study to examine executive pay in private Chinese firms. China provides an ideal research setting because of the prevalence and importance of political connections in its business sector (Fan, Wong, & Zhang, 2007; Li, Meng, Wang, & Zhou, 2008). This study adds to the limited but growing literature on executive compensation in transitional economies. Much of the research on executive pay has focused on Western settings (Chizema, Liu, Lu, & Gao, 2015). Our study extends the existing research to a different institutional setting with a particular focus on private firms, an increasingly important business sector in China but one often neglected in the literature.

The remainder of the study is organized as follows. In Section 2, we discuss the theoretical setting for the study, private businesses in China, and the development of multiple hypotheses. Section 3 describes data collection and our methodology. In Section 4, we present the results. Finally, Section 5 concludes the piece and outlines avenues for future research.

2. Background and hypothesis development

2.1. Theoretical setting

This study is informed by resource-dependence theory. This theory emphasizes the importance of firms establishing links with external contingencies to manage uncertainty and interdependence. The government is a key source of external uncertainty for businesses, and one way to manage this uncertainty is to appoint politicians to the board of directors (Hillman, 2005). There is a growing body of management and economic literature on the various roles of political connections in creating value for businesses. Prior studies have provided evidence that political connections can bring about a range of benefits, including preferential treatment by government-controlled banks (Dinç, 2005), favorable regulatory conditions (De Soto, 1989), government subsidies (Johnson & Mitton, 2003), and tax discounts (De Soto, 1989), ultimately resulting in increases in a firm's value (Faccio, 2006; Fisman, 2001; Hillman, 2005).

Political connections are particularly important for private Chinese businesses. Because such firms operate in a hostile environment, which is further discussed in the next section, they seek out political connections to secure political legitimacy and government-controlled resources. Indeed, empirical evidence shows that Party membership helps private entrepreneurs to obtain loans from banks, and affords them more confidence in the legal system (Li et al., 2008).

2.2. Private businesses in China

The evolution of private businesses in China was essentially shaped by political ideology; private businesses were initially completely prohibited, were then revived, and have since grown rapidly. China was formed as a socialist country, with sole leadership assumed by the Communist Party of China in 1949. Because public ownership, including state and collective ownership, was considered superior to private ownership, all private companies were transferred to public ownership by 1955, with state-owned enterprises dominating the national economy (Doupnik & Perera, 2011).

Private businesses reemerged following the Third Plenum of the Communist Party's Eleventh Central Committee held in 1978, which initiated reform policies to transform China's economy. After more than three decades of rapid growth, private businesses now account for more than two thirds of output, contribute to almost all job growth, and are the leading driver of export growth (Lardy, 2014).

Despite the increasingly important role private businesses play in the Chinese economy, they remain constrained by various institutional difficulties. First, unlike their state-owned counterparts, private firms are continually subjected to ideological discrimination, both constitutionally and practically. The existing 1982 Constitution (amended) emphasized public ownership as the foundation of China's fundamental economic system, although other forms of business ownership, including private businesses, were being developed jointly (Article 6). Furthermore, the state-owned economy is viewed as the dominant force in the national economic system, and its growth is secured by the country (Article 7). Private ownership was considered to be an inferior form of ownership from an ideological point of view. The legitimacy of private firms has frequently been challenged by social movements that have demanded a crackdown on the private sector on the basis of countering bourgeois liberalization, attacking speculation, or rectifying the market (Li, Meng, & Zhang, 2006).

Second, private enterprises have endured an unfavorable economic environment. The government still controls most resources, despite dramatic economic reforms. State-owned firms enjoy preferences in obtaining bank loans, tax benefits, and other key resources (Brandt & Li, 2003; Che, 2002; Lee, Walker, & Zeng, 2014; Li, Yue, & Zhao, 2009). On the other hand, private firms have to endure arbitrary harassment by bureaucratic officials (Pearson, 1997). Self-interested bureaucrats use their discretionary power to impose excessive regulatory burdens on private firms, including unnecessary official routines, complex rules, and extended procedures (Li et al., 2006). Private firms often pay taxes, licensing fees, administrative fees, and penalties at punitive levels (Peng, 2001). Today, the Chinese government continues to struggle to create a market environment in which private firms can compete fairly with their state-owned peers (Li et al., 2008).

Third, China's legal system offers little protection for private firms. Compared to legal institutions in advanced economies, China's legal system is much younger and less developed (Allen, Qian, & Qian, 2005). China's economic transition has unfolded in an environment in which the rule of law has been nonexistent or ineffective at preventing bureaucrats from encroaching on private firms. Laws and government policies concerning private firms are subject to the broad and varied interpretation of the officials who enact and enforce them (Ahlstrom & Bruton, 2001). Despite the widespread abuse, it is rare for private firms to seek legal redress (Wank, 1996). Although continuous efforts have been made to improve the legal system in the past three decades, the market-oriented legal system is still relatively untested, and unexpected government policy changes continuously add to its uncertainty and complexity (Schlevogt, 2000).

2.3. Effect of political connections on firm performance

Resource-dependence theory suggests that firms can use political connections to address uncertainty created by the government and obtain government-controlled resources. As summarized above, private firms in China operate in a hostile environment. Obtaining political legitimacy and government-controlled resources is critical for their survival and success in this challenging environment. In advanced economies, the rights of private firms to operate freely are secured by the institutional infrastructure. In a transitional economy such as China's, such rights are not enforced automatically because of the absence of supporting institutions (Ahlstrom & Bruton, 2001). Private firms have pursued strategic action to establish their legitimacy in society to mitigate the negative effects of the adverse political, economic, and legal environment. Establishing political connections is one important and effective legitimacy-building strategy.