

**Origins of executive pay**

**&**

**corporate governance reform codes**

**Essays on an institutional approach to corporate governance**

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**Origins of executive pay  
&  
corporate governance reform codes**

**Essays on an institutional approach to corporate governance**

De herkomst van bestuurdersbeloningen

&

corporate governance hervorm codes

Essays over een institutionele benadering van corporate governance

(met een samenvatting in het Nederlands)

**Proefschrift**

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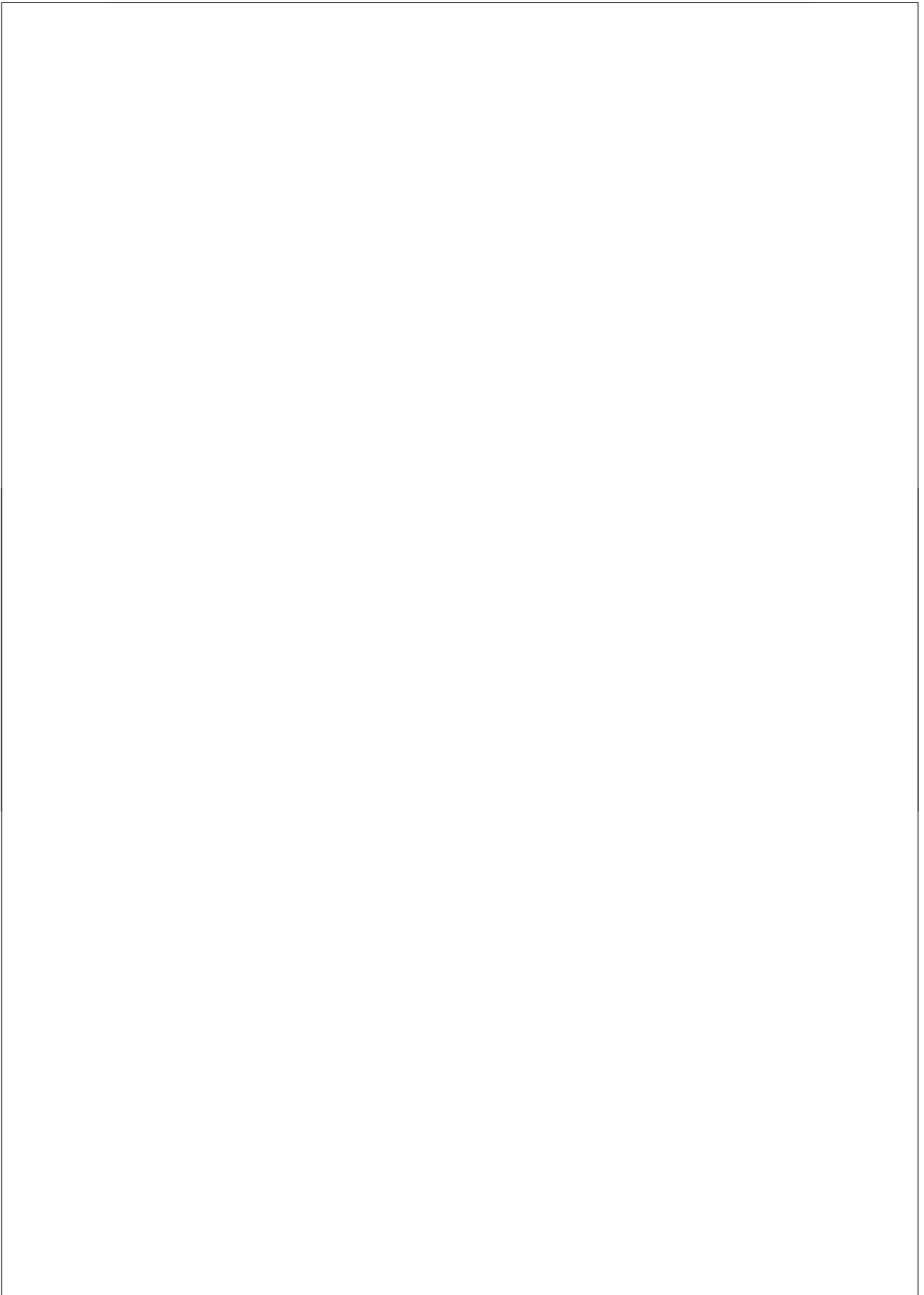
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Promotor: Prof. dr. E.J.J. Schenk MBA

Co-promotor: dr. P.P.M.A.R. Heugens

*Voor mijn ouders*

*To my parents*



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## ***Chapter 1***

### ***Introduction***

#### **1.1. Introduction**

Governance issues have accompanied publicly held firms ever since they were introduced some 400 years ago at the founding of the VOC (the Dutch East India Company) and the British East India Company (e.g. Frentrop, 2002; Ferguson, 2004). Although “modern” governance problems are thus several centuries old, corporate governance as a separate field of academic research really only took off after the late 1970s (Zingales, 1998). Since then, the book *The Modern Corporation and Private Property* by Berle and Means (1932/2004), which contains classic insights into problems associated with governing the publicly held firm, has received a prominent place in the literature.

One of these insights is that in corporate settings private property tends to be separated from control over this property (Berle and Means, 1932/2004). Inspired by Berle and Means, Jensen and Meckling (1976) developed a theory of agency that specifically deals with this situation. Based on the assumption that the ulterior organizational goal is to maximize value for the owners, the so-called agency problem is framed as one of ensuring the owners that managers make value-maximizing decisions. Value maximization is problematic in this setup, because agency theorists assume that the interests of owners and managers diverge. To prevent sub-optimal outcomes for shareholders, these differences must somehow be reconciled.

Agency theory subsequently evolved into the dominant theoretical approach to corporate governance. Adherence to agency theory and its assumptions is in fact now so widespread that the notion of corporate governance itself is usually understood in agency-theoretical terms (Davis and Thompson, 1994; Zajac and Westphal, 2004). One example of an oft-cited definition suffices to illustrate this phenomenon: “corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment” (Shleifer and Vishny, 1997: 737).

One problem with this powerful but narrow definition is that it focuses our attention on one specific governance problem only. Since the late 1970s, agency theorists have mostly occupied themselves with the problem of interest divergence between the “representative” shareholder and management. Their primary focus is on finding solutions to this divergence problem that are either rooted in reducing the separation of firm ownership and control or rendering it more or less harmless. Empirical researchers typically investigate the effects of two such solutions. A first way of ensuring that managers operate in the best interest of the shareholders is to directly “monitor” their behavior. Whereas in everyday parlance “monitoring” merely means observing behavior, agency theorists adopt a broader definition, which includes not only the stipulation of desired managerial behavior, but also measuring managerial behavior and sanctions against managers who deviate from desirable behavior. This broader perception of monitoring prevents management from making decisions that from representative shareholders’ views are sub-optimal. A second way to solve the divergence problem that is typically investigated is the application of incentives. By providing managers with the right incentive, the interests between shareholders and management can be aligned as incentives are assumed to steer desirable managerial behavior.

I will focus on two central phenomena in the corporate governance debate, notably executive pay and corporate governance reforms. Both phenomena have typically been analyzed from an agency theoretical angle and I intend to show that an alternative approach is needed. In this study corporate governance is defined as those processes and mechanisms that control corporate welfare and regulate the distribution of corporate wealth in society. The research presented explores the implications of this broader view on corporate governance for our understanding of the two focal

phenomena of executive pay and corporate governance reforms. The alternative I suggest offers a better grip on these two focal phenomena in particular and on corporate governance in general.

Traditionally, agency and other theorists have addressed executive pay and corporate governance reforms using the lens of neoclassical economics, which can be described as “an approach which (1) assumes rational, maximizing behavior by agents with given and stable preference functions, (2) focuses on attained, or movements toward, equilibrium states, and (3) excludes chronic information problems” (Hodgson, 1998: 169). This lens has led researchers to focus on transactions and contracts, which are embedded in price and market mechanisms (cf. Augier, Kreiner, and March, 2000; Coase, 1988; Kay, 2000; Simon, 1991).

This study experiments with a different lens. I will adhere to an institutional approach, which assumes at the systemic level that the aforementioned price and market mechanisms are not frictionless and value-free instruments, but rather are *themselves* “brought under the jurisdiction of institutional meanings and controls” (Meyer and Rowan, 1977: 351). At the actor level, institutional approaches go beyond rational actor models, as they set aside the assumption of rational action by allowing for the assumption of rule-based or identity-based action (Heugens, 2005; Schenk, 2005a). In combination, these assumptions allow economic history to be partly or even wholly inefficient at times (Greif, 2006; North, 2005; Schenk, 2005a).

The plan of this introductory chapter is as follows. First, I sketch the agency approach to corporate governance, and focus on its underlying logic of decision making. Second, I present the institutional approach followed in this study, which adheres to an alternative decision making logic. Third, I discuss prior applications of agency theory on my two focal phenomena of executive pay and corporate governance reforms, and concisely address their limitations. I then seek to demonstrate the added value of approaching the same phenomena from an institutional angle. Fourth, I discuss my research design and provide an overview of the subsequent chapters of this study.

## **1.2. Agency theory and the logic of consequence**

No self-respecting work on corporate governance can do without a concise overview of the state-of-the-art in agency theory. Not only is agency theory the dominant lens through which corporate governance scholars look at their subject matter; it also provides policy makers and practitioners with a powerful blueprint. This agency blueprint is commonly used to devise executive pay schemes, structure corporate governance reforms, guide new legislation in the domains of company and corporate law, and appraise the role and performance of corporate boards. I therefore begin my thesis with a recapitulation of this theoretical framework.

Agency theory, which is grounded in neoclassical economic theory, assumes that actors are fully rational, behave according to stable risk preferences, and maximize their self-interests (cf. Jensen, 2001; Jensen and Meckling, 1976; for more critical reviews, see Aguilera and Jackson, 2003; Eisenhardt, 1989; Gomez-Mejia and Wiseman, 1997; Perrow, 1986). At the heart of the theory lies a focus on so-called agency problems. These arise because of the differential interests and risk preferences of firm owners and management. Firm owners can spread their wealth across many different firms, and optimal portfolio theory suggests that it is in fact wise for them to do so (Fama, 1980). Managerial wealth, on the other hand, is tightly linked to the firm that employs management. Due to these differential positions owners and managers have different risk preferences. They therefore tend to have different interests and subsequently behave differently in similar circumstances.

To solve these conflicts of interests, it is typically assumed that a firm's goal is to "maximize" (Jensen, 2001) by furthering shareholders' interests or to "economize" (Williamson, 1991) by lowering transaction costs. Problems of organizational and contractual design must therefore be tackled with these objectives in mind. Given that managers enjoy the delegated control over a firm, it is their influence that must be tempered. In order to avoid them making self-interested decisions that have subversive effects on shareholders, a contract is typically drawn up between the firm owners (i.e. principals) and firm managers (i.e. agents) that specifies desired managerial behaviors under all circumstances. The purpose of this contract is to minimize residual losses for shareholders.



Given that managers are expected to maximize their self-interests, they are not expected to abide by this contract. However, to ensure managerial compliance with the contract, owners have two basic instruments at their disposal. They can control managerial behavior to prevent management from making the “wrong” decisions by observing managerial behavior, and to the extent that this is not possible, provide management with incentives to act on their behalf. Since sub-optimal behavior by management cannot wholly be avoided, the efficient contract is one that minimizes residual losses for shareholders. In practice, this comes down to finding an optimal balance between the costs associated with monitoring managerial behavior and the cost of incentives.

One important way to understand agency theory is to assess the model of human decision making that agency theorists normally subscribe to. Within an agency-theoretical setup, decisions are taken on the basis of what Cyert and March (1963/1992) call “the logic of consequence”. This decision making logic is grounded in a rational choice model of human behavior, in which actors are expected to “evaluate alternatives in terms of the values of their consequences” (Cyert and March, 1963/1992: 230). According to this decision making logic, the decisions of principals and agents alike are rooted in rational, calculative, anticipatory, and consequential actions (Cyert and March, 1963/1992). Agency-theoretical models produce accounts involving multiple strategically interacting actors, “each pursuing self-interested objectives and constrained or facilitated by the similar rational pursuit of self-interested objectives by others” (Cyert and March, 1963/1992: 230).

By taking an institutional approach I intend to show that the actors involved with corporate governance do not always operate according to the logic of consequence. If they do not, or do so only limitedly, then corporate governance problems, solutions to these problems, and observable governance outcomes may not always be adequately captured by agency theoretical accounts. Hence, the principle of my intended contribution is to argue that agency theory limits our understanding of corporate governance, and potentially misguides our search for solutions to corporate governance problems. I therefore experiment with a different model of human decision making. The alternative is more perceptive of institutional and contextual factors than the agency model. Consequently, it may offer a better practical and theoretical understanding and explanation of how my two focal phenomena of executive pay and corporate governance reforms are shaped as they are.

### **1.3. Institutions and the logic of appropriateness**

Not all economic and organizational theories adhere to the logic of consequence. Some are rooted in a different logic of decision making, the so-called “logic of appropriateness” (Cyert and March, 1963/1992). For decision makers operating under this logic, the act of decision making is not merely a matter of simply choosing between a limited number of well-defined action alternatives characterized by easily discernable future pay-offs. Instead, decision making is seen as more than a simple elimination process, and is in fact a decidedly social process. Decision making is a social process precisely because individuals do not only draw on rational factors when making decisions, but also on factors like norms, trust, culture, advice, rules, history, and authority (e.g. Cyert and March, 1963/1992; March and Olson, 1984). In the social sciences, most approaches that acknowledge the influence of such factors on human behavior tend to be labeled as “institutional” approaches (e.g., see Elster, 1989; Greif, 2006; North, 1990; 2005).<sup>1</sup>

In an institutional approach not all human behavior is rooted in “deliberation” or “computation” (Hodgson 1988; Kahneman and Tversky, 1979). Individuals also draw on rules of thumb and other heuristics, which make at least part of their behavior “habitual” or “reflexive” (Cyert and March, 1963/1992; Heugens, 2005; Hodgson, 1988; Scott, 2001). All individuals are constrained in their capacity to make fully rational decisions, due to the cost and unavailability of appropriate information and because of their own cognitive limitations (Cyert and March, 1963/1992; DiMaggio and Powell, 1983; Elster, 1989; Jepperson, 1991; March and Olson, 1984; Meyer and Rowan, 1977). Rather than searching for “optimal” or “maximizing” decisions, individuals quite often tend to select the decision alternative that simply seems

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<sup>1</sup> In economic terminology: institutions constrain decision making by defining and limiting the set of choices individual actors have (North, 1990). These constraining factors could, however, refer to factors that make behavior “boundedly rational” but also to those leading to “irrational behavior”. According to a pure logic of consequence, as is, for instance, adhered to by agency theory, irrational behavior is theoretically ruled out, since it is understood as behavior that departs from (constrained) maximizing or optimal behavior. Actors that behave irrationally according to this logic are not able to survive, not even for a short period of time, as such behavior is instantaneously sanctioned by the disciplinary rules of (boundedly) rational conduct, accommodated by markets and pricing mechanisms (See Schenk, 2005a). There is an academic debate on what exactly an (economic) institutional approach is and what the different streams of “new” and “old” institutional approaches are. See for a discussion of this debate Schenk 2005b.

“appropriate” or “legitimate” against the background of perceived institutional norms, values, and beliefs (Jepperson, 1991; Meyer and Rowan, 1977; Suchman, 1995). This understanding of human behavior offers the possibility to argue that actors imitate the behavior of others. For instance, paying an executive € 5 million in options and shares may not be a decision rooted in agency assumptions of optimal incentive alignment at all, but may simply be based on a social comparison of one executive’s income position to that of another. There is no room for such comparison logic in consequentialist theories like agency theory.

If behavior cannot be fully rationalized by the logic of consequence, and if individuals thus tend to root a fair proportion of their decisions in social cues from their environment, reliable institutions are necessary to create relatively stable conditions of human interaction (North, 1990) or “social peace” (Roe, 2003). Institutions socialize individuals in order to interpret environmental cues “appropriately”, sanction them positively if they follow suit, and punish them if they go against the grain of the prevailing institutional order. Institutions thus not only make actors aware of the consequences of their decisions, but also equip them with selected means to make appropriate decisions.

Although institutional approaches are certainly not a new phenomenon in the economic and organizational sciences, they have been sparsely used in the field of corporate governance (but see e.g. Zajac and Westphal’s (2004) application of an institutional approach to the corporate governance practice of stock repurchasing plans). The sparse use of alternative frameworks is largely due to the dominance of agency theory, which forms the theoretical core of the by far largest contingent of publications on the topic. Yet, agency theorists tend to neglect the influence of institutional factors on the behavior of agents and principals, thus treating institutions as if they were exogenous. This approach reduces the institutional environment of the firm to a mere set of boundary conditions for possible solutions of governance problems. In a typical agency theory inspired corporate governance article, principals and agents are reduced to a set of “ontological actors, frozen in space and time and isolated from social and cultural context” (Aguilera and Jackson, 2003: 449). A first contribution of the work presented here is therefore that it highlights the role institutions play in corporate governance processes. In this sense institutional factors are not understood as boundary conditions. Institutions, as we will see, are enabling and constraining factors that can be influenced by powerful actors, who thus

participate in setting the rules of the game by which they themselves are expected to abide.

