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CEO compensation and corporate social responsibility

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ABSTRACT

We examine the association between CEO compensation and corporate social responsibility (CSR). We find that CEO compensation is negatively associated with CSR investment. We find CEO compensation is positively associated with normal CSR, suggesting that CEO is rewarded for investing in optimal level of CSR. The positive association between CEO compensation and normal CSR is more pronounced in firms with stronger corporate governance. However, CEO compensation level is negatively associated with abnormal CSR, suggesting that when CSR investment deviates from its optimal level, CEOs receive lower compensation level for excessive CSR investments. Firms with good corporate governance penalize abnormal CSR.

1. Introduction

Conventional wisdom suggests that firms should reward CEO for undertaking corporate social responsibility (CSR) which improves firm performance. Corporate governance and CSR advocates such as Global Reporting Initiatives and Corporate Register recommend that compensation of top level management should reflect CSR. For instance, the 2013 joint report by the Investor Responsibility

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Research Center and the Sustainable Investments Institutes suggest that 43% of the Fortune 500 firms tie executive compensation to CSR.[1] The overall empirical evidence on the association between CEO compensation and CSR is inconclusive. On one hand, Berrone and Gomez-mejia (2009) find that in polluting industries, good environmental performance increases CEO compensation.[2] On the other hand, contrary to conventional wisdom, other studies find that CEO compensation level is negatively associated with CSR (Coombs and Gilley, 2005; Russo and Harrison, 2005; Stanwick and Stanwick, 2001).

While the preceding studies differ in sample, time period and method, they do not explicitly consider the heterogeneity in CSR investments. For example, Borghesi et al. (2014: 164) find that "in some instances, CSR investments enhance shareholder value. However, in other cases, altruistic managers or managers who privately benefit from the positive attention arising from these activities may choose to make CSR investments even if they are not value enhancing." By introducing the concepts of normal (value increasing) CSR and abnormal (value decreasing) CSR, our paper revisits the association between CEO compensation and CSR investment and aims to provide new insights to the puzzling findings of the previous papers.

We posit that the association between CEO compensation and CSR depends on whether CSR investments are value increasing or value decreasing. Furthermore, it is plausible that association between CEO compensation and CSR may vary systematically across different corporate governance structures. Accordingly, we examine whether there is an interplay between corporate governance structures and CSR investments in affecting CEO compensation.

We begin our analysis by considering two alternative views on the association between CEO compensation and CSR. Under the first view, greater CSR investment enhances shareholders' value because better CSR investment is associated with better retention of high quality employees (Greening and Turban, 2000), higher demand for the firm's products (Navarro, 1988), higher customer loyalty (Maignan et al., 1999; Sen and Bhattacharya, 2001) and higher access to valuable resources (Cochran and Wood, 1984; Cheng et al., 2014). Other studies find that CSR is associated with better non-financial performance such as higher operational efficiencies (Sharma and Vredenburg, 1998) and higher product quality (Johnson and Greening, 1999). These studies draw extensively from the stakeholder value maximization theory (Cornell and Shapiro, 1987; Hill and Jones, 1992; Jensen and Meckling, 1976; Oliver et al., 2014; Servaes and Tamayo, 2013; Tang et al., 2014), the theme of which is that a firm is a nexus of contracts between shareholders and other stakeholders (such as customers, suppliers and employees). Each group of stakeholders supplies the firm with critical resources in exchange for claims outlined in explicit contracts (e.g., wage contracts and product warranties) or suggested in implicit contracts (e.g., promises of job security to employees and continued service to customers). If higher CSR investment is associated with greater firm-specific focus on the interests of other stakeholders (such as customers, suppliers and employees), these stakeholders are more likely to support the firm's operation, which increases shareholders' value. Stated differently, CSR activities have a positive effect on shareholders' value because focusing on the interests of other stakeholders increases their willingness to support a firm's operation, which in turn increases shareholders' value.[3] In the context of our study, if higher CSR is associated with higher shareholders' value, we expect CEO to be rewarded for his effort in improving CSR investment. Hence, we predict a positive association between CSR and CEO compensation. We refer to this view as the value-creation hypothesis.

Under the second view, CSR is associated with investments in negative net present value projects that destroy shareholders' value. The key to this view is that managers may over-invest in CSR that transfer wealth from shareholders to other stakeholders (such as community, regulators and

[1] http://www.csrhub.com/blog/2013/05/top-companies-tie-compensation-to-sustainability.html.

[2] The authors focus on firms from industries subject to reporting under the Environmental Protection Agency's Toxics Release Inventory, a program that requires facilities exceeding a threshold level to report their emissions.

[3] We acknowledge that institutional forces can often lead to symbolic rather than genuine CSR actions and policies whereby firms may appear to engage in CSR, but these initiatives are simply intended to appease stakeholder demands or meet the minimum requirements of standards. Under this view, if CSR is purely symbolic without any effect on shareholders' value, we expect no association between CEO compensation and CSR. However, if symbolic CSR reduces shareholders' value, we expect a negative association between CEO compensation and CSR.