Journal of Comparative Economics 40 (2012) 621–642

Contents lists available at SciVerse ScienceDirect

Journal of Comparative Economics

journal homepage: www.elsevier.com/locate/jce

# CEO compensation and large shareholders: Evidence from emerging markets

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ARTICLE INFO

*Article history:*
Available online 6 March 2012

*JEL classification:*
G3
J3
M52

*Keywords:*
CEO compensation
Large shareholders
Family firms
Emerging markets

ABSTRACT

**Gallego, Francisco, and Larrain, Borja**—CEO compensation and large shareholders: Evidence from emerging markets

Using a novel data base for three emerging markets we study large shareholders and their relationship with professional managers. This is important to understand wage inequality and returns to high-level human capital since concentrated ownership is prevalent in developing countries. We find a compensation premium of about 30 log points for professional (not controller-related) CEOs working in firms controlled by a family compared to firms controlled by other large shareholders. The premium cannot be explained away by standard firm characteristics, observable executive skills (e.g., education or tenure), or the compensation of the CEO in her former job. The premium comes mostly from family firms with absent founders and when sons are involved. *Journal of Comparative Economics* **40** (4) (2012) 621–642. Pontificia Universidad Católica de Chile, Instituto de Economía, Avda. Vicuña Mackenna 4860, Macul, Santiago, Chile; Pontificia Universidad Católica de Chile, Escuela de Administración and Finance UC, Avda. Vicuña Mackenna 4860, Macul, Santiago, Chile.


## 1. Introduction

There is a large literature on the effect of institutions – e.g., the legal system, the government, or the country's cultural background – on economic performance. The institutions that prevail in the corporate sector also vary substantially across countries. Perhaps one of the main differences between the US corporate sector and other countries is that large controlling shareholders are rarely seen in the US while they are the norm in other countries. As suggested by Morck et al. (2005) the concentration of ownership in large shareholders can have macroeconomic impact, for example, by affecting resource allocation, public policies, and the distribution of income and political influence. The concentration of corporate ownership is typical of Latin America – our focus of study – but also Asia and continental Europe (see Claessens et al., 2000; Faccio and Lang, 2002; La Porta et al., 1999).[1] Beyond ownership concentration, Latin American financial markets are similar to many of these other markets in terms of their size (relative to the country's GDP), the number of listed firms relative to population, the legal protection given to investors, and other dimensions (Djankov et al., 2008). Therefore, understanding corporate institutions in Latin America can shed some light on a host of other markets.

In this paper we study large shareholders and their relationship with professional managers. Given the debate about the role of large shareholders in executive compensation, and in corporate governance more broadly (see, for example, Shleifer

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[1] Even in the US some publicly-traded firms are controlled by a small number of shareholders with large stakes (e.g., Microsoft or Wal-Mart Stores).

0147-5967/$ - see front matter 
doi:10.1016/j.jce.2012.02.003

and Vishny, 1997), this paper attempts to fill a gap in the literature by studying whether it is appropriate to talk about large shareholders as a uniform class of ''hands-on'' principals or if different large shareholders have different implications for how managers are compensated.[2] In particular, we study whether families stand out from other classes of large shareholders in terms of how they compensate executives. In addition, understanding the relationship between the ownership structure of firms and managerial compensation can help us to understand in a better way the returns to high-level human capital in developing countries. These countries typically present high wage premia.

The principal-agent framework has been the workhorse model for studying executive compensation as seen in Jensen and Murphy (1990) and Murphy (1999). In this framework a principal must delegate control to an agent who cannot be easily monitored, and who needs incentives to work hard. This captures the conflict between a set of dispersed shareholders, with little incentive to monitor, and a manager, which is typical of US firms. Principals with large stakes, which are more typical of the corporate environment in Latin America, have powerful incentives to monitor managers and therefore can be a solution to the principal-agent problem posed by dispersed ownership (Shleifer and Vishny, 1986). For example, Bertrand and Mullainathan (2001) find that executive pay is less sensitive to pure luck in firms with large shareholders.