A second way in which an institutional approach refines and adds explanatory power to the dominant agency theoretical setup is that it questions the adherences of agency theory's optimization principle. One of the pillars of agency theory is the assumption that actors' decision making according to the logic of consequence will rapidly lead to a "unique optimal that is guaranteed to be achieved" (March and Olson, 1984: 737). A second contribution of the institutional approach chosen here is that it demonstrates that corporate governance problems are "essentially contested" (Gallie, 1956) in the sense that the actors involved can perceive corporate governance problems and solutions to these problems differently. This approach offers a number of insights — though perhaps no solace — about how we can come to grips with the fact that corporate governance problems have no unique "optimal" solution that is durably acceptable for all of the parties involved. I will use the remainder of this chapter to provide a brief prolegomena of how the adoption of an institutional approach might affect our view of my two focal phenomena of executive pay and corporate governance reforms.

#### **1.4. The logic of appropriateness and executive pay**

A substantial part of the research presented in this study deals with the high profile case of executive pay. We probably all know of examples of executives earning several millions of euros in salary, bonuses, and options. And it is most likely that you entertain an opinion about this, especially when comparing their paychecks with your own. The most central question in the executive pay debate, one that has still not been addressed adequately, is: What exactly determines the level and structure of executives' pay packages?

Agency theorists use the logic of consequence to provide an answer to this question that is "neat, tractable, and reassuring" (Bebchuk and Fried, 2006: 12). They see the process of setting pay as one that is inspired by shareholder interests and involves arm's length contracting between shareholders or their representatives on the one hand, and top managers on the other. Given the possibilities that shareholders or their representatives, the board of directors, can observe managerial behavior and to minimize residual losses for shareholders, executive pay is seen as a problem of

optimal pay design (Gomez-Mejia and Wiseman, 1997). In order to align the interests between shareholders and management and to transfer the risks of contract deviation to the agent, a given efficient makeup of the pay package is necessary. In other words, the problem of executive pay is framed as one of providing “optimal” incentives to influence efficient managerial behavior. It is assumed that this should lead to an observable positive link between pay and corporate performance, as managerial behavioral outcomes can be influenced by providing managers with the right incentives if perfect monitoring is not possible.

Unfortunately, even though the positive pay-performance link has become something of a “holy grail” for the executive pay literature, in that it represents something that most scholars “hope” to find, several decades of this type of research have led us into a “blind alley” (Gomez-Mejia, 1994; Barkema and Gomez-Mejia, 1998). A problem with this line of research, first, is that positive pay-performance relationships are rarely observed in practice. Empirical studies typically report no or, at most, weak (positive but also negative) relationships between pay and performance (e.g. Tosi, Werner, Katz, and Gomez-Mejia, 2000). This weakens the case for agency theory for two reasons. First, the theory can only furnish weak explanations of the observable pay arrangements in practice. Its theoretical applicability could somehow be limited in the sense that incentives lead to other outcomes (in theory and/or practice). The effectiveness of incentives, or monitoring, could be influenced by factors or theoretical assumptions that are not considered by agency theory. And, second, actors involved in the pay setting process may in practice simply choose not to adhere to agency theory’s prescriptions or not be able to follow its logic of consequence.

Another problem with this line of research, second, is that the focus on agency theory in the executive pay literature has taken up so much of the field’s research capacity in this area that it has rapidly exhausted other possibly fruitful research streams. Leading experts dare to stress that we are reaching the explanatory limits of this theory (e.g., Finkelstein, 2006; Tosi et al., 2000), whereas we have collectively left other, perhaps more promising ways of approaching the problem of executive pay, underexplored.

In this thesis I will explore the promise of one possible alternative, notably: an institutional approach, grounded in the logic of appropriateness. This alternative allows me to analyze and explain two aspects of the executive pay setting process that

are incompatible with the perfect contracting approach that lies at the heart of agency theory (cf. Bebchuk and Fried, 2003; 2004; 2006).

First, what is most often overlooked by agency theorists is the “apparent obviousness” (Pfeffer and Salancik, 1978/2003) of the fact that contextual factors matter. Institutional conditions have a profound influence on the executive pay setting process, as corporate boards, who ultimately determine how and how much to pay, take informational cues from institutional actors like the media, business analysts, pay consultants, and industry associations. To incorporate these factors in an account of the concepts behind determining executive pay, however, we require a shift from the assumption of rational action towards an assumption of rule-based or identity-based action informed by the logic of appropriateness. This underwrites the need to explore theoretical alternatives, since this take on human decision making is conceptually incompatible with the logic of consequence that underlies the perfect contracting approach of agency theory.

Second, many agency theorists assume that the arm’s length contracting process between shareholders and managers is incorruptible, and that the compensation contracts it yields are somehow cast in stone. What is overlooked is that managers are often in an excellent position to tamper with the pay setting process, and that they enjoy considerable discretion in altering the resulting contract in their favor. Setting executive pay is thus an agency problem in itself (Bebchuk and Fried, 2003). To account for discretion in the pay setting process, the alternative logic of appropriateness must be taken into consideration, as it shows how executives can co-opt seemingly rational and neutral institutional actors like business analysts, consultants, and even boards of directors themselves, and use their influence over these actors to create the public impression that the pay setting process is fair and their pay package appropriate, given the institutional conditions. Again, such an account is incompatible with the rational contracting approach suggested by agency theory, but it is reconcilable with the type of institutional alternative I advance here.

### **1.5. The logic of appropriateness and corporate governance reforms**

Another substantial part of the research presented here deals with corporate governance reforms. Especially after the mid 1990s, a number of developments have triggered policy makers to make amendments to their national corporate governance systems. A good example in this respect is formed by so-called “jolts to the system” (Meyer, 1982) in the form of corporate scandals (Enron, Parmalat, Ahold, et cetera), and the subsequent increase in concerns regarding the norms upholding good governance. Another case in point is the problem of determining appropriate executive pay levels and structures, and the call in many jurisdictions for greater disclosure of executive pay. In Europe and other parts of the world, and to a lesser extent the US, reforms have taken the form of corporate governance codes of best practices. These codes describe the national “ideal type” or “archetypical” approach to corporate governance, and reflect the norms of aspiration after which countries seek to model their extant corporate governance arrangements. They typically provide recommendations regarding, for example, the disclosure of executive pay arrangements; rules of operation and guidelines for the composition of different board committees, such as the audit, appointment, and remuneration committees; and rules concerning which issues shareholders can vote on, how minority shareholders must be protected, and what additional responsibilities are allocated to institutional investors. These reform codes are typically formulated by a national, authoritative body and are furthermore legitimated and upheld by institutions such as the state or stock exchange commission.

A central question in the reform debate is in which direction national corporate governance arrangements will develop. Again, most of the answers in this debate tend to come from agency theorists. Using the logic of consequence, they argue that policy makers ought to structure their governance reform codes along the premises of the agency framework in order to maximize shareholder value (e.g. Becht and Roëll, 1999; Buck and Shahrin, 2005; Gedajlovic and Shapiro, 1998). It is often argued that the US style of corporate governance most strictly adheres to these theoretical guidelines. This style is often considered to be superior, and thus the most viable candidate to serve as a blueprint for policymakers (e.g. Hansmann and Kraakman, 2004; Gilson, 2001). Therefore, one important answer to the question above is that all national systems of corporate governance will sooner or later converge towards an

agency theory inspired setup, more or less similar to the one we can already observe in the United States today.

My approach is to study the suggested directionality of corporate governance reforms directly by exploring the content of national reform codes. A casual reading of the preambles to these codes suggest that they are generally meant to serve three closely related goals: (1) to establish or restore trust in financial markets; (2) to create the conditions for attracting new investments; and (3) to make the stock market a safe place where all parties, including individual investors, can work towards increases of their private wealth. If all policy makers would stick to an agency theory inspired account, the measures proposed to achieve these three goals would center only on the relationship between shareholders and management. Thus, if an agency approach is commonly believed to be the only viable approach, this must be traceable in the content of codes of best practices.

It is undeniable that much of the content of these codes pertains to the classical agency problem between shareholders and management. We should be cautious, however, to therefore conclude that agency theory is the sole or even a dominant source of inspiration for policy makers. Corporate governance codes tend to display significant variety, and in this thesis I study that variety directly and trace it to its origins. The results show that both the premises and the recommendations of many — though not all — of these codes are irreconcilable with the classical agency theory setup, and therefore their interpretations require alternative frameworks. Three common characteristics of codes that are at least partially incommensurable with agency theory, but are reconcilable with an institutional approach are recommendations for dealing with: (1) concentrated ownership; (2) multiple stakeholders; and (3) assumptions of altruism and benevolence on behalf of managers. I will now briefly elaborate on these.

I will first deal with the issue of concentrated and other forms of non-traditional ownership. Agency theory has historically been developed with the so-called “Berle and Means firm” in mind (cf. La Porta, Lopez-de-Silanes, and Shleifer, 1999), in which ownership and control are fully separated due to a high degree of ownership dispersion. Yet in practice, with the exception of the US and UK, firm ownership in other countries is mainly concentrated in the hands of large blockholders like states or families (La Porta et al., 1999; Roe, 2003). This fact weakens the applicability of agency theory, since this framework assumes the presence of a “representative” (i.e.



dispersed) shareholder. This is important as different classes of shareholders may have different institutionalized positions of power, hold different interests in the corporation, and entertain different opinions about how managers ought to serve these interests. Whereas dispersed shareholders may be focused on short term results, larger institutional investors with illiquid portfolios may be assumed to be in it for the long(er) run, and both foci require different decisions by management. In short, the corporate ownership situation in many parts of the world is hard to reconcile with the classical agency theory setup. The results of the present study show that these ownership positions translate into the content of reform codes.

A second agency theory defying characteristic of many reform codes relates to the referencing and inclusion of multiple stakeholders, other than the “usual suspects”, i.e. owners and managers. Many codes acknowledge that other actors play important roles in corporate governance and in financial markets in general. Irreconcilable with agency theory are considerations of institutional conditions that facilitate an active role for third parties in corporate governance. It has been documented, for instance, that labor and the news media play active roles, and that they influence corporate governance arrangements and their outcomes (Blair and Roe, 1999; Core, Guay, and Larcker, 2005; Dyck and Zingales, 2002; 2004; Roe, 2003; Wade, Porac, Pollock 1997). Due to its straightforward two-party structure, agency theory simply cannot capture the institutionalized roles these third parties play in many countries. An alternative framework would therefore be most welcome.

A third characteristic of many reform codes that goes against the grain of agency theory is these codes' rejection of the assumption of managers' unrestrained pursuit of self-interest. It is impossible to reconcile with an agency approach that not all policy makers are equally likely to make assumptions of managerial opportunism as agency theorists themselves make. Especially in non-western countries, where the role of individualism is downplayed and where social factors play a larger role in economic decision making (Gerlach, 1992), it is misleading to assume purely self-interested behavior as a reference point when drawing up codes of best practices. Policy makers from, for instance, more collectively oriented societies, may choose not to follow this conceptualization of human behavior. An alternative conceptualization is available in the form of stewardship theory, in which the assumption of opportunism is supplanted with one of altruism rooted in high identification with social collectives (Davis, Schoorman, and Donaldson, 1997; Donaldson and Davis, 1991). Other non-pecuniary

considerations, such as the balance between extrinsic and intrinsic motivation (Frey, 1997a; 1997b), or considerations of the effects of esteem (Brennan & Pettit, 2004), may also find their way into codes of corporate governance. To the extent that they do, a reconceptualization along theoretically different lines seems warranted. Such a reconceptualization is offered here.

Due to the fact that countries take substantially different measures to solve apparently similar, but in fact different governance problems, it seems evident that national historical and institutional factors play a large role in shaping corporate governance reforms. Furthermore, the suggestion I will make here is that reform codes promote a type of decision-making that uses the alternative logic of appropriateness. This view entails that codes emerge in response to actors' social needs for reassurance, and that their rationalist undertones help create a systemic belief that national corporate governance systems are founded on premises of efficiency, effectiveness, and efficacy. Similarly, to be in compliance does not necessarily mean that corporations are doing everything in their power to materially improve their governance situations, but rather that they take the issue seriously enough to try to create an impression of good governance, even though this impression may in fact be decoupled from the underlying governance practices of the firm or from the consequences for shareholder value. The consequence of compliance is then a sort of truce in which managers, shareholders, and other stakeholders decide to proceed together in accordance with the "doctrine of good faith" (Meyer and Rowan, 1977). My proposition is that this alternative conceptualization is better equipped than its agency theory inspired rivals to deal with the aforementioned "aberrations" of alternative ownership forms, multiple stakeholders, and managerial altruism. In the remainder of this thesis, I will put this proposition to the test.

## **1.6. Research design**

My study is comparative in nature, and it is oriented towards building new theory in a crowded and highly crystallized field. Furthermore, I hope to shed new light on the role and influence of institutional factors on corporate governance processes. A study like this calls for a comparative research design, and for a combination of exploratory and more conclusive techniques that allow for both hypothesis development and testing. To find potential diversity and variety at national levels and to find evidence

of institutional influences, it is necessary to take into account different institutional settings. In addition to being conclusive at times, the study is also partially explorative in nature, since even though an institutional approach to corporate governance is not completely new, the field is still dominated by agency frameworks and models that apply the logic of consequence. I will now turn to a brief discussion of the design of the individual studies that I have conducted on my two focal phenomena of executive pay and governance reforms.

The first question to which I hope to find an answer is: *What are the drivers of executive pay?* To address it, first, I make inventory of existing theories in the executive pay literature that deal with this question. This literature study investigates the state-of-the-art in theoretical approaches, leading to several implications for building new theory that is able to provide a more conclusive answer to the question raised. Based on this, I argue that institutional conditions must be taken into account to address the question satisfactorily. Second, to be able to empirically test the proposition that contextual factors matter in setting executive pay, I require a dataset that captures variance in governance structures and associated conditions both within countries and between countries. This two-level research design is inspired by a conceptualization of institutional systems that sees regularities at the system- or macro-level as being produced and reinforced by variety and diversity at the actor- or micro-level (Hodgson 1988). My empirical work is therefore conducted on the basis of a self-compiled dataset that focuses on capturing both within-country variance of pay levels and structures and sufficient cross-country variance of these same arrangements. The dataset consists of 3880 executive pay levels and 1195 executive pay structures, representing 940 firm-year observations from 17 different countries. The pay data are from CEOs and executives from the largest listed firms in these jurisdictions.

The second research question I intend to explore is: *How do countries differ in terms of the solutions they provide to corporate governance problems in their reform codes?* To address it, I explore 38 national codes of corporate governance by using content analysis, which is an analytical technique for exploring the underlying meaning of rich and voluminous narrative sources (Carney, 1972; Holsti, 1969). Content analysis offers the possibility to systematically investigate the content of corporate governance reform codes. It starts with a set of predefined concepts in relation to which relevant sections of the text can be attributed. This systematic

explorative approach makes it possible to quantify the variance in the narrative accounts of corporate governance arrangements as they are reported in these codes. To further explore possible patterns in these codes, and to identify latent conceptual structures, I make use of an exploratory factor analysis. In all, this exploratory exercise could reveal regularities and foci in the governance arrangements to which the countries in my sample aspire.

### **1.7. Overview of the study**

To provide the reader with an a priori grasp of the subjects under investigation in this study, I conclude this introduction with a brief overview of the chapters that follow. Including this introduction, this study consists of 6 chapters. Chapters 2 through 5 are intended as separate, stand-alone essays and can be read as such. As a consequence, however, some overlap between certain chapters does exist. The overlap is especially apparent between chapters 4 and 5. Both report the process of conceptualizing what I will call corporate governance philosophies.

The next chapter, chapter 2, consists of a review of theories that are used in the literature to explain executive pay levels and structures. I introduce three streams of thought on theorizing executive pay. Based on the different insights from the different theoretical approaches, I provide an integrative framework of executive pay theories. It captures the acquired notions that: (1) no discussion on executive pay can go without a broader discussion on corporate governance in general; (2) executive pay is not merely an instrument for solving agency problems, but needs to be considered more as an outcome of pay setting practices; and (3) these pay setting practices are embedded in socially constructed corporate governance arrangements over which executives can exercise discretion.

In chapter 3, I elaborate more on the conceptual limitations of using agency theory to furnish explanations for executive pay levels and structures. In its place, I put forward an account based on managerial power theory. This theory argues that the process of setting pay is an agency problem in itself. In contrast to agency theory, it argues that executives have discretion over the pay setting process, and that they are not hesitant to use it. The chapter empirically tests managerial power theory for the first time on data that reflects both within-country as well as considerable between-country variance of executive pay. This research design also allows for much-needed

conceptual extensions to managerial power theory, providing explanations of executive pay levels and structures which reflect the institutional embeddedness of corporate governance arrangements.

