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The sensitivity of compensation to social capital: Family CEOs vs. nonfamily CEOs in the family business groups ☆

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Abstract

This study examines the role of CEO social capital, defined as external directorship ties held by the CEO, in determining family vs. nonfamily CEOs' compensation in a network-based business society and governance system. Using a sample of pooled data of family firms listed on the Taiwan Stock Exchange (TSE) from 2000 to 2002, the empirical results show that CEO social capital is an important determinant in setting nonfamily CEOs' pay level, consistent with the expectation of the contractual governance model. By contrast, as expected by relational governance model, family CEOs' social capital is not incentive-relevant. This study extends the literature on CEO compensation by documenting that in a market where guanxi and connections are considered valuable business tools, corporations will be willing to compensate professional CEOs for the social capital that they bring to the firm.

Keywords: Intellectual capital; Social capital; CEO compensation; Networks; Family business groups

1. Introduction

The design of executive compensation programs is important since, by aligning manager rewards with stockholder wealth, firms can keep their managers focused on doing the right things and on doing things right. From the agency or human capital theory perspectives, an array of studies have explained executive compensation by putting emphasis on performance measures informative of unobservable managerial efforts (e.g., Jensen and Murphy 1990) and on the human capital contributions to firms (e.g., Harris and Helfat 1997), respectively. However, a substantial part of the variance in managerial compensation remains unexplained.

Social capital is the sum of the actual and potential resources embedded within, available through, and derived from the network relationship (Nahapiet and Ghoshal 1998). Some studies (e.g., Geletkanycz and Hambrick, 1997) argue and find that, besides human capital (including experience, judgment, knowledge, skills, and expertise), a manager's social capital also plays a central role in business value creation. Therefore, it is an important job to motivate and reward managerial efforts in building external relationships and thereby create a firm's significant competitive advantage. In light of the significant importance of social capital and the difficulties in explaining CEO compensation, Geletkanycz et al. (2001) have turned to a socio-perspective by explicitly assessing how the board rewards CEOs' social capital attributes. However, their evidence is restricted to a sample of U.S. firms in a market-oriented corporate governance system only.

Corporate governance systems can be differentiated as market-oriented and network-oriented (Weimer and Pape, 1999). A market-oriented system (the Anglo-Saxon style), which describes

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corporate governance in the United States, United Kingdom, Canada and Australia, has an active external market for corporate control that serves as a mechanism for independent shareholders to influence managerial decision-making. By contrast, network-oriented governance is relatively oligarchic and is predominately influenced by family (or bank) networks of relatively stable relationships, or by networks of interconnected shareholders. Since the key features of the family system that usually have the greatest influence on the operation of the firm are implicit social ties among family members (Harvey, 1999), it is probable that the extent to which firms rely on incentive compensation in motivating family CEOs to extend social capital might be quite different from that for nonfamily CEOs. Therefore, it remains an open question whether the results of Geletkanycz et al. (2001) with respect to the Anglo-Saxon corporate governance system can be generalized to firms in a network-oriented corporate governance system. If families have advantages in disciplining and monitoring family-member CEOs, whether the presence of family membership mitigates the importance of monetary incentive becomes an interesting issue.

Taiwan represents an ideal setting to examine this issue because it is characterized by a predominance of family control, lack of an active external market, and an abundance of pyramidal groups and cross-holdings, all features being associated with a network-oriented governance system and similar to most emerging markets around the world. Specifically, this study aims primarily to investigate the CEO's social capital as a determinant of CEO pay in a sample of Taiwanese family business groups, focusing the analyses on the differential sensitivities of compensation to social capital between family CEOs (CEOs being members of the controlling family) and nonfamily CEOs (CEOs not being members of the controlling family). Since one of the primary ways in which senior managers invest in social relations is through participation in the network of interlocking directorships among firms (Haunschild, 1993; Mizruchi, 1996), this study measures CEOs' social capital by their external directorship ties. In light of the different roles of both the CEOs' intra- and extra-business group directorships in value creation (Young, 2005), whether these two directorate ties receive different emphases in setting CEO pay is noteworthy and is also examined in the current study.

Using a sample of pooled data of firms listed on the Taiwan Stock Exchange (TSE) in the period 2000–2002, the main results suggest that the incentive relevance of CEO social capital varies between family CEOs and nonfamily CEOs. More specifically, CEO social capital is an important determinant of the CEO's pay level, beyond the factors such as firm performance and other non-financial measures of managers' human capital, for nonfamily CEOs but not for family CEOs. This implies that the presence of family membership does mitigate the importance of a monetary incentive for CEOs.

The remaining parts of this paper are organized as follows. This study reviews the literature regarding the determinants of top management compensation and outlines the hypotheses in Section 2. Section 3 discusses the research methodology used in this paper. Data analyses and discussion are included in Section 4. Section 5 presents the sensitivity tests, and the final section concludes the paper.

2. Literature review and hypotheses development

2.1. The incentive relevance of social capital

Executive compensation has long attracted a great deal of attention from both the public press and academic research. Many previous researchers have explained the compensation of managers in publicly traded firms with dispersed shareholders from agency, managerialism, and human capital theoretical perspectives (Gomez-Mejia, 1994). According to agency theory, earlier studies in this area focus on the relation between executive compensation and firm performance, but only find a small positive or an insignificant relation (Jensen and Murphy, 1990). Evolving as tests or applications of agency theory, exploding interdisciplinary research examines whether executive compensation is affected by governance factors, investment decisions, capital structure, diversification, industrial structure and regulation (Murphy, 1999). However, the variation in CEO compensation still cannot be adequately explained by agency theory.

Managerialism and human capital theory complement agency theory by using manager-specific attributes (power and skill) to explain the variation in compensation level beyond which firm- and job-specific variables can predict. A central hypothesis of managerialism is that compensation is primarily a function of firm size relative to performance (Tosi, Werner, Katz, and Gomez-Mejia, 2000). As for human capital theory, the relationship between human capital and managerial compensation is provided by the resource-based view that superior managerial skills and experiences appear to meet the criteria for delivering a sustainable competitive advantage—valuable, rare, and difficult to imitate or purchase (Castanias and Helfat, 1991). Both managerialism and human capital theory are supported by empirical evidence (Harris and Helfat, 1997; Tosi et al., 2000).

Despite of a wealth of research grounded in agency, managerialist, or human capital theory perspectives, the determinants of managerial pay are still far from clear (Gomez-Mejia, 1994). In response, some scholars have turned to socio-political models in explaining CEO pay (e.g., Finkelstein and Hambrick, 1989; Westphal and Zajac, 1994; Geletkanycz et al., 2001). Since social capital is important in helping firms to acquire and combine new skills and knowledge at low cost, achieve better forecasting of future market demand, anticipate customer preference, stimulate innovation, and create intellectual capital (Burt, 1992; Powell et al., 1996; Nahapiet and Ghoshal, 1998; Ahuja, 2000; Dyer and Nobeoka, 2000; Gulati et al., 2000; Zaheer and Bell, 2005; Salman and Saives, 2005), it is thus desirable to use social capital-linked pay schemes to motivate CEOs' networking efforts.

The setting of this study is in a Chinese business environment, where the *guanxi* network is the lifeblood of the business community indeed (Fan, 2002). Specifically, firms in such an environment demand their CEOs to establish external relationships and thereby extract resources from these