A parallel literature studies the peculiarities of one form of concentrated ownership: family ownership (e.g., Bertrand and Schoar, 2006). Family firms are special in that they tend to pursue a special set of values, managerial practices, and specific traditions related to the family (sometimes with a strong distrust for outsiders). Management is many times kept within the family, even after the retirement of the family founder, potentially as a way to preserve a specific form of human capital related to the family's business expertise. Family ownership may also act as a remedy for market imperfections that exacerbate agency problems (e.g., Burkart et al., 2003). All these dimensions make family ownership stand out from other forms of concentration and of particular interest in emerging markets (Fan et al., 2011).

The lack of empirical work on this topic is probably related to the absence of detailed data on executive compensation outside the Anglo-Saxon world precisely where large shareholders are prevalent.[3] As emphasized by Fan et al. (2011), due to the opacity of data we still do not know much about managerial compensation in emerging and developing markets. In this paper we shed light on this issue by presenting a unique data set of approximately 1700 top executives in Argentina, Brazil, and Chile. For each executive we know base and bonus compensation, biographical information such as age, gender, education, and a detailed description of previous work experience. For approximately 40% of executives we also have compensation in their previous jobs. Through the biographical information we can study several dimensions of executives' careers such as tenure and promotion within firms, which complement the study of compensation itself.

The executives in our sample work in a wide array of firms: private and publicly-traded, small and large, in financial services and manufacturing, and so on. Despite this variety, ownership structures are amazingly homogeneous. The majority of firms are controlled by a single, easily-identifiable, large shareholder, who typically is a family, a foreigner (mostly foreign corporations), or the government. The rest of the firms are controlled by coalitions of a few wealthy individuals, families or foreigners. Widely-held corporations, in which there is no controlling block of, say, 10% of shares or more, are almost nonexistent. Some could argue that these markets are perhaps not the best setting to study executive compensation precisely because of the high levels of ownership concentration. However, if one wants to understand the role of large shareholders in executive compensation, then one could even argue that these are among the best markets to study their influence. Also, these Latin American countries are at the top of the pack of emerging markets, instead of being among the relatively poorer ones. This ensures that the companies that we study are modern corporations, comparable in many ways (not all) to corporations in developed countries in terms of organizational structure, internal hierarchy, managerial practices, and so on.

Our main result comes from comparing executive compensation across different classes of large shareholders. We find that professional CEOs in family-controlled firms make around 30% more than CEOs in other firms. The premium is not observed among executives below the CEO level. Given that our sample includes only professional executives who are not family members, the family-premium is not a mechanical result of nepotism.

We explore several hypotheses that could explain the family premium. First, the premium can reflect special characteristics of family firms, for example, that family control is more prevalent in certain sectors, such as financials, where executive compensation is typically higher. We do not find evidence for this. In fact, the family premium survives a host of control variables such as sector fixed effects, firm size, volatility, and profitability. The fact that the premium is seen only among CEOs and not among other executives also suggests that the premium is not a firm-level effect, but something more specific to the CEO position.

Second, it can be the case that CEOs in family-controlled firms have special characteristics vis-à-vis executives working for other types of large shareholders. At least in terms of observable characteristics we do not find clear evidence for this either. CEOs in family firms are of about the same age, education, and are as likely to come from the lower ranks of the firm as CEOs in other firms. Executives in family firms frequently come from firms controlled by other types of large shareholders and viceversa, which reinforces the idea that executives in family and non-family firms are part of a general executive population and not separate populations.

[2] For example, it would be much harder to separate the pure effect of family ownership from the effect of ownership concentration if we were conducting this study with US firms where ownership is typically dispersed.

[3] See some notable exceptions mentioned in Murphy (1999), although most of the studies refer to developed countries (Canada, Japan, and continental Europe).