Chapter 4 explores and conceptualizes the different approaches to corporate governance that are used by policy makers across the globe. Based on a content analysis of 38 authoritative national reform codes, I introduce the notion of corporate governance philosophies. I show that national approaches to corporate governance do not follow agency theory's prediction of a unique optimum, but rather consist of a relative focus on 5 general structuralized beliefs, i.e. 5 philosophies, about corporate governance. Additionally, the process of content analysis results in measures that facilitate cross-national comparisons of corporate governance arrangements. I thereby respond to the call in the literature for the development of such measures (Guillén, 2000a).

Chapter 5 builds on the conceptual development of corporate governance philosophies and puts the associated measures to the test. Based on the acquired notion that national corporate governance approaches differ across countries and that corporate governance arrangements are known to be characterized by different dominant firm ownership structures, the chapter relates national dominant firm ownership structures with national corporate governance approaches.

Chapter 6, finally, consists of the overall conclusions of this study, drawing on the different conclusions from the previous chapters. The conclusions are discussed in terms of the research questions laid out in this introduction. Before presenting my concluding remarks, I discuss some limitations of the research presented in the different chapters, followed by a concise research agenda for the years to come.



## *Chapter 2*

### *Legitimizing executive pay: A review of theoretical approaches*

#### **2.1 Introduction**

There is hardly any other aspect of business life that catches the newspaper headlines as much as executive pay. Almost every day, the media display outrage about the tremendous heights that executive salaries, bonuses and other financial gratuities have reached. Amidst all this turmoil, boards of directors still have problems explaining and hereby legitimizing what they pay their executives.

Not only in practice but also in theory the debate on what determines executive pay levels and structures is still ongoing. In line with Wade, Porac, and Pollock (1997) and Zajac and Westphal (1995), theories that are used to explain executive pay levels and structures provide also forms of legitimization for what is actually paid. This legitimizing process comprises explanations of how executive pay is set and of what is paid (cf. Gomez-Mejia and Wiseman, 1997). This is in line with the inclination from both practice and theory that it is not only important to exactly determine the height and method of pay, but that it is also important for firms to be able to explain and hereby legitimize how pay is set and what is paid (cf. Gomez-Mejia and Wiseman, 1997; Wade, Porac, and Pollock, 1997; Zajac and Westphal, 1995). Insight into the process of the setting of pay is thus crucial in order to explain the levels and makeup of pay and hereby legitimize what is paid.

The fundamental question is how executive pay is set. Although this question entails determinants of executive pay such as firm size and performance, it also entails the mechanisms and contextual conditions under which decisions on pay levels and pay structures are made. Setting executive pay is a complex issue with many implications for organizational outcomes, processes and executive motivation (e.g. Finkelstein and Hambrick 1988; 1989; Gomez-Mejia, 1994; Ungson and Steers, 1984). Observing executive pay means observing the fundamental governance processes in an organization (Hambrick and Finkelstein, 1995).

Although there are many theories that can be used to explain how executive pay is set, most of these theories have received little attention in the literature. The focus in the literature has very much been on a single theory. The “official story” (Bebchuk and Fried, 2004) on executive pay in both practice and theory is based on the perfect contracting approach of agency theory. To render the separation between firm ownership and firm control harmless, the complete contract design of agency theory argues that executive pay is a “tool” to align interests between shareholders and management (Jensen and Meckling, 1976). According to this dominant “tool idea”, managerial behavior can be guided by providing the right incentives. Under conditions of imperfect information, the right incentives would guide managerial decision making in a way that maximizes shareholder value. This instrumental approach of the theory argues that pay setting is merely a matter of pay design (Gomez-Mejia and Wiseman, 1997). A major implication most often argued by scholars when applying this view is that, given incomplete information in practice, executive pay must somehow positively be related with firm performance (i.e. shareholder value). A positive pay-performance link, after all, would demonstrate that it is (1) do-able for shareholders to set the “right” incentives, and (2) expectable that managers will adjust their behaviors accordingly. One of the problems is that most empirical studies find only weak or no empirical evidence for this pay-performance link (Tosi, Werner, Katz, and Gomez-Mejia, 2000). Incentives could have perverse, unintended and unforeseen side effects that are not anticipated by the perfect contract approach of agency theory, such as corporate fraud (Bebchuck and Fried, 2004; Frey and Osterloh, 2005). An other problem with using the dominant perfect contracting approach of agency theory is its neglect of discretion and contextual factors that could influence decisions on executive pay. The approach is incapable to provide conclusive



explanations for the fact that executive pay levels and structures still differ within and across national contexts (cf. Abowd and Bognanno, 1995; Conyon and Murphy, 2000; Kaplan, 1994; Tosi and Greckhamer, 2004; Zhou, 1999). When controlling for known firm-level indicators of executive pay, such as firm size, performance, and executives' human capital, as suggested by perfect contracting accounts, these differences do not disappear (cf. Abowd and Bognanno, 1995; Conyon and Murphy, 2000; Tosi et al., 2000). This could imply that other factors that are irreconcilable with the perfect contract approach (e.g. the influence from managerial discretion and institutional conditions), systematically differ across the contexts in which executive pay is set. The dominant use of theoretical assumptions of agency theory and the unfulfilling, often contradictory, empirical results when testing this theory have led us into a "blind alley" (Barkema and Gomez-Mejia, 1998) when it comes to explaining the phenomenon of executive pay.

To find a way out of the blind alley and to advance our understanding of executive pay, this chapter reviews the existing literature that deals with theoretical approaches of explaining executive pay. This literature study resulted in the identification of 16 theories from the literature that deal with the question how executive pay can be explained. Besides the dominant agency theory, I discuss 15 other theories from the literature that deal with this question. The wide spectrum of possible different theories indicate the many possible explanations and implications in theory and practice of executive pay. Although this indicates the blurred picture of the state-of-the-art in explaining executive pay, the review presented is able to reveal a current consensus. It shows that the process, the "nuts and bolts" (Elster, 1989), of setting executive pay are more complex than simply the end result of arms' length perfect contracting based on shareholders interests as the "official story" argues. The review of the literature results in a new theoretical framework that does justice to the acquired notions that executive pay is (1) not so much a tool to align interests, (2) that executives have the discretion to influence their pay and the pay setting process, and (3) that pay setting cannot be understood without the implications of socially constructed corporate governance arrangements.

The chapter is structured as follows. First, a short description and the classification of 16 theories used in the executive pay literature are given. The 16 theories in the executive pay literature that are addressed in this chapter are categorized into three different approaches. Based on the central legitimizing mechanisms of these theories and the role of pay in these theories, they are categorized as either belonging to: 1) the value approach, 2) the agency approach, or 3) the symbolic approach. Second, based on this classification in combination with some already existing empirical evidence, a theoretical framework is introduced. Finally, future research questions for testing the framework are formulated, followed by the conclusions of the chapter.

## **2.2 Explaining executive pay**

I briefly discuss 16 different theories that are used in the executive pay literature. Extending previous overviews by Gomez-Mejia (1994) and Balsam (2002), I categorize the theories into three approaches. The classification is based on the main role that pay plays in a specific theory and on the underlying legitimizing mechanism that is used within the theory. The three approaches are labeled respectively as follows. 1) The *value approach* focuses mainly on *how much* to pay executives. Executive pay is legitimized here by arguments of market forces and is regarded as the market value of executive services. 2) The *agency approach* considers pay mainly as a consequence of agency problems, and focuses on the question as to *how* to pay executives. Legitimizations of pay levels and structures are based on arguments of market forces and conceptions of executive pay at risk. And 3) the *symbolic approach* mainly considers pay as a reflection of expectations, status or dignity of executives, and plays a more secondary role in executive motivation. The arguments used to legitimize executive pay are based on socially constructed (normative) beliefs about the implications of an executive position. The approach deals mainly with the question of *how socially constructed beliefs influence what pay ought to reflect*. In this sense the question of how and how much executives ought to be paid is based on social beliefs about the expected role or status of executives and how pay ought to reflect these beliefs by certain pay levels and makeup. Table 2.1 provides an overview of the 16 different theories and their classification according to the three streams of thought.

Following Machlup (1978: 496 as cited in Koppl, 2000: 595), theoretical “rules of procedures” cannot be termed “true” or “false”; they are either useful or not useful and are empirically meaningful (Koppl, 2000; see also North, 1990). As with most classifications, a tendency exists to oversimplify. Theories in general can be contradictory and complementary at the same time. This seems especially true for theories used in the executive pay literature (see also e.g. Gomez-Mejia, 1994; Gomez-Mejia and Wiseman, 1997). Some theories could be classified within a certain approach as indicated by table 2.1, but may be complementary or may be based on theoretical principles from a theory classified in the same or another approach. Nevertheless, and keeping these points in mind, classifications are based on the underlying legitimizing arguments of specific pay levels and structures and are based on the main role that pay plays within the theory.

As can be seen in table 2.1, the first cluster of 5 theories are categorized in the value approach. The agency approach, the second cluster of theories, consist of 2 groups, each comprised of 2 theories. The distinction between these two groups is made between (group 1) theories that argue that pay design is a solution to agency problems and (group 2) theories that argue that pay setting is influenced by executive discretion and that therefore executive pay is not a solution to agency problems, but rather an agency problem in itself. The third and last cluster, comprised of 7 theories, makes up the symbolic approach. The table reports the fundamental role that executive pay plays in all 16 different theoretical approaches.

**Table 2.1 Theoretical approaches of legitimizing executive pay**

<i>Value approach</i>		<i>Agency approach</i>		<i>Symbolic approach</i>	
<i>Theory</i>	<i>Role of Pay</i>	<i>Theory</i>	<i>Role of Pay</i>	<i>Theory</i>	<i>Role of Pay</i>
<i>Marginal Productivity Theory</i>	Value of input equal to marginal revenue productivity; equal to equilibrium on market	<i>Complete Contract Theory (Group 1)</i>	Overcome incentive misalignment; based on risk preferences	<i>Tournament Theory</i>	Highest price in a contest, motivation for lower level employees
<i>Efficiency wage Theory</i>	Idem Marginal Productivity plus incentive to increase productivity and reduce turnover	<i>Prospect Theory (Group 1)</i>	Incentive alignment caused by loss aversion preferences	<i>Figurehead Theory</i>	Token of executive's mandate and as accomplishment
<i>Human Capital Theory</i>	Value of capabilities and skills on the market	<i>Managerial Theory (Group 2)</i>	Exhibit of power when negotiating contract	<i>Stewardship Theory</i>	Secondary, intrinsic motivation is of more importance
<i>Opportunity Cost Theory</i>	The opportunity cost of next best alternative for the executive	<i>Class Hegemony Theory (Group 2)</i>	Use of power and protection of managerial class	<i>Crowding-out Theory</i>	Part of extrinsic motivation
<i>Superstar Theory</i>	Disproportionate pay for imperfect substitution			<i>Socially Enacted Proportionality Theory</i>	Result of socially normative proportion differences of socially enacted hierarchical levels
				<i>Social Comparison Theory</i>	Based on pay of comparable executives. Likely above going rate of benchmark
				<i>Implicit / Psychological Contract Theory</i>	Symbol of appreciation, accomplishment and dignity

### **2.2.1 The value approach**

The value approach generally regards pay as the reflection of the market value of an executive's services. This approach uses the laws of economics of supply and demand as determinant factors for executive pay. Legitimizing executive pay is grounded in arguments of market forces and market mechanisms. Most likely because these theories are less applicable for addressing specific corporate governance problems (see discussions at the end of this section), the theories of the value approach have received little attention in the corporate governance and executive pay literatures. Because of this, and due to oversimplification of the theories and lack of attention for the many applications of the theories put forward in, for instance, the field of labor economics (e.g. Lazear 1995), only the very basics of the theories as they appear in the executive pay literature are addressed. Nevertheless, as will be further discussed below the theories do relate to and underlie many other theories and they provide a solid foundation for many other theories. The value approach consists of the following five different theories: 1) marginal productivity theory, 2) efficiency wage theory, 3) human capital theory, 4) opportunity cost theory, and 5) superstar theory.

Within the value approach, the marginal productivity theory is presumably the most fundamental theory. The input from executives, i.e. the services they provide to the firm, is treated as any other input factor of production (e.g. Roberts, 1956). The value of this input is equal to the intersection of supply and demand on the labor market for executives. In this equilibrium pay is equal to the executive's marginal revenue product. Marginal revenue productivity can be defined as the observed performance of the firm minus the performance of the firm with the next best alternative executive at the helm, plus the costs of acquiring the latter's services (Gomez-Mejia, 1994). Under the basic market assumption that "competition on both sides of the [executive] labour market and a continuum of alternative jobs open to the executive and of executives available to the firm" (Roberts, 1956: 291), executive pay can be understood as the result of the value of the executive's marginal revenue productivity. In equilibrium this is equal to the intersection of supply and demand on the market for executives.

Based on this, human capital theory, the second theory in the value approach, argues that an executive's productivity is influenced by his accumulated knowledge

and skills, i.e. his human capital. The more knowledge and skills an executive has, the higher his human capital will be. An executive with a greater quantity of human capital would be better able to perform his job and thus be paid more. The market for executives determines the value of this capital (see for human capital approaches in the executive pay literature e.g. Agarwal, 1981; Carpenter, Sanders, and Gregersen, 2001; Combs and Skill, 2003; Harris and Helfat, 1997).

The third theory, efficiency wage theory (Lazear, 1995; Prendergast, 1999), argues that executives will put in extra effort if they are promised an above-market-level wage. Because pay is set at a level above market level, executives are less likely to leave the firm or to shirk their work, and will feel their contributions to the firm are valuable. Executives subsequently have the incentive to put in extra effort, which reduces executive turnover and increases productivity (Balsam, 2002; Prendergast, 1999).<sup>2</sup> Executive pay is considered to be the result of the value of executive's marginal revenue productivity plus a premium above market level to provide extra incentives.

An opportunity cost approach, which is the fourth theory in this approach, argues that the transparency of job-openings on the executive labor market makes it possible for executives to change employers. The opportunity cost perspective argues that in order to hire or retain an executive the level of pay must at least be equal to the amount that would be paid to an executive for his next best alternative (Thomas, 2002; see also Gomez-Mejia and Wiseman, 1997).

The fifth theory is superstar theory (Rosen, 1981). Although Rosen (1981) does not specifically address the implications of this theory in regard to explanations of executive pay, the theory does address the skewness in the distribution of income. Following Rosen (1981), less talent is hardly a good substitute for more talent. And thus imperfect substitution among different "sellers" of talent exists. Given imperfect substitution, demand for the better talented increases disproportionately. If production costs do not rise in proportion to the size of the sellers market, it is argued that a concentration of output is possible. Economy of scale of joint consumption allows for

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<sup>2</sup> As already indicated, the theories are oversimplified in the overview here. There is much attention for, for instance, efficiency wages in other fields of research. Within the field of corporate governance and executive pay, this theory and other theories in the value approach have received very little specific attention. For an exception on efficiency wages see Muhlau and Lindenberg (2003).

relatively few sellers to service the entire market. Then again, fewer sellers are needed if these sellers are more capable of serving the entire market. When combining the joint consumption and the imperfect substitution features, it becomes apparent that talented persons can serve very large markets and subsequently receive large incomes (Rosen, 1981).

The skew-ness in the distribution of executive pay could thus be explained by the disproportionate premiums that firms are willing to pay for executives' talent or capabilities for which no good substitutes exist. Furthermore, albeit in relatively smaller proportions as indicated by Rosen (1981), the distribution of executive pay can be explained by possible joint consumption of executive services. The possibilities for better talented and/ or more capable executives to serve on (multiple) boards implies that fewer executives are needed to serve the market, and that subsequently their pay would increase disproportionately.

The fundamental legitimizing argument that underlies executive pay in the value approach is founded on market forces on the market for executives. The theories in this approach are focused on how markets determine executive pay. Some of the theories also address implications of pay as incentives and hereby address the question of how to pay. However, the central role of pay is more a reflection of the (above) market value of executive services and capabilities and the implications thereof on productivity. In this sense executive pay is set on what Cyert and March (1963/1992) call the logic of consequence. Executive pay is set in terms of the evaluated market values of its consequences (cf. Cyert and March, 1963/1992). Decisions on pay are made on behavioral assumptions that are rational, calculative, anticipatory, and consequential (Cyert and March, 1963/1992; see also chapter 1 for further explanation of this logic).

Legitimizing executive pay based exclusively on efficient market assumptions of supply and demand for executive services is, however, problematic. The fundamental problem is the incapacity of tackling problems of corporate governance. Even in the strong hypothetical case of perfect market conditions, markets are not strong enough to completely solve problems of agency (Jensen and Meckling, 1976; Jensen and Murphy, 2004), sunk investments (Shleifer and Vishny, 1997), bargaining power over (quasi) rents (Roe, 2003; Zingales, 1998), allocation of organizational slack (Cyert and March, 1963/1992), and governing transactions (Williamson, 1985). Incomplete

information about firms' hiring practices and available executives and about the assessment of executives' capabilities across the globe causes problems with regard to the legitimization of executive pay based solely on market forces (Finkelstein and Hambrick, 1988; Perkins and Hendry, 2005).

The fundamental problem is that markets cannot actually make decisions. As Kay (2000) argues, markets only provide signals and cannot make real decisions. In the value approach the firm is considered as a black box and is considered to be nothing more than "just" another production function (cf. Cyert and March, 1963/1992). To be able to legitimize executive pay, the processes and circumstances by which decisions upon executive pay are made are central. Adherence to arguments of market forces and the underlying assumption of the logic of consequence in these theories, explaining known variance between executive pay levels and structures, especially across countries, ultimately lie in addressing market imperfections (cf. Abowd and Kaplan, 1999; Conyon and Murphy, 2000). These imperfections could however be (partly) attributed to decision making processes within the firm and the institutional contexts in which decisions are made (e.g. cf. Cyert and March, 1963/1992; North, 1990; Pfeffer and Salancik, 1978/2003; Powell and DiMaggio, 1991; Scott 2001).

Although possibly constrained by market forces, actors within the firm ultimately decide on executive pay levels and makeup. Many different actors within and outside the firm could have direct or indirect influence in this decision making process. Questions about how, who, and when these processes are organized, and how, who, and when decisions are made are crucial for an understanding of executive pay. The need for corporate governance arrangements at micro and macro levels, even under the assumptions of perfect markets, indicates at least one major problem not specifically dealt with in this approach. Corporate governance arrangements and the social construction of the practicality of these arrangements have to be addressed (cf. Cyert and March, 1963/1992; North, 1990, Perkins and Hendry, 2005; Roe, 2003; Williamson, 1996). The relative balance of power between the actors involved in corporate governance results in certain institutionalized corporate governance arrangements (cf. North, 1990; Meyer and Rowan, 1977; Perkins and Hendry, 2005; Rajan and Zingales, 2003; Roe, 2003; Williamson, 1996). An adherence to the value approach only would ultimately disregard the existence of these socially and economically meaningful constructions of governance mechanisms and relationships between social actors within and outside the firm (cf. Cyert and March, 1963/1992;



North, 1990; Roe, 2003; Williamson, 1985; 1996; Zingales, 1998). The value approach evidently lacks the ability to legitimize executive pay within a framework of corporate governance.

Adhering to the value approach makes one thing clear: besides the global market for executives - even if it were a perfect market - other mechanisms are at play in determining pay levels and structures. Legitimizations of executive pay based solely on arguments of market forces would thus ultimately not hold. The value approach contributes to our understanding of how economic theories could help to explain differences in pay between executives and between executives and other employees. It could further be helpful in signaling possible market inefficiencies or market outcomes under certain conditions of market inefficiencies. This approach is, however, of less use when addressing specific corporate governance issues. The limited view of the firm in this approach results in the problem of addressing decisions made within the firm. The value approach is very limited for legitimizing executive pay within a framework of corporate governance arrangements, especially when the question of who has discretion over decisions in the pay setting process is raised and firm internal governance arrangements have to be addressed. The theories provide a solid economic basis for addressing the question of how much to pay, but do however require extensions to be able to legitimize executive pay within a framework of corporate governance.

### **2.2.2 The agency approach**

Extensions on the value approach used to consider corporate governance problems are central in the agency approach. Rather than determining how much to pay executives, the central legitimizing issue in the agency approach is how to pay them (cf. Barkema, Geroski, and Schwalbach, 1997; Jensen and Murphy, 1990a). Pay levels are in this approach mainly assumed to be based upon the market value of executives' services. As pay is seen as a consequence of agency problems, the question how to pay the executive is the main issue addressed in these theories. Agency problems exist in any situation where one party entrusts responsibility of tasks to another party. In this agency approach a distinction can be made between two groups. Group 1 consists of theories that consider executive pay as a (partial) solution to overcome agency problems by incentive alignment and the transference of risks. Group 2 comprises of

theories that consider pay as a result of executives' discretionary powers resulting in turn from agency problems. The theories in the first group are the complete contract approach, referred to in the literature as agency theory (Jensen and Meckling, 1976), and prospect theory. The second group consists of managerial power theory and class hegemony theory.

Problems of agency are central in the corporate governance literature. A distinction that can be made between agency theories is between positive and normative agency theories (Eisenhardt, 1989; Rajagopalan, 1996). In positive agency theories problems of managerial control and motivation from the owners' point of view, known as the "incentive alignment" problem, are central. The central question is determining which incentives are needed to align the interests between agents and principals. In normative agency theories, the manager's point of view is put forward. The central issue in these normative theories is the problem that managerial wealth is at risk. The level of risk can be influenced by the strategic context of the firm and by the ability of the principal to observe and evaluate appropriate managerial actions (Eisenhardt, 1989; Rajagopalan, 1996). These two problems are often conflicting in the design of effective pay systems. Optimal incentive alignment can conflict with efficient risk-bearing and *visa versa* (Rajagopalan, 1996).

Gomez-Mejia and Wiseman (1997) sum up three basic assumptions of a simple agency model. First, agents are risk averse, second, agents behave according to self-interest assumptions, and third, agents' interests are not in line with the principals' interests. Based on these assumptions they also identify two cases. The first is the case of complete information about agents' actions. In this case no information asymmetries between principals and agents exist. Under these conditions the principal is completely aware of the agent's actions. Providing the agent with incentives is unnecessary in this case, as the principal is completely aware of how results are achieved and would unnecessarily transfer risk to a risk averse agent. The costs of providing incentives are unnecessary because the principal already has complete information about the agent's efforts and behavior.

The second case is when the principal has incomplete information on the agent's behavior. In this case the principal is not completely aware when the agent deviates from the interests of the principal. In the case of incomplete information, agency problems could arise because of two factors. One is moral hazard, by e.g. shirking,

and the other is adverse selection, by e.g. hubris actions. Agents can, for instance, be so involved in pursuing their own interests that they neglect their duties and/or overestimate their own capabilities. To solve these problems of incomplete information, the principal has two options. Either obtain (more) information about the agent's efforts and behavior by increased monitoring, or provide the agent with incentives in a way that the interests of the principal and agent become aligned. By providing incentives, the risk of deviation from the interests of the principal is transferred back to the agent. Because the agent is risk averse and maximizes his self interests, he is presumed to adhere to these incentives in a way that his behavior will result in an outcome that is preferable to the principal. The contract between principal and agent is then based on the outcome of the agent's behavior. The optimal contract is a tradeoff between the cost of (additional) monitoring and the cost of incentives (Gomez-Mejia and Wiseman, 1997).

The central issue of agency problems has developed into two groups of approaches within the agency approach on executive pay (cf. Bebchuk, Fried, and Walker 2002). The first group consists of complete contracting and prospect theory. The complete contracting approach (Jensen and Meckling, 1976) is the most prominent one in academic research on executive pay and is most often simply referred to as "agency theory". Both theories in this group consider executive pay as a "tool" with which to solve agency problems.

The second group in the agency approach is managerial power theory and class hegemony theory. These theories (convincingly) argue that because of principal agent relationships, agents are in the natural position to have discretion in setting their own pay (cf. Bratton, 2005; Jensen and Murphy, 2004).

Complete contract theory is classified as the first theory in group 1 (see table 2.1). As this theory is by far the dominant theory in the executive pay literature Bebchuk and Fried (2004) labeled it as "the official story" on executive pay. The central issue of the optimal contract problem is formulated by Gomez-Mejia and Wiseman as: "the tradeoff between the cost of measuring agent behavior and the cost of transferring risk to the agent, that is, balancing the insurance and incentive properties of compensation design" (1997: 296). Basically the theory argues that executive pay is a "tool" with which to align the interests of executives with that of shareholders. By arms' length

negotiations, a contract with the right incentives is made up to transfers risks to a risk averse executive. In a simple model of this theory one could argue that what setting executive pay really comes down to is the incentives that are needed to bring a risk averse executive's interests and behavioral outcomes in line with the expectations and interests of the shareholder. Typically, the contract is made up between the board of directors, as representatives of the shareholders, and management. Pay levels are based on market forces and pay structures are based on the necessary incentives from the shareholders' point of view to uphold the perfect contract following given levels of monitoring. The outcome based complete contract is made up based on efficiency arguments and is the most efficient tradeoff between the cost of incentives and the cost of monitoring.

The second theory in group 1 of the agency approach is prospect theory and is based on the same agency problem. In contrast to the complete contract approach which is based on risk aversion assumptions, prospect theory (Kahneman and Tversky, 1979) uses loss aversion assumptions. Building on prospect theory and on agency theories, Wiseman and Gomez-Mejia (1998) formulated a behavioral agency model of risk taking. Their approach argues that prospect and agency theories are complementary and, by combining internal corporate governance with problem framing, help to explain executive risk-taking behavior (Wiseman and Gomez-Mejia, 1998). The theory argues that the executive is willing to take risks under certain circumstances, i.e. to avoid losses or missing goals or targets. The executive is unwilling to take risks once he has received his performance goals, as the benefit to the executive of increasing performance is more than offset by the possibility of falling below target (Balsam, 2002). In this theory, wealth maximization is a less accurate explanation for executives' decisions making preferences than a loss minimization perspective. Executive decisions are argued to generally seek to limit losses to wealth while also increasing opportunity costs (Wiseman and Gomez-Mejia, 1998). Influences from prospect theory on executive pay could be brought back to a loss aversion perspective on executive behavior. Strategic decision making and governance mechanisms have effects on executive risk bearing and thereby affect the executives' perceived risk of his wealth. Setting executive pay is thus a result of the amount of risk bearing of executive's wealth. Governance arrangements, such as monitoring mechanisms, and implications of risk levels, risk shifting, and risk sharing, determine the pay of a loss averse executive.

Group 2 of the agency approach consists of managerial power theory and class hegemony theory. The separation between ownership and control has resulted in conditions where the interests between owners and executives can diverge and the checks to limit the use of power (from owners as well as ultimate managers) can disappear (Berle and Means, 1932/2004). The relative balance of power between the principals and agents are argued to influence the outcome of the contract and therefore influence the level and structure of executive pay. The managerial power approach to agency problems does not exclusively see pay design as a “tool” to alleviate agency problems. Managerial power theory argues that because of principal-agent relations, agents are in the natural position to use their discretion to set their own pay. Pay design is not a solution to agency problems but is seen as part of the same problem; it is an agency problem in itself (Bebchuk et al., 2002). Executives are in the position to use their power to influence those decision making authorities especially designed to keep them in check (i.e. the board of directors; Fama, 1980; Fama and Jensen, 1983). In contrast to the complete contracting theory, natural relationships between principals and agents and the consequent possible use of discretion are considered as real possible behavior (Grabke-Rundell and Gomez-Mejia, 2002). In the perfect contract approach, discretion is effectively ruled out, as managers are expected to behave according to the contract, because of the incentives they receive for upholding this contract. In this sense, discretion is not considered as a possible behavior, but only as a cost (Grabke-Rundell and Gomez-Mejia, 2002). Managerial power theory argues that executive pay is an outcome of power relationships and that pay setters and pay receivers are able to use discretion in the pay setting process.

A theory that extends managerial power theory is class hegemony theory. This theory argues that executives within a firm and executives from other firms share a commonality of interests. Where managerial power theory stops at the boundaries of firms, class hegemony theory extends managerial views beyond these boundaries (Gomez-Mejia, 1994). Shared interests and objectives create bonds between executives that extend beyond a single organization. These bonds form relationships which in turn form a class across different organizations. By using (shared) power the executives can protect their privileges and the wealth of their class. Although primarily executives’ input is used to legitimize high executive pay, setting high pay is also a token of executives’ power to protect shared interests and objectives (Gomez-

Mejia, 1994). Setting executive pay is thus a result of the social managerial class's power to protect their interests and objectives that are at potential risk.

In the agency approach the central legitimizing arguments of pay are market forces and implications of risks. Because of agency problems the theories in this approach argue that pay depends on market values and optimal levels of risks of executive wealth (Gomez-Mejia, 1994). Extending the solid economic theories of the value approach, the agency approach provides the possibility to address corporate governance problems. Other mechanisms that influence the level of risk can also be addressed. For instance, questions around monitoring and how this monitoring is organized and subsequently affects risk-bearing and therefore affects pay can be raised. The legitimization of pay is nevertheless still based on implications of market forces, as is the case in the value approach. However, the agency approach extends this approach by pointing out the crucial role of pay design in the relationships between principals and agents. Similarly, the theories in both the value as the agency approach adhere to the "logic of consequence" (Cyert and March, 1963/1992). Agency-theoretical models involve multiple strategically interacting actors (i.e. agents and principals), "each pursuing self-interested objectives and constrained or facilitated by the similar rational pursuit of self-interested objectives by others" (Cyert and March, 1963/1992: 230). According to this logic of consequence, the decisions of principals and agents alike are rooted in rational, calculative, anticipatory, and consequential actions (Cyert and March, 1963/1992). Setting executive pay in the agency approach is rooted in a rational calculative manner that evaluates alternatives in terms of market values and their consequences for executive (or shareholder) wealth that is at risk (cf. Cyert and March, 1963/1992).

In general, efficient executive pay is set as a tradeoff between the cost of steering behavior by incentives and the cost associated with monitoring. The central mechanisms of monitoring are often thought of as a mechanism operated by the board (Fama, 1980; Fama and Jensen, 1983). An important insight from the second group of theories in the agency approach is that executives have discretionary power to influence corporate governance outcomes and the ability not to adhere to market signals. Executives can influence the pay setting process, and pay setting is thus not a solution to the problem, but part of the same problem. The insight that executives could be seen as a social class emphasizes the notion that the relative balance of

power in societies of different classes could influence corporate governance arrangements and their outcomes in, for instance, certain pay levels and structures. Nevertheless, the fundamental problem with the agency approach is the often overlooked implications of “social embeddedness” (Granovetter, 1985; Uzzi, 1997). Although markets may be powerful enough to influence solutions of governance problems, they are not powerful enough to (immediately) sanction decision making. Following Roe (2003), markets compete for organizational rents. Not only outside but also within the firm actors compete for the created rents. Markets with less competition create more rents which actors inside and outside the firm can compete for. Absence of competition, in contrast, increases rents that executives can use, also for their own interests (Roe, 2003). Although there is interaction, there is a fundamental difference in, on the one hand, control over rents and discretion in making decisions and, on the other hand, control and discretion over managerial slack with regard to personal gains (Roe, 2003). The distinction is between self-interested behavior with the intention to cooperate and opportunism, i.e. self-interested behavior without regard for the consequences (Gomez-Mejia, Wiseman, and Dykes 2005). The judgment of an agents’ behavior in the first case is based on the agent’s business sense (e.g. possible mismanagement of firm resources) and in the second case is related to behavior purely for personal gains (e.g. theft of firm resources) (cf. Roe, 2003). Similarly, the power of executives to bargain over their pay and the power of executives to extract rents with only personal gains in mind (i.e. opportunism) are different concepts of managerial power (Murphy, 2002). Executives thus not only have discretion in determining their pay setting process and its outcome, but are also in a position to (mis-)use their delegated authority to use firm resources for selfish or altruistic means.

The point is that even perfect market conditions cannot completely influence efficient decision making, as markets provide only signals to inform the decision making process (Cyert and March, 1963/1992; Kay, 2000). Problems of a wide range of different bilateral dependencies indicate that discretion and other mechanisms are at play in determining pay setting outcomes (cf. Williamson, 1988). When bilateral dependencies come together because of incomplete contracting and asset specificity, such as sunk- investments, or bargaining over (quasi) rents, the opportunity is created that managers can use firm rents for different (e.g. organizational or personal) goals. Markets are simply not immediately able to sanction these decisions (cf. Roe, 2003;

Shleifer and Vishny, 1997; Williamson, 1988; Zingales, 1998). Although stronger market competition may increase constraints on executives, it does not constrain them from acting according to principals' interests or to self-interests only.

The dominant use of an ex-ante perfect contracting approach does not resolve these issues. Notably, this approach effectively rules out the consideration of problem resolutions within the firm and disregards the hierarchical structures within firms that influence corporate governance outcomes (Williamson, 1988; Zingales 1998). In an ex-ante complete contracting view, the designer of the contract has to anticipate all future possible problems that clearly exist ex-post (Zingales, 1998).<sup>3</sup> As complete contracts are simply not possible, other mechanisms besides contracts have to be in place to resolve problems regarding (mis)use of discretion. This problem becomes apparent especially when we have to admit that executives have discretion over their own pay arrangements (cf. Bratton, 2005; Jensen and Murphy, 2004). Not only checks and balances outside the firm, such as legal institutions (e.g. courts rulings over (mis)uses of firm resources by executives as either mismanagement or theft), play a role in organizing corporate governance arrangements, but also firm internal checks and balances, such as the board of directors and employees. Other mechanisms inside and outside the firm are clearly at play in solving problems of incomplete contracting and (mis)use of executives' discretionary powers. These mechanisms are not only employed and developed by providers of financial capital but also by many other actors such as employees, suppliers, costumers, governments, and the general public (Roe, 2003; Williamson, 1988; Zingales, 1998).

Thus, a view that considers the firm more as a system that co-evolves with other institutions seems more appropriate (see e.g. Cyert and March, 1963/1992; North, 1990; Meyer and Rowan, 1977; Pfeffer and Salancik, 1978/2003; Powell and DiMaggio, 1991; Scott 2001; Williamson 1996). Such a view considers that institutions create, develop, maintain, and alter corporate governance arrangements and that these processes are influenced by different actors holding different levels of

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<sup>3</sup> Zingales (1998) argues that complete contracting assumptions result in a conception of the firm that is too narrow (i.e. the firm is considered as a nexus of contracts). This implies that problems regarding ex post bargaining cannot be addressed. This would further imply that in a world of complete contracts no meaningful definition of corporate governance as discussed in the corporate literature can exist. Zingales argues that the question of how an effective corporate governance system might function to overcome conflicts that clearly exist ex post cannot be raised, as the perfect contract would resolve all possible conflicts ex ante.



discretion and ideas about how and when to make decisions. The underlying argument is that to be able to make production possible some stable condition of human interaction (North, 1990) or “social peace” (Roe, 2003) is necessary. Institutions and the relative balance of power between executives and others that influence corporate governance arrangements can influence how corporate governance arrangements are shaped and how this condition is achieved (cf. Aquilera and Jackson, 2003; Jepperson, 1991; Meyer and Rowan, 1977; Perkins and Hendry, 2005). The many possible ways in which societies, firms, and actors structure and develop these arrangements and provide the different actors the ability to use their discretion can influence decision making on pay levels and pay structures. Societies can differ, for instance, in legal protection or political orientation in favoring certain actors (e.g. shareholders protection versus employee protection). These socially constructed preferences influence the decision on who has control, and how big this control is over corporate governance arrangements and their outcomes (see, for instance, La Porta et al. (1997) for influences from legal institutions on shareholder protection; see Roe (2003) for influences from political institutions on corporate governance; and see Tosi and Greckhamer (2004) for influences from cultural environments on executive pay). Executive pay in this sense is more an outcome of interdependent relationships and mechanisms embedded in institutions that the many actors involved can develop, use, or abuse in order to pursue their own goals.

The implications of this social embeddedness (Granovetter, 1985), in which all contracts are made up, is most often overlooked in the executive pay literature and especially by the many scholars that solely adhere to the perfect contract approach of agency theory. Although the extension of institutional implications could endanger idiosyncratic theoretical explanations of executive pay across different societies (Gomez-Mejia, Wiseman, and Dykes, 2005), the agency approach neglects the importance of the social context for problem framing and problem resolutions in the corporate governance debate. The strengths of the agency approach lie, however, in signaling the existence of agency problems. Problems regarding the delegation of activities result in interdependencies of the actors involved and indicate the reasons for governance structures. As executives are in the natural position to make bad business calls or show opportunistic behavior, and given the discrepancy of the interests of the actors involved, executives are able to steer corporate governance arrangements and their outcomes, and thereby steer their pay levels and makeup.

Agency problems and the interdependency of the actors involved are, however, not solved by markets alone. Even perfect markets cannot completely constrain executives from making certain business calls and from self-dealing. This issue requires a view of the firm as a system that coevolves with other institutions. The agency approach offers great insights. However, generalizations of solutions to agency problems and the ultimate outcome of decisions in certain pay levels and pay structures seem reliant on the institutional embeddedness of these problems.

### **2.2.3 The symbolic approach**

The third approach to legitimizing executive pay comprises of theories that consider pay more as a social constructed symbol fitting the expectation, status, or role that executives play in a society or firm. Executive pay has a primary role in reflecting executive status, dignity, and expectations and plays a more secondary role in executive motivation. The legitimizing arguments are based on social (or social-economical) constructed beliefs about executive roles and how pay ought to reflect this. The approach provides further insights into how pay differences with lower level employees or between executives can be legitimized. The symbolic approach consists of the following 7 theories: 1) tournament theory, 2) figurehead theory, 3) stewardship theory, 4) crowding-out theory, 5) implicit/ psychological contract theory, 6) social enacted proportionality theory, and 7) social comparison theory.

Tournament theory (Lazear and Rosen, 1981) treats pay as a prize in a contest. First prize in the tournament is the highest pay received by the CEO, the highest-ranking position in an organization. Setting a high prize provides incentives for the contestants to climb higher on the corporate ladder (Rosen, 1986) and indirectly increases the productivity of competitors at lower levels (Balsam, 2002). Although high levels of executive pay also provide executives themselves with incentives, they serve more as incentives for their subordinates (Balsam, 2002). When the top prize is set at a disproportionately high level it has the effect of lengthening the career ladder of high-ranking managers (O'Reilly, Main, and Crystal, 1988). "Contestants who succeed in attaining high ranks in elimination career ladders rest on their laurels in attempting to climb higher, unless top-ranking prizes are given a disproportionate weight in the purse. A large first-place prize gives survivors something to shoot for, independent of

past performances and accomplishments” (Rosen, 1986: 701). The symbols needed to keep the tournament going result in highly differing pay levels at the different levels in the organization, with a disproportionately high first place for achieving the top position.

Figurehead theory argues that behavior is assumed to reflect purpose or intention and that a diversity of goals and interests co-exist within firms (Ungson and Steers 1984). Because of these different, possibly conflicting, goals and interest “actions and decisions result from bargaining and compromise, with those units with the greatest power receiving the greatest rewards from the interplay of organisational politics” (Ungson and Steers, 1984: 316). Three perspectives of executives roles can be identified (Ungson and Steers, 1984). First, executives act as “boundary-spanners” for owners, governments, employees and the general public. In this regard executives, and especially the CEO, play political/symbolic figurehead roles when communicating within and outside the firm. Second, the executive manages political coalitions within and outside the firm and plays the role of political strategist. And third, the executive plays the role of internal politician in the relationship between members of the board of directors when new directors are hired and executive pay is set (Ungson and Steers, 1984). Because of the different roles that managers play and represent, the “appropriate role for the manager may be [that of an] evangelist” (Weick, 1979: 42). As a reflection of these different roles executive pay is set by the individual’s ability to manage the complexity of the symbolic political roles and is used as a token of the executive’s mandate. The makeup of the pay mix depends on the complexity of these roles and accommodates political processes in the best interest of the firm (Ungson and Steers, 1984). Executive pay is part of the status the executive has within and outside the firm and is intended to reinforce this figurehead image (Gomez-Mejia, 1994).

The third theory in the symbolic approach is stewardship theory. Stewardship theory argues a contradicting view on governance (Davis, Schoorman, and Donaldson, 1997; Donaldson and Davis, 1991). Stewardship theory does not provide a-priori clear hypotheses about pay levels or pay structures and could therefore be questioned as a useful theory to legitimize executive pay. Nevertheless, stewardship views are addressed because the theory does attempt to explain that executive pay does not have to be (strongly) related to shareholder wealth or other measures of the firm’s financial performance (Davis, Schoorman, Donaldson, 1997). Using

sociological and psychological approaches, stewardship theory sees subordinates as collectivists, pro-organizational and trustworthy as opposed to e.g. agency theory, which assume subordinates to be individualistic, opportunistic, and self-serving (see Donaldson 1995). Stewardship theory defines situations in which managers' motives are aligned with the objectives of their principals, rather than motives of individual goals (Davis, Schoorman, Donaldson, 1997). Executives are motivated to act in the best interest of their principals and the firm (Donaldson and Davis, 1991). Even in situations where the interests of stewards and principals diverge, Davis et al. (1997) argue that stewards place higher value on co-operation and thus perceive greater utility in co-operative behavior. Stewardship theory assumes a strong relation between the firm's success and principal satisfaction. The theory argues that there is no general executive motivation problem, because executives act as true stewards of the firm, in pursuit of organizational goals. Executive pay plays a secondary role in executive motivation, because non-financial rewards are of more importance (Donaldson et al., 1991). The theory focuses more on intrinsic, rather than extrinsic rewards. Executives are intrinsically motivated by the need to achieve and to receive recognition from others (Donaldson et al., 1991). Executive pay could be legitimized by arguing that it is merely a relatively minor part of executive motivation and forms only part of the recognition executives receive for being stewards of the firm.

Extending on the balance of intrinsic and extrinsic motivation, crowding-out theory argues that monetary incentives can crowd-out intrinsic motivation and thereby also good intentions (Frey, 1997a; 1997b). Pay plays a part of executive motivation, but intrinsic motivation to pursue organizational goals is likely more important. There is a delicate balance between intrinsic and extrinsic motivation. Pay levels that are too high or the provision of too many extrinsic incentives could drive out intrinsic motivation, resulting in lower efforts by the executives. In turn, high pay levels and high incentives could result in behavior that pursues goals that are not in line with the best interests of the firm (e.g. corporate fraud) (Frey and Osterloh, 2005). Executive pay plays a secondary role in executive motivation. A higher level of intrinsic motivation from executives requires lower pay levels and fewer incentives to balance intrinsic motivation with extrinsic motivation.

The fifth theory in the symbolic approach is implicit contract or psychological contract theory (see e.g. Baker, Gibbons, and Murphy, 2002; Kidder and Buchholtz, 2002; Rosen, 1985). This theory argues that a contract exists between an individual

and another party that is composed of the individual's beliefs about the nature of the exchange agreement. Based on social exchange theory, relational contract theory tends to rely on principles of generalized reciprocity. The psychological contract is an individual's personal set of reciprocal expectations of his obligations and entitlements which do not necessarily have to be mutually agreed upon between the contractors (Kidder and Buchholtz, 2002). In this respect Baker, Gibbons, and Murphy (2002) use the term relational contracts. Baker et al. (2002) argue that a relational contract is composed of informal agreements and unwritten codes of conduct that affect individuals' behavior. The relationship contract is based on trust and the common beliefs of the parties regarding fairness and sense of justice. The job characteristics of executives and the nature of their positions create a relational psychological contract. Pay is seen as a symbol that reflects appreciation, accomplishment, and dignity (Kidder and Buchholtz, 2002).

The sixth theory is referred to here as the socially enacted proportionality theory. This theory argues that the value of an executive is the result of positions of different ranks within a firm. Simon argues that executive pay is "determined by requirements of internal "consistency" of the salary scale with the formal organization and by norms of proportionality between salaries of executives and their subordinates" (1957: 34). Because of hierarchical structures induced by authority relations, large organizations are roughly pyramidal shaped. Furthermore, it is widely (socially) accepted that executives and their immediate subordinates have different salaries. This line of arguing can be followed down to the lowest organizational level where employees are hired outside the firm, e.g. school graduates. Salaries at this level are set by forces of market competition. The socially enacted norm of proportionality determines the ratio of an executive salary and the salaries of his immediate subordinates (Simon, 1957). According to the socially enacted proportionality theory, executive pay is the result of socially normative proportional differences between socially enacted hierarchical levels within firms, with a market-based pay at the lowest level.

The seventh theory of the symbolic approach is social comparison theory. This theory is also based on comparison but comparison is made at the top level of the firm and with executives externally to the organization. With the help of Goodman (1974) and Festinger's (1954) theories of social comparison processes, which in turn are related to equity theory, O'Reilly, Main, and Crystal (1988) argue that executives use

their own pay as a reference point when setting the pay of other executives. This theory originates from the argument that people have the drive to evaluate their abilities and options. People tend to use other people with similar performances and/or ideas to themselves when selecting reference points. People preferably compare themselves with others who are seen as slightly better or more expert than themselves. In the case of setting executive pay, executives rely on normative judgments of their own pay and experience and on judgments of the experience and pay of other executives (Gomez-Mejia, 1994; O'Reilly et al., 1988). Executive pay reflects normative judgments of other executives and in this sense serves a function of symbolic judgment.

The legitimizing arguments of the symbolic approach seem less straightforward than the other two approaches in which market forces (value and agency approaches) and pay at risk (agency approach) form the main legitimizing arguments. The symbolic approach relies more on normative inclined beliefs (especially apparent in the implicit contracting theory) of how executive pay ought to look, rather than on market forces. In tournament theory, for instance, the level of pay is most likely set above the contributed value of the executive's services in order to increase the efforts and productivity of lower level employees (Lazear and Rosen, 1981). Executive pay is, however, set at some kind of normative level that provides enough incentives for lower level employees to believe that they must take part in and do their best to win the tournament. The legitimization of executive pay relies thus on the symbolic value of a prize that is big enough to keep the tournament going.

The symbolic approach in general relies on arguments of legitimizing pay levels and structures on socially inclined beliefs and arguments about how executive pay ought to look. The arguments are based on the concept of pay as a symbol of accomplishment, good stewardship, dignity, normative judgments of reference points, status, mandate, normative socially accepted proportionality, and reflections of a delicate balance between intrinsic and extrinsic motivations. Although economic reasoning of market forces may play (a small) part (e.g. socially enacted proportionality theory considers pay at the lowest level of the firm to be based on market value) or may influence the results (e.g. by implicit contracting it could be argued that in a relatively bigger and/ or better performing firm there may be higher expectations with regard to executive capabilities than in a smaller or more poorly

performing firm, with subsequent affects for the market value of executive capabilities), market forces are not explicitly considered the most determining factor for the setting of executive pay. Although market forces could influence decision making on executive pay, the symbolic approach focuses on the social construction of pay levels and structures. The answer to the question how and how much to pay executives is rooted here in the degree of social acceptance or “appropriateness” of given pay arrangements. As indicated above, the two other approaches, the value and the agency approaches, use the logic of consequence to set pay. Pay in these two approaches is mainly considered as a result of calculated, fully rational actions based on evaluations of market values and the implications for pay levels, structures, and/or risk. The symbolic approach, in contrast, focuses more on the “logic of appropriateness” (Cyert and March, 1963/1992) of setting pay. According to this logic decisions on executive pay packages are not based on fully calculated and optimal consequences. Decisions on executive pay are made and legitimized by referring to pay as simply being “appropriate”, given the contextual positions of the actors involved and given the perceived position, role, status, expectations, standards of comparison, and intrinsic (non-priced) motivation of being an executive.

### **2.3 Empirical evidence**

As already indicated by Gomez-Mejia (1994), many empirical studies test hypotheses derived from a variety of theoretical models. The (often contradictory) results of these studies have implications for more than one theory. Empirical studies on the determinants of executive pay lack theoretical foundations and show a rather weak fit with the data (Mueller and Yun, 1997). Possible causes of the mixed results and different interpretations could be the use of different methodologies, different data sets, differences in the degrees to which the whole or parts of the pay mix are taken into account, or different definitions of the variables used (Agarwal, 1981; Ciscel and Carroll, 1980; Finkelstein and Boyd, 1998; Gomez-Mejia, 1994; Rosen, 1990; Schmidt and Fowler, 1996; Murphy, 1999). Nevertheless, scholars’ known biases and ideological orientation often serve as the best predictors of the findings presented (Gomez-Mejia, 1994; Gomez-Mejia and Wiseman, 1997). With the help of two main pay-determinants, firm size and performance, the problems of interpreting empirical evidence and developing theory are illustrated. These problems furthermore indicate

the complexity of explaining and legitimizing executive pay based on a single theory or approach. Barkerma and Gomez-Mejia (1998) have for instance argued that studies on executive pay are heading into a “blind alley” because of a single focus on agency theory. For more complete overviews of determinants of executive pay see, for instance, Murphy (1999), and especially Gomez-Mejia and Wiseman (1997). A distinction between streams of empirical studies is made by Rajagopalan (1996). He has made a distinction between 3 streams: 1) studies that focus on the link between firm strategy and pay, 2) studies that focus on the performance implications of a possible link between strategy and pay, and 3) studies that solely focus on performance-pay relationships.

Most, if not all, empirical studies find a (strong) positive relationship between firm size or firm growth and executive pay (changes) (see Tosi, Werner, Katz and Gomez-Mejia, 2000 for an overview of studies). As discussed above the interpretations of these linkages provide evidence for more than one theory. Interpretation of this result may provide evidence that pay is linked to a wider span of control, added complexities of the job, higher status, increased responsibilities, higher expectations of managing a bigger firm, and increased discretion over firm resources. It could indicate that managing bigger firms requires higher valued human capital. But also, top executives are employed in larger firms where the marginal productivity of their actions is greatly magnified over the many people below them to whom they are linked (Rosen, 1990). Moreover, interpretations of a strong link between firm size or growth and executive pay provides also support for theoretical arguments that bigger firms are better able to afford fixed cost expenditures than smaller firms, that managing more resources can provide the possibility or (socially constructed) expectation for larger firms to pay more, that firms have the ability to set premiums above market levels, and that executives can transfer their pay at risk towards a determinant that is more under their control (e.g. increasing firm size by mergers and acquisitions) and less on determinants out of their direct control (e.g. firm performance) (see e.g. Balkin and Gomez-Mejia, 1987; 1990).

The large number of studies on pay-performance relationships further illustrates the complexity of and problems for theory development when interpreting empirical results. Although most theories do not assume a priori a (strong) relationship between executive pay and performance, one of the most studied relationships is this exact link (e.g. Barkerma and Gomez-Mejia, 1998; Gomez-Mejia, 1994; Gomez-Mejia and



Wiseman, 1997). The outcomes of these studies show mixed results, and range from finding no relationships or weak relationships, to finding strong positive and negative significant relationships (for an extensive overview and references to other studies see Tosi, Werner, Katz, and Gomez-Mejia, 2000). Early studies from Taussig and Barker (1925) and Baker (1939) have already indicated that the link between pay and performance is weak, but is stronger for relatively smaller firms. More recent, Jensen and Murphy (1990b) have shown that executive wealth, measured as total pay including options and shareholdings, changes by \$3.25 for every \$1000 change in shareholder wealth (measured as shareholder return). Every \$1000 change in shareholder wealth leads to about \$0.02 increase in salary and cash bonuses. Changes in executives' wealth are also found to be larger for smaller firms than for bigger firms. Jensen and Murphy (1990b) report that per \$1000 change in shareholder wealth, executive wealth changes by \$1.85 for large firms. In smaller firms executive wealth changes with \$8.05 per \$1000 change in shareholder wealth.<sup>4</sup> Meta analyses from over 40 different studies that investigate pay-performance relationships show that firm performance explains less than 5% of the variance in executive pay levels. Changes in performance explain about 4% of changes in pay (Tosi, Werner, Katz, and, Gomez-Mejia, 2000). In contrast Tosi, Werner, Katz and, Gomez-Mejia (2000) find that firm size explains 40% of pay levels and that firm growth explains about 5% of pay changes.

Drawing conclusions and judging the strength of a pay-performance link is, however, problematic because it is not always clear whether scholars analyze the theoretically fundamental differences between relating pay levels with performance levels or changes in pay with changes in performance (Conyon, Gregg, and Machin, 1995; Benito and Conyon, 1999). Overall, however, the general consensus seems to be that pay-performance relationships are not very strong (see also Gerhart and Milkovich, 1990; Conyon, Gregg, and Machin, 1995; Gomez-Mejia and Wiseman, 1997; Murphy, 1999).

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<sup>4</sup> Jensen & Murphy (1990b) define large and small firms by market values above or below the median value of their sample, which is respectively above or below \$1.2 billion.

The empirical question whether or not executive pay is related to performance is straightforward at first sight. However, it actually is highly complex. The wide variety of possible variables to capture firm performance (e.g. Tosi, Werner, Katz, and Gomez-Mejia, 2000) and the lack of theoretical clarity regarding the right measurement of performance (e.g. Conyon, Gregg and Machin, 1995; Gomez-Mejia and Wisemen, 1997; Schmidt and Fowler, 1990) make it a very complex question. Adding to the complexity are questions around the implications of different relationships between pay and market based, accounting based, and economic value added measures (e.g. Core, Guay, and Verrecchia, 2003; Fatemi, Desai, and Katz, 2003; Lambert and Larcker, 1987); implications from relationships with non-financial measures (e.g. Davila and Venkatachalam, 2004; Ittner and Larcker, 1998; Ittner, Larcker, and Meyer, 1997; Srinivasan, Sayrak, and Nagarajan, 2004); implications when analyzing different time frames (e.g. Boschen and Smith, 1995; Gomez-Mejia and Wiseman, 1997; Hayes and Schaefer, 2000); relative performance indicators between firms (e.g. influence from industry performance) (Coles, McWilliams, and Sen, 2001; Garvey and Milbourn, 2003; Gibbons and Murphy, 1990; Porac, Wade, and Pollock, 1999); relative performance evaluations between executives (Bushman, Indjejikian, and Smith, 1996; Main, O'Reilly, and Wade, 1993; Prendergast and Topel, 1993) and whether to measure performance evaluations objectively or subjectively (Gomez-Mejia and Wisemen, 1997; Jensen and Murphy, 2004; Prendergast and Topel, 1993).

Problems arise on how the effects of all these facets should be interpreted. Although not all of the above discussed theories explicitly hypothesize a (strong) relationship between pay and performance, especially in cases where pay rises and where firms show bad performance results or have to downsize, it seems to be a matter of fairness that pay is related to performance (for discussions see Gomez-Mejia, 1994; Jensen and Murphy, 2004; and Murphy, 1997). Moreover, pay-performance relationships seem to play at least a background role in most theories. This leads to discussions on the interpretation of the overall weak relationships and theory developments. The weak relationships could indicate that pay-performance linkages are too weak to support theories that hypothesize some form of a pay-performance relationship or arguments of incentive alignments between principals and agents (e.g. Jensen and Murphy, 1990b). On the other hand, it is argued that although a relationship might be weak, it at least exists and therefore could be interpreted as

efficient and could show support for incentive (alignment) arguments (e.g. Gomez-Mejia, 1994; Gomez-Mejia and Wiseman, 1997). Nevertheless, disputes remain on whether or not executive pay provides incentives to trigger efficient management behavior (Rosen, 1990).

Providing insights into the determinants of executive pay is a highly complex matter. Moreover, the results of empirical studies are interpreted in various ways. Despite all possible different interpretations of empirical results and the both contradictory and overlapping theoretical approaches, some progress seems to have been made over the years. This progress is discussed in the next section.

#### **2.4 Towards an institutional managerial power theory**

Although the theoretical (behavioral) assumptions of the theories are at times fundamentally different, the implications of the different theories provide more insights than each theory would provide on its own. The first approach shows that markets and economic reasoning could form a solid basis for explaining executive pay. Based on assumptions of economic actors and transactions embedded in markets and pricing mechanisms the approach indicates that markets do play a role in finding explanations for executive pay. However, markets do not determine executive pay, but can only inform the actors who are involved in the decision making process. What is important is the notion that corporate governance problems also exist in perfect market conditions. When addressing corporate governance problems, the firm's black box has to be opened up. The agency approach indicates that pay arrangements are made in a certain context of relative balance of power within and outside the firm. Especially this approach points out the important (power) relationships between shareholders and managers. The third approach, the symbolic approach, addresses more the social context in which decisions on executive pay are made. Although these decisions are possibly influenced by market forces, the role, status and expectations towards executives and the pay that reflects this provide additional insights into the way executives and others can play out their discretion to make decisions on executive pay. Perception of expectation, status, and the role executives play provides executives with additional discretion to legitimize their own pay and that of others even when constrained by market forces.

A recent development in the so far blurred sketched status of the literature is the growing notion that studies that consider executive pay solely as a “tool” that provides (the right) incentives have been shown to be inconstant with theory and with each other (Tosi, Werner, Katz, and Gomez-Mejia, 2000). Views that consider executive pay as a “tool” have lost ground because they have to admit that executives have discretion in negotiating their own pay arrangements (Bratton, 2005). This seems to have led even former prominent proponents of this view to reconsider their views and shift in the direction of considering executive pay as an outcome of practices developed by the interactions of different corporate governance mechanisms. Jensen and Murphy (2004) are among these former prominent proponents who nowadays argue in this direction. The apparent recent consensus of viewing executive pay as an outcome of pay setting practices further deepens and fuels the idea of socially constructed corporate governance arrangements that influence pay levels and makeup. Although the apparent recent consensus indicates that the time seems ripe to formulate an integrated framework, attempts to integrate different approaches are not new. Previous frameworks are, for instance, from Barkema and Gomez-Mejia (1998), Finkelstein and Hambrick (1988), and Gomez-Mejia and Wiseman (1997). Based partly on their insights I propose a new framework.

The framework (Figure 1) takes an institutional approach rooted in “the logic of appropriateness” (Cyert and March, 1963/1992). The framework as discussed below is based on the notion that any attempt to explain what is truly going on in the world of executive pay should be more focused on all mechanisms, all of “the nuts and bolts” (Elster, 1989) that actually shape executive pay. As Elster argues “[E]xplaining events is logically prior to explaining facts” (1989:3).<sup>5</sup> What is meant here is that explaining the pay setting process is logically prior to explaining pay itself.

Many of the above-discussed theories are grounded in neoclassical economic thinking and consider human decision making to be based on “the logic of consequence” (Cyert and March, 1963/1992).<sup>6</sup> Neoclassical economic theory in

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<sup>5</sup> Elster defines a fact as “a temporal snapshot of a stream of events, or a pile of such snapshots” (1989: 3). Events according to Elster are “individual human actions, including mental acts such as belief formation” Elster (1989: 3).

<sup>6</sup> Hodgson’s definition of neoclassical economics is “an approach which (1) assumes rational, maximizing behavior by agents with given and stable preference functions, (2) focus on attained, or movements toward, equilibrium states, and (3) excludes chronic information problems” (1998: 169).

general considers the firm as a form of coordination systems that influence resource allocation and focuses mainly on transactions and contracting embedded in price and market mechanisms (cf. Augier, Kreiner, and March, 2000; Coase, 1988; Kay, 2000; Simon, 1991). Many of the theories addressed above consider actors to pursue self-interests and to be constrained or facilitated by similar rational pursuits of self-interests by others (cf. Cyert and March, 1963/1992). According to the logic of consequence, decisions are rooted in rational, calculative, anticipatory, and consequential actions (Cyert and March, 1963/1992). Decisions are made on the basis of their evaluated “alternatives in terms of the values of their consequences” (Cyert and March, 1963/1992: 230).

In contrast, the view further developed here is that executive pay is an outcome of institutionally determined conditions. An institutional approach brings pricing and market mechanisms “under the jurisdiction of institutional meanings and controls” (Meyer and Rowan, 1977: 351). The logic on which decisions are based is one that follows the logics “of appropriateness, obligation, identity, duty and rules” (Cyert and March, 1963/1992: 230). Human behavior is significantly constrained by the cost and availability of appropriate information and other (physical) means, such as awareness, comprehension and recognition, to make “explicit and timely calculations of optimality” (Cyert and March, 1963/1992: 214; Jepperson, 1991). Human behavior is assumed not to be purely based on “deliberation” or “computation,” but to also be grounded on learning and belief formation. Decision making processes also follow rules of thumb and other cognitive decision rules that make behavior more “habitual” or “reflexive” (see Cyert and March, 1963/1992; Hodgson, 1988; March and Olson, 1984; Meyer and Rowan, 1997). Decisions and the setting of goals and targets are intended to be considered sequentially, rather than simultaneously (Cyert and March, 1963/1992). Firms are seen as institutions themselves that co-evolve with other institutions. Firms are thus not only influenced by institutions, but are also influencing other institutions themselves (e.g. Cyert and March, 1963/1992; Jepperson, 1991; North, 1990; Pfeffer and Salancik, 1978/2003; Powell and DiMaggio, 1991; Scott, 2001). In this respect corporate governance problems, and also the problem of setting pay, are considered to be problems of social action (cf. Becht, Bolton, and Roëll, 2002; Davis and Thompson, 1994; Guilén, 2000b;). “[S]ocial action is embedded in social structures that influence whether, when, and how collective action is accomplished by interest groups” (Davis and Thompson, 1994: 141).

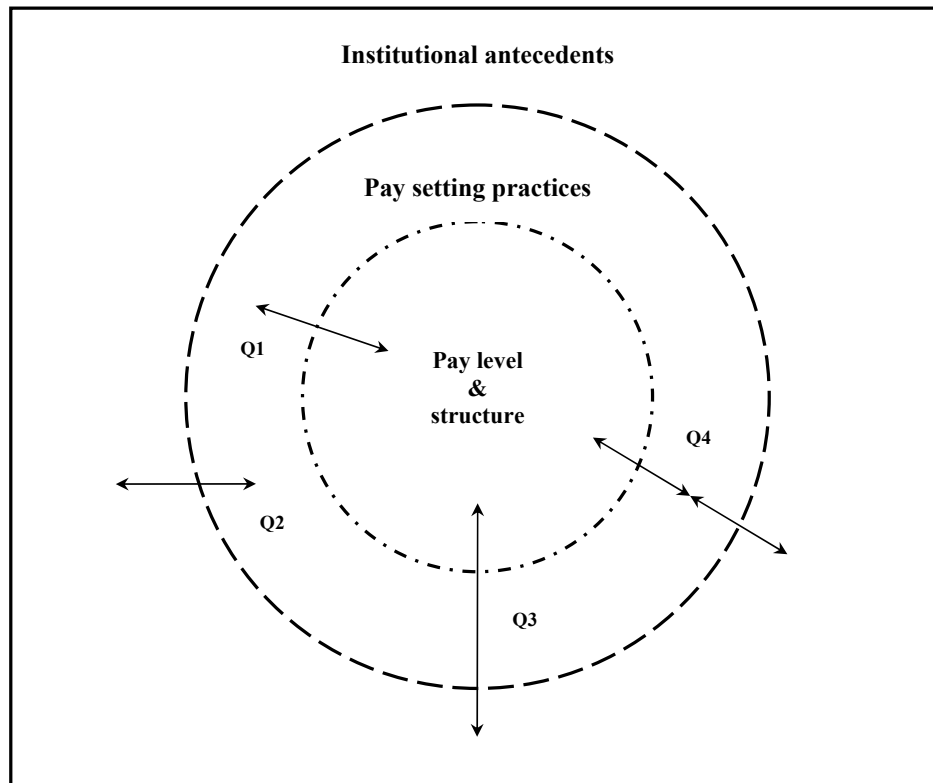
In this case, the elemental question of how executive pay is set not only entails the question what the determinants of pay are (e.g. firm size and performance), but addresses much more. It also addresses the question of what influences pay and pay setting practices. It is because of the logical existence of the previous event of setting pay that these institutions should be included in any attempt to explain executive pay (cf. Elster, 1989). Thus, explaining executive pay setting practices cannot logically go without being embedded in a broader discussion of socially determined corporate governance arrangements.<sup>7</sup> The guiding idea is that when considering executive pay as an outcome of corporate governance arrangements, ample room must be provided for the social makeup of these arrangements and the institutional conditions in which decisions on pay are made.

Figure 2.1 schematically reflects this theoretical approach of the pay setting process. As will be further discussed below, institutional antecedents refer to the institutional arena in which pay setting practices are embedded. Pay setting practices refer to those firm level processes that serve to set, compare, and implement pay levels and structures. The arrows reflect possible future research questions about the relationships between institutional antecedents, pay setting practices, and pay levels and structures.

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<sup>7</sup> “To explain an event is to give an account why it happened. Usually, and always ultimately, this takes the form of citing an earlier event as the cause of the event we want to explain, together with some account of the causal mechanism connecting the two events” (Elster, 1989: 3).

**Figure 2.1** *A theoretical framework of explaining executive pay*



Most attention in the executive pay literature regarding determinants of pay levels and structures has been given to firm level and executive characteristics. Also, corporate governance mechanisms are considered as antecedent variables that influence pay and receive certain weights when deciding on pay levels and makeup (see for overviews e.g. Gomez-Mejia and Wiseman, 1997; Murphy, 1999). Examples are boards of directors' compositions, board committees as remuneration and nominating committees, firm size (or growth), firm performance, firm strategy, industry, firm ownership structures, and age and experience of the executives. The process of attributing the relative weights to these antecedents in determining executive pay levels and structure are what I refer to as pay setting practice. Pay setting practices are those firm level processes that serve to set, compare, and implement pay levels and

structures. The outcome of these pay setting practices result in certain weights attributed to firm and executive level antecedents of executive pay and result in certain pay levels and compositions. Based on past research many firm level and executive level antecedents are already known.

What is, however, less known is how pay practices operate (for an extensive overview see Gomez-Mejia and Wiseman, 1997). Questions that still remain are, for instance, how the interaction of mechanisms function and how decision makers ultimately decide on pay levels and structures. An example of what is meant here can be found in Finkelstein and D'Aveni's (1994) model of interactions and moderating effects on the implications of CEO duality. They argue that vigilance boards balance the implications from overt monitoring and incentives by combining firm characteristics (e.g. executive informal power, firm performance, strategy and size) to implement CEO duality. Similarly for executive pay, relatively less is known about how the interaction of corporate governance mechanisms and firm and executive characteristics interact and possibly have moderating effects in determining pay levels and pay structures. Although the determinants seem to be well documented, knowledge on how they interact and what their possible moderating effects are has received less attention. A possible area for future research (Q1 in figure 2.1) is to investigate how the interaction and possible moderating effects of firm level antecedents (mechanisms as well as firm level and executive level determinants) (co-) determine pay levels and structures. This research question could be formulated as:

*Q1 What are the implications from the moderating effects of firm level corporate governance mechanisms, firm level determinants, and executive characteristics for executive pay levels and makeup?*

The comparative corporate governance literature looks towards the institutional environment for possible explanations for differences in corporate governance arrangements at national levels. When considering executive pay as an outcome of pay setting practices that are part of more broadly defined corporate governance arrangements, it becomes apparent how institutions could influence pay practices and thereby indirectly influence pay (Q2 in figure 2.1), and also how they could influence pay directly (Q3 in figure 2.1). The roles, effectiveness and possible changes in



developing and maintaining corporate governance arrangements are deeply rooted in society through, for instance, corporate law, codes of conduct, stock exchange regulation, political orientation, and national culture, and thus through social needs, wants and acceptance of these arrangements (cf. Perkins and Hendry, 2005). The relative (shifts in) balance of power between the actors involved and the ability to game the system can help maintain or develop new corporate governance mechanisms and help determine different operating processes for these mechanisms. Formalizing these mechanisms and operations in, for instance, formal rules and procedures requires judgments of their applications in society (Perkins and Hendry, 2005; see also the works of e.g. Davis and Thompson, 1994; Gordon and Roe, 2004; Guilén, 2000a; 2000b; Hansmann, 1996; La Porta et al., 1997; Rajan and Zingales, 2003; Roe, 2003; Tosi and Greckhamer, 2004, which address the institutional embeddedness of corporate governance and corporate governance outcomes and arrangements).

The *institutional antecedents* in figure 2.1 refer to the socially constructed arena in which decision makers decide upon standards of pay setting practices. Markets in certain institutional environments may operate more effectively than in others, possibly requiring other corporate governance mechanisms and pay setting practices to aim for forms of economic efficiency, resource allocations, or conditions of social peace (cf. North, 1990; Roe, 2003; Williamson, 1985). The institutional antecedents not only refer to circumstances and actions based on more explicit consequential intended implications, but also on learning and belief formation about formal and informal norms, values, symbols, expectations, and rules of thumb (e.g. Cyert and March, 1963/1992; Hodgson, 1988; Jepperson, 1991; March and Olson, 1984; Scott, 2001). On a comprehensive level, an institution refers to a certain form of “a rule enforcing mechanism” (Elster 1989: 147). What is meant here is that not only tangible institutions are of importance but also intangible institutions. The difference is between circumstance based more on intended consequential implications such as actions that are more deliberate, conscious or anticipated, such as the institutional arena of which having a democracy or a stock exchange watchdog could be part, and circumstances and actions based on behavior that is more “habitual” or “reflexive” (Hodgson, 1988), such as the institutional arena of which a certain culture and certain social belief formation about expectations, norms and values are part (cf. Jepperson, 1991). Following Jepperson, “all institutions simultaneously empower and control” (1991: 146), implying that institutions not only influence social stability, but also

influence instability. Institutions provide the possibility to facilitate decision making in the sense that they make decisions possible that are more altruistic but also more self-interested and opportunistic. These decisions may either be appropriate or inappropriate, given the actor's perception and notion of available means to make decisions (cf. Jepperson, 1991).

The comparative corporate governance literature addresses how institutions shape certain corporate governance arrangements at national levels (see e.g. Djankov, La Porta, Lopez-de-Silanes, and Shleifer, 2005; La Porta, Lopez-de-Silanes, and Shleifer, 1999; Roe, 2003). Some of the investigated arrangements also refer to corporate governance arrangements that form pay setting practices. However, little is known about their specific influence on pay. Extending on the comparative corporate governance literature, research questions (Q2 in figure 2.1) could ask how and which configurations of institutions shape executive pay setting practices.

*Q2 Which effects do institutional configurations have on firm level mechanisms that serve to set, compare, and implement executive pay levels and structures?*

Institutional configurations indirectly influence executive pay levels and structures as indicated by research question Q2. In short, institutions shape the makeup of pay setting practices and by that they indirectly influence pay levels and makeup. Question Q2 is aimed at identifying the institutional configurations that influence the pay setting process.

Another possibility is to look at the direct effects of institutions on executive pay. Although some studies have made an effort in linking institutions directly with executive pay, little attention has been paid to the relevance of an institutional makeup (exceptions are e.g. the cross-country studies by Abowd and Bogananno, 1995; Tosi and Greckhamer, 2004). Extending on this, the research question that can be asked is:

*Q3 Which direct effects do institutional configurations have on executive pay levels and makeup?*

On one hand, institutions do play a role in shaping pay setting practices and subsequently pay levels and makeup. The institutional embeddedness of corporate governance mechanisms that determine executive pay practices can differ from country to country. For instance societies acknowledged to be more socially orientated such as Sweden and Germany provide the (legal) possibility for labor representatives to participate more explicitly on boards of directors. The makeup of the institutional embeddedness can thus influence the development and maintenance of corporate governance mechanisms and subsequently influence the firm level mechanisms and processes that serve to set, compare, and implement pay levels and structures. On the other hand (question Q3), institutional makeup could influence pay levels and structures directly. For instance, law restriction regarding certain pay components, taxes, insider trading regulations or social norms about acceptable proportionality between average workers' pay and executive pay could directly affect pay levels and makeup.

Most likely because of the unavailability of data across countries, very little is known about, on the one hand, the interactions between institutions and pay setting practices, and on the other hand, insights into the direct effects of institutions on pay levels and makeup. The worldwide development of corporate governance reforms and the increased attention for disclosure regulations of pay in these reforms indicate that more research can now be done on the topics raised in research questions Q2 and Q3.

A more far-reaching research question is, however, the integration of Q2 and Q3. Comparative corporate governance focuses on the extent to which conditions at national levels differ. The insights could be applied to those corporate governance arrangements that relate to pay setting (Q2) and to pay levels and makeup (Q3). However, it is important to note that the comparative corporate governance literature often neglects the possible within country variance of corporate governance arrangements. Consequently, the variance of firm level corporate governance arrangements and outcomes (i.e. variety and diversity at the micro level) are not considered to have any influence on institutions or be influenced by institutions themselves (i.e. regularities at the system level: see Hodgson, 1988).

The executive pay literature on the other hand focuses mainly on within country variance of pay arrangements and generalizes conclusions across institutional environments. Thus, the variance of corporate governance arrangements across institutional contexts are neglected. Although extending institutional implications may cause explanations to lean on idiosyncratic explanations of executive pay across different societies (Gomez-Mejia, Wiseman, and Dykes, 2005), the institutional implications could also provide much-needed additional insights into how corporate governance and pay setting practices operate across countries (cf. Aquilera and Jackson, 2003; Tosi and Greckhamer, 2004). The problem becomes especially apparent when considering that most empirical research on executive pay uses US data and that generalizations of the conclusion imply that the US example is the worldwide standard. However, well-known variances between countries of pay levels and makeup indicate that the US case is more of an outlier than the worldwide standard (see e.g. Abowd and Bogananno, 1995; Conyon and Murphy, 2000; Murphy, 1999; Kaplan, 1994 for examples of large cross-country differences in pay levels and makeup).

Pay setting practices and the balance of actors' powers that can influence pay setting processes differ across countries and across firms. The mandatory employee representation on the board of large listed German firms is, for instance, different from the US and the UK where employees are not represented on boards. These in turn are different from Sweden and France, where some firms do have employees on the board and others do not. When considering executive pay as an outcome of pay setting practices, differences in institutions in which these practices are embedded and the possible variance between firms under the same institutional conditions, are highly relevant for efforts made to legitimize and generalize explanations of executive pay. Some corporate governance mechanisms can exist in some countries and firms but may not exist in others. Differences in institutional makeup can cause a variation in the weights attributed to antecedent variables of executive pay levels and structures. What is most often overlooked in the executive pay literature is the risk of "under socialization" (Granovetter, 1985) when legitimizing and explaining executive pay based upon only one institutional setting. Insights into configurations of different institutions and the interactions of different firm level practices could therefore contribute to our general understanding of executive pay in an international context.

Past research has tried to answer parts of the research questions. Q1 and, to lesser extents, Q2 and Q3 have received some attention in the executive pay literature and the comparative corporate governance literature. A comprehensive theory of explaining and hereby legitimizing executive pay, however, would capture all 3 questions. In order to generalize and explain (the lack of) variance in the weights attributed to antecedent variables of executive pay, we are reliant on the institutional matrix in which decisions on pay are made. The growing inclination from theory development on executive pay and the recent consensus in theorizing explanations of executive pay point towards the importance of the discretion that executives have to influence pay setting practices and their pay levels and structures. Based on the inclination from the comparative corporate governance literature, this discretion is influenced by the institutional makeup in which the pay setting practices in particular and corporate governance arrangements in general are embedded. Promising legitimizations for executive pay and provisions of more conclusive explanations thus lie in a focus on the institutionally determined relative balance of executives' discretion over pay setting practices. The most far-reaching future research question could be formulated as:

*Q4 What are the effects of configurations of institutions on pay setting practices and how do these institutional configurations and pay setting practices translate into pay levels and makeup?*

## **2.5 Conclusion**

The review presented here has addressed 16 different theories. Classifying these theories is problematic. The different theories are overlapping and contradictory at the same time. The theories are also at risk of being oversimplified. Even so, based on the underlying main legitimizing arguments of the theories, an assessment is made of their usefulness for explaining executive pay levels and makeup. The differences in the theories with regard to their focuses for legitimizing arguments and the roles they give to pay resulted in a classification of 3 approaches; 1) the value approach, 2) the agency approach, and 3) the symbolic approach. The focuses of these approaches are regarding questions of how much to pay, how to pay, and what pay ought to represent, respectively.

The value approach main arguments for legitimizing executive pay are based upon market mechanisms and market forces. The main contribution of this value approach is the insight it provides into how economic theory can contribute to a general understanding of markets and market inefficiencies in determining executive pay. This approach is, however, less capable of providing irrefutable explanations for executive pay when addressing the question how decisions on pay are made. The value approach is incapable of providing explanations regarding questions around actual decisions on executive pay within a framework of corporate governance that at the same time address how corporate governance arrangements are organized within and outside firms.

The theories that comprise the agency approach, clearly indicate the importance of corporate governance arrangements at national and firm levels even under perfect market conditions. Governance problems such as problems of agency, (ex-post) bargaining over (quasi-) rents and governing transactions indicate the need for corporate governance mechanisms. However, the complete contracting view of the firm is too narrow and result in the inability to raise questions about the centralized institutional configurations in which any contract is made up. A power based view, one of the two sub-streams in the agency approach, indicates that power relationships between the actors involved influence both the pay setting practices and their outcomes. This approach, however, still mainly considers the firm as a nexus of contracts. This in turn results in a conceptual problem regarding questions about the hierarchical structure of firms and the implications for corporate governance

arrangements. According to the agency approach, explaining and hereby legitimizing executive pay is based on 1) the implication that executive pay is subject to risks and 2) possible discretionary powers of the actors involved.

The symbolic approach provides additional insights into the concept of pay as a social phenomenon. Decisions on pay in this approach are based on an institutional approach that appreciates the logic of appropriateness. The symbol of certain pay levels and structures reflects the contextual role of an executive in the firm or in society. At the same time, and possibly also problematic within this approach, is the normative inclined social construction of pay levels and makeup. The normative inclinations in this approach point out the problems of legitimizing executive pay in practice. Nevertheless, economic arguments play a background role in these theories. The legitimization of executive pay in this approach is based on arguments that address socially (or social-economically) normative constructed beliefs. The symbols that pay represents reflect the social belief of what is “appropriate” to pay an executive and what the executive role constitutes.

To be able to do justice to the many implications and different conditions in which executive pay is set, purely economic theories, such as those in the value approach and the dominant perfect contracting approach of agency theory, fall short in providing conclusive explanations. Executive pay is not simply the end result of market forces and is not simply a tool to align interests between shareholders and managers. Observing executive pay means observing the fundamental governance processes in an organization (Hambrick and Finkelstein, 1995). It is an outcome of complex corporate governance systems that carries highly important informational values not only for executives and shareholders but also for lower level employees, executives outside the organization, and other parties involved in corporate governance. It not only provides signals about the functioning of governance processes within an organization, but also about the institutional conditions in which these processes are developed, employed and contested.

Mistakenly often overlooked in the executive pay literature, and especially in empirical studies, is the notion that institutions influence and are influenced by decisions on executive pay. Based on an institutional approach, which is rooted in the logic of appropriateness, I argue that executive pay is an outcome of pay setting practices. Pay setting practices, those firm level processes that serve to set, compare,

and implement pay levels and structures, can differ from firm to firm and from country to country. Social configurations of tangible and intangible institutions are argued to co-determine corporate governance arrangements in which pay setting practices play a central role. The introduced framework enables the contextual importance of corporate governance arrangements to be addressed. This framework captures the revealed consensus in the literature that executive pay is an outcome of institutionally evolved corporate governance arrangements, rather than a tool within these arrangements. The comparative corporate governance literature suggests that the relative balance of power in society determines the configuration of institutions that influence how corporate governance arrangements function and how they develop. The development of reaching a consensus in theorizing explanations on executive pay furthermore points out that executives have discretion over their pay setting practices and can influence their pay levels and structures. This leads me to argue that the most important question for future research is to assess how executives across firms can play out their discretion under conditions of different configurations of institutions that shape those corporate governance arrangements that set, compare, and implement their pay.



**Chapter 3**  
***Extending the managerial power theory of executive pay:***  
***A cross-national test***

**3.1 Introduction**

Executive pay levels and structures differ greatly within and across national contexts (Abowd and Bognanno, 1995; Conyon and Murphy, 2000; Kaplan, 1994; Tosi and Greckhamer, 2004; Zhou, 1999). These differences do not seem to disappear over time and still seem to exist after controlling for known firm-level indicators of executive pay, such as firm size, performance, and executives' human capital (cf. Abowd and Bognanno, 1995; Conyon and Murphy, 2000; Tosi et al., 2000). Apparently, to understand the drivers of executive pay across national settings, our theoretical nets need to be cast across a wider area than most received accounts of executive pay have so far suggested. The research presented in the current chapter, therefore, shift the focus away from the traditional principal agency explanation of pay (cf. Hall and Liebman, 1998; Hall and Murphy, 2003; Jensen and Murphy, 1990b; Murphy, 1999, 2002), in which executive pay is considered as a “tool” within an arm's length contracting process between a company's professional managers and the designated representatives of its owners, i.e. either the board of directors as a whole or its remuneration committee.

Instead of the traditional agency theory, an account based on managerial power theory is put forward. As has been proposed by others, and seems to be heading towards a recently achieved consensus in the literature, executive pay should be considered as an outcome of pay setting processes that are mediated by the level of discretion of the actors involved (cf. Bebchuk and Fried, 2004; 2006; Bebchuk, Fried, and Walker, 2002; Bebchuk and Grinstein, 2005; Core, Holthausen, and Larcker, 1999; Finkelstein and Boyd, 1998; Finkelstein and Hambrick, 1989; Grabke-Rundell and Gomez-Mejia, 2002; Hallock, 1997; Jensen and Murphy, 2004; Tosi and Gomez-Mejia, 1989; Useem, 1996; Westphal and Zajac, 1995, chapter 2). For an understanding of the make-up of executive pay levels and structures, managerial power theory suggests that we look beyond the stylized accounts provided by the economic models of considering executive pay merely as a tool to align the interests between firm owners and executives. Instead, we should turn our attention to the actual conditions under which pay is set. These conditions are explained in two steps.

First, conventional managerial power theory is followed in order to predict that certain company-level corporate governance features give CEOs and other executives considerable discretion over the pay setting process, enabling them to manipulate it in their favor of relatively less pay at risk, and to extract greater pay from the corporations they lead. Specifically, the focus is on five executive-empowering/limiting corporate governance features: CEO/Chair duality, single-tiered boards, the proportion of executives to non-executives on a board, employee representation on boards, and the number of non-executives on a board. Since conventional managerial theory has thus far mainly been tested in the US, the first research question addressed here is whether its predictions can be generalized across a considerably broader cross-national sample.

Second, efforts are made to extend the theory by hypothesizing how certain features of the institutional environment in which the firm is incorporated can further increase (or decrease) executive discretion over the pay setting process. Relevant influences on executive control over pay setting processes emanate from the legal (La Porta et al., 1997), political (Roe, 2003), economic (Rajan and Zingales, 2003), social environments such as culture (Tosi and Greckhamer, 2004), and news media (Core, Guay, and Larcker, 2005; Dyck and Zingales, 2002; 2004). The second research question, to what extent managerial discretion over the pay setting process is

contingent upon forces emanating from national institutional contexts, will be tested by taking a broad range of these institutional indicators into account.

The theoretical intuitions concerning the role of managerial power in the pay setting process are tested on a primary data set of 3880 pay levels and 1195 pay structures, representing 940 firm-year observations from 17 countries. Results indicate that a significant portion of the within-country variance in executive pay levels and structures is indeed explained by structural corporate governance characteristics that give executives more or less discretion over the pay setting process. These results confirm earlier arguments put forward by, for instance, Bebchuk and Fried (2004). In this study, however, these are tested for the first time on a cross-national dataset that allows to simultaneously analyze within and between-country variance of pay arrangements. Furthermore, the results also indicate that firm-level corporate governance antecedents interact with the institutional contexts in which these are embedded. Cross-national differences in executive pay levels and structures thus seem to derive at least in part from a combination of firm and country-level factors that allow executives to exert discretion over the process by which their pay is set. These results remain intact when other relevant firm-level variables, like size and performance, and country-level variables, like per capita income and personal and corporate tax levels, are controlled for.

The results indicate that managerial power theory can be generalized across institutional contexts. However, predictions, conclusions, and policy implications based on this theory are highly reliant on contextual conditions. This does not disconfirm the theory; it merely shows that when applying the theory extensions need to be able to make predictions that are powerful enough to deal with these highly important contextual conditions.

The chapter is structured as follows. First, both the complete contracting and managerial power theories are discussed (section 3.2). After each theory is given, hypotheses are made on the generalizations of managerial power theory predictions across a considerably broader cross-national sample. Second, the managerial power approach is subject to further discussion, and hypotheses are made concerning the predictions of the theory when extended to an institutional context (section 3.3). Next, the dataset used to empirically test the hypotheses is discussed, followed by the results

of the analyses. The subsequent sections conclude and provide some implications of the results for both theory development and practice.

### **3.2 Theory and hypotheses**

The first step offers a discussion of the basics of “the official story” on executive pay (Bebchuk and Fried, 2004). This dominant approach in the literature is based on an agency framework, relies on optimal contract views, and considers pay as a tool to align interests between shareholders and management. Pay is seen as a tool that comes with certain costs. These costs are reflected by the needed incentives (i.e. pay) to transfer the risks of possible deviations from the principals’ interests to the agent. Managerial power theory, which is discussed next, resembles the optimal contract approach rather closely. One major difference is that managerial power theory considers the discretion that pay setters and pay receivers have in the pay setting process itself. Discretion is in this theory not merely considered a cost but a real possible behavior (Grabke-Rundell and Gomez-Mejia, 2002). It does not see pay arrangements exclusively as a purpose to alleviate agency problems, but also as an outcome of the pay setting processes. After the discussion of the basic premises of the two theories, a first set of hypotheses is formulated.

#### **3.2.1 Optimal contracting theory**

How is executive pay determined? In the stylized world of agency theory, the answer is: through arm’s length contracting. In the traditional setup, the owners of a firm delegate the authority to make day-to-day operating decisions and long-term corporate policy to a set of competent professional managers (Shleifer and Vishny, 1997). One motivation for doing so is the fact that shareholders lack expertise in running firms on their own. Another reason, rooted in optimal portfolio theory (Fama, 1980), is that shareholders also lack the incentive to lead firms, as their investments are spread across numerous businesses in order to minimize risk. Considering the lack of information on managerial behaviors shareholders lack insight into managers’ minds, and it would thus be unwise for them to hand over all residual control rights to managers. Shareholders have therefore traditionally delegated the rights to hire, fire, and set pay policy for executives to a separate supervisor in the form of the corporate

board or the board's remuneration committee (Conyon and He, 2004). The latter bodies are assumed to act in the sole interest of shareholders.

The board or compensation committee will then engage in arm's length contracting with executives, in order to produce an implicit or explicit employment contract (Gillan, Hartzell, and Parrino, 2005). Executive employment contracts typically have a fixed duration and they stipulate terms of employment, such as salary, bonuses, and perquisites, such as pension advice, country club membership, and the use of the corporate jet (Rajan and Wulf, 2004; Schwab and Thomas, 2004; Yermack, 2005a; 2005b). The supervisor's responsibility is to draw up the best possible contract as seen from the shareholders' perspective – one that “maximizes the net expected economic value to shareholders after transaction costs (such as contracting costs) and payments to employees. An equivalent way of saying this is that [optimal] contracts minimize agency costs” (Core, Guay, and Larcker, 2003).

It is assumed that writing a good contract is hampered by myopia problems. Specifically, executives are motivated to advance their own interests above those of the shareholders they are supposed to serve (Jensen and Meckling, 1976). Intelligent supervisors will therefore make use of outcome based contracts serving as incentives, the value of which is contingent on performance, such as bonuses, stock options, restricted stock, and long-term contracts (Conyon, 2006). If all goes well, performance-contingent arrangements will motivate executives to work on shareholders' behalf. The outcome-based contract serves to transfer the risks of not adhering to the incentives to the risk-averse self-serving executive, with the result that his wealth will be diminished. The actual level of pay is based on the market value for which executives with applicable capabilities are willing to risk contracting themselves to a specific firm (cf. Jensen and Murphy, 1990b). In sum, the arm's length view of the pay setting process is “neat, tractable, and reassuring” (Bebchuk and Fried, 2006: 12).

### **3.2.2 Managerial power theory**

The problem with optimal contracting theory is that it hinges on two crucial assumptions. First, by presuming that misalignment of interests between pay setters and receivers is merely a cost, it effectively rules out that discretion is a real possible behavior (Grabke-Rundell and Gomez-Mejia, 2002). The theory assumes that

executives are not able to put their self-serving behavior to use in the contracting process itself. In other words, as argued by Bebchuk and Fried (2003) and Bebchuk, Fried, and Walker (2002), if a-priori executives are expected to make non-shareholder value maximizing decisions, which is the reason to write the outcome based contract in the first place, there is no reason to a-priori assume that executives make shareholder value maximization choices at all. Setting executive pay is thus an agency problem in itself, as the solution cannot be part of the same problem. Thus, setting pay is not a perfect means to an end in alleviating agency problems (Bebchuk and Fried, 2003; 2004; Bebchuk, Fried, and Walker, 2002).

Second, optimal contracting theory presumes that even though managers are self-serving and thus constantly on the lookout for ways to extract rents for personal gain, board members (i.e. non-executives) are presumed to be altruistic doves who always faithfully serve shareholders' interests. Managerial power theory differs from optimal contracting theory in that it challenges this assumption. As Bebchuk and Fried (2003, 2004, 2006) and others have argued there are no good reasons to believe that directors will automatically do everything in their power to serve the interests of shareholders. In fact, a more tenable position appears to be that directors' willingness to serve is contingent on whether their interests are more tightly linked with those of shareholders or management (Conyon and He, 2004). There are numerous good reasons for assuming that self-interested directors will in many cases side with the latter.

First, directors may collude with managers in order to get reelected. The nominal right to reelect directors may rest with shareholders, but in practice many of the director slates offered at annual meetings are the ones proposed by management (Bebchuk and Fried, 2006). Secondly, directors may adopt a generous attitude towards executives in the hope of receiving higher pay themselves. Prior empirical studies have shown that in companies with higher CEO compensation, directors get paid more too (Brick, Palmon, and Wald, 2006). Third, board members may not care about the economic consequences of high pay. Directors typically own only a small fraction of the firm's shares, which means that the economic cost of excessive compensation may be quite low for them (Bebchuk and Fried, 2004). Fourth, board members may simply be generous to the CEO because they are on a friendly terms (Daily, Johnson, Ellstrand, Dalton, 1998). Evidence of this cronyism exists in the form of studies showing that remuneration committees whose chairs were installed

after the appointment of the CEO tend to pay more than those for which this order is reversed (Main, O'Reilly, and Wade, 1995).

Needless to say, examples of how executives can use their discretion and how directors can collude with them are plentiful. Rather than elaborating on more examples and dwelling on conceptual concerns, the present chapter will focus on the pay setting process of executives, and not on the pay setting process of non-executives. The process of setting pay for non-executives and further investigation of how their discretion affects their pay and the pay of executives is left for future research. A similar approach to the one pursued here could provide more insights into non-executive discretion and non-executive pay. The general issue under investigation here is: which conditions mediate the discretion between pay setters (i.e. non-executives) and pay receivers (i.e. executives) in the pay setting process of executives? Like many others have already argued (e.g. Boyd, 1994; Conyon and Peck, 1998), possible answers must be sought in the area of governance, as weak governance empowers CEOs in particular and possibly also executives vis-à-vis non-executives. There is certainly no lack of firm-level corporate governance mechanisms designed with the intention of limiting executives' power over boards. But the diffusion of these mechanisms should not be taken for granted, and even within one and the same jurisdictions the adoption of governance provisions can differ from company to company (Tosi and Gomez-Mejia, 1989).

### **3.3 Managerial power theory: Firm-level hypotheses**

This section formulates a number of hypotheses, consistent with received managerial power theory, on the influence of possible executive discretion over pay levels and structures. The underlying logic behind the formulated hypotheses is straightforward. More discretion on the part of the executives is expected to lead to higher pay levels, and to lower pay at risk. More discretion is expected to lead to higher pay, as it provides the executives with more leverage to serve their own interests of attaining higher levels of wealth. More discretion is expected to lead to lower pay at risk, i.e. in theory less performance contingent pay, as the executives are assumed to be risk averse and will thus negotiate higher fixed components as a proportion of total pay (i.e. higher salary as a proportion of total pay).

### **3.3.1 CEO/chair duality**

The first governance provision considered here, one that is known to weaken non-executives vis-à-vis executives, is CEO/Chair duality; a situation in which both functions of Chairman of the board and Chief Executive Officer are carried out by a single person (Boyd, 1994; 1995; Fama and Jensen, 1983). CEO duality plays two complementary roles in managerial power theory. First, it typically increases the CEO's discretionary powers over firm resources and is thereby taken by inside and outside stakeholders to reflect strong leadership (cf. Finkelstein and D'Aveni, 1994). As a significant and visible symbol, duality reinforces the CEO's "figurehead status" (Ungson and Steers, 1984). The figurehead CEO/Chair tends to present himself as the ulterior representative of the corporation, and typically seeks to underwrite this status and mandate with higher than average pay (Gomez-Mejia, 1994). Second, in a situation of duality, the CEO, as a leader of his fellow collaborating executives, is also the leader of the board, and can therefore command additional obedience and loyalty on behalf of those entities that are put in place to set executive pay (cf. Bebchuk and Fried, 2004). Duality therefore offers executives opportunities for increasing pay levels and manipulating pay structures to make them at least in theory less reliant on performance, i.e. to raise the proportion of executive fixed salary components over total pay. Formally stated as:

*Hypothesis 1a: Executive pay levels will be higher in firms where there is CEO/Chair duality.*

*Hypothesis 1b: The salary component of executives' pay will be larger in firms where there is CEO/Chair duality.*

### **3.3.2 One-tier boards**

Companies are either governed by a one-tiered or a two-tiered board. One-tier boards are composed of both executive and non-executive members, and may be chaired by a representative of either group. Typical for the single tier situation, and important for managerial power theory, is that the non-executives do not meet independently of the executives. Thus, even the non-executive members of the board are never completely out of the CEO's and other executives' sphere of influence (cf. Conyon and Peck, 1998). Two-tier boards, in contrast, have a first tier in the form of a supervisory body



composed exclusively of non-executive directors. The supervisory board mostly “appoints the members of the management board [i.e. the second tier], equivalent to the executive directors of a U.K. or U.S. [single tier] board, approves the annual accounts and the firm’s long-term strategy, and can intervene when there is a serious deterioration in the company’s fortunes” (Franks and Mayer, 2001: 952). It is of special interest to managerial power theory that even though the CEO is typically the chair of the management board, the CEO and his fellow executives are not members of the supervisory board and do not normally attend their meetings. One-tier boards thus offer executives greater opportunities for persuading non-executives to go along with higher salary levels and with less pay that is contingent on performance. This leads to the following hypotheses:

*Hypothesis 2a: Executive pay levels will be higher in firms with a one-tier board structure.*

*Hypothesis 2b: The salary component of the executive pay will be higher in firms with a one-tier board structure.*

### **3.3.3 Employee board representation**

The third set of 2 hypotheses concerns the representation of employees on the board, a governance mechanism that shows firms’ commitment to human capital and willingness to let lower level employees “codetermine” the fate of the organization. Employee board representation plays at least four constraining roles in limiting executive discretion. First, since employee representatives are not usually drawn from the inner circles of the corporate elite, certain social control processes that give executives greater influence over fellow elite members (such as long-standing friendships and the “shadow of the future” (Axelrod, 1984), imposed by external business ties and protection of the managerial class (Gomez-Mejia, 1994)), are rendered ineffective. In this sense, employee representatives are less likely to be co-opted by management than other directors. Second, in the case of employee representatives, firms allow a third residual claimant (in addition to management and shareholders) into the boardroom (Aguilera and Jackson, 2003) thus potentially lowering management’s “piece of the pie” and discretion over firm resources. Third, employees are more likely than other directors to have a keen eye for the

proportionality between executive pay and their own pay, and to object when the differences become socially unacceptable (cf. Simon, 1957). Fourth, due to their day-to-day relationships with management, employee representatives are in better positions than most directors to directly oversee executives' actions (Dow, 2003; Hansmann, 1996). Employee representations on the board thus result in lower managerial discretion, leading to the following hypotheses:

*Hypothesis 3a: Executive pay levels will be lower in firms with employee representation on the board.*

*Hypothesis 3b: The salary component of executive pay will be lower in firms with employee representation on the board.*

#### **3.3.4 Number of non-executives**

One governance characteristic that is often explored in terms of its implications for management monitoring is board size (Boyd, 1994; 1995). Here, in order to make the results comparable across the 17 countries in the sample, the number of non-executives on a one-tier board and the number of people on the supervisory board of a two-tier board represent the potential number of directors that monitor executives. Applying managerial power theory as addressed would suggest that more non-executives lead to more monitoring, thus leaving less discretion to executives. An additional counter explanation deriving from managerial power theory is that greater absolute numbers of the supervisors on a board could reduce the effectiveness of board monitoring and increase executive entrenchment due to problems of collective action (Conyon and Peck, 1998; Yermack, 1996). This effect is often tested on US and UK data, where it is likely to be stronger due to the smaller degree of independence of boards from management, which in turn is due to their one-tier board structures (Gedajlovic and Shapiro, 1998). It is found to support the view that bigger boards tend to pay more (Core, Halthausen and Larcker, 1999) and could be interpreted as evidence that bigger boards leave executives with more discretion.

On the other hand, Yermack (1996) found that smaller boards often tend to rely more heavily on incentive pay, possibly in order to compensate for their lack of monitoring ability (cf. Finkelstein and D'Aveni, 1994). This suggests that bigger boards are more capable of constraining executive discretion. Therefore, bigger

boards may want to avoid “overt monitoring” by providing too much incentives (Finkelstein and D’Aveni, 1994). The arguments indicate that executive discretion under conditions of bigger board size could go either way, and could still fit more or less within a managerial power view. It could be that interpretations of theoretical concepts such as overt monitoring and problems of collective action are biased by generalizing the empirical results based on single country data that reflect only one-tier board structures. Interpreting previous results could thus be biased by generalizing the results from these “special cases” of one-tier board structures. Because it is here that for the first time managerial power theory is subject of a cross-national sample, comprised of both two-tier and one-tier board structures “standard” managerial power theory is followed. The expectation is that a higher number of non-executives is, at least potentially, better in constraining executive discretion. Thus:

*Hypothesis 4a: Executive pay levels will be lower with more non-executives on the board.*

*Hypothesis 4b: The salary component of the CEO’s pay will be lower with more non-executives on the board.*

### **3.3.5 Proportion of executives/non-executives**

A similar argumentation can be used to hypothesize relationships with the board structure variable proportion of executives to non-executives and executive pay. Previous empirical results are mixed, ranging from no relationship to positive and negative relationships, with pay and board structure variables like the proportion of executives to non-executives, proportion of inside to outside directors on the board, and the composition of remuneration committees (Carpenter and Sanders, 2002; Conyon and Peck, 1998; Core, Halthausen and Larcker, 1999; David, Kochhar, and Levitas, 1998; Sanders and Carpenter, 1998; Daily, Johnson, Ellstrand, and Dalton 1998). Making the conceptually challenging assumption as argued in section 3.2, i.e. that non-executives are truly altruistic doves and are truly independent and live up to their fiduciary duties, implies that the presence of more non-executives in proportion to executives will lower managerial discretion (cf. Conyon and Peck, 1998; Fama and Jensen, 1983; Finkelstein and Hambrick, 1988; Yermack, 1996). To further strengthen the argument that less executives to more non-executives decreases managerial

discretion, outside directors are also brought on boards in order to bring critical resources into the firm (Hillman, Cannella, and Paetzold, 2000; Luoma and Goodstein, 1999; Pfeffer and Salancik, 1978/2003). Backed by the importance of the resources they represent, these directors could reduce management's discretion. Using this arguments, higher proportions of executives to non-executives are expected to increase managerial discretion, formulated as:

*Hypothesis 5a: Executive pay levels will be higher with the higher proportions of executives to non-executives on the board.*

*Hypothesis 5b: The salary component of the executive pay will be higher with higher proportions of executives to non-executives on the board.*

### **3.4 Theory extensions and hypotheses**

The question of how executives can exploit or circumvent firm-level governance mechanisms in order to influence pay setting practices and extract rents from the firm is of primary concern to managerial power theorists (Bebchuk and Fried, 2003; 2004; 2006). To date, the main body of theory and research on the role of managerial power in executive pay has originated in the United States and is strongly colored by its culture and institutional makeup (cf. Conyon and Schwalbach, 2000; Conyon and Murphy, 2000; Gomez-Mejia and Wiseman, 1997; Tosi and Greckhamer, 2004). Yet, prior research has shown that it is precisely in the US that "CEOs receive higher levels of pay than those in other [economically advanced] countries" (Abowd and Kaplan, 1999: 148). This not only raises questions about the extent to which explanations of a theory to global settings can be generalized, but also about the role of context in that particular theory (cf. Bruce, Buck, and Main, 2005; Gomez-Mejia, Wiseman, and Dykes, 2005; Gomez-Mejia and Wiseman, 1997). Despite repeated pleas for more attention to the role of contingency factors in executive pay (e.g. Barkema and Gomez-Mejia, 1998; Finkelstein and Boyd, 1998; Gomez-Mejia and Wiseman, 1997), very little is known about possible influence from national institutional contexts of executive pay setting practices.

The core theoretical premise followed here is that the efficacy of a given firm-level corporate governance mechanism is contingent on the quality and makeup of the institutions of the country in which that mechanism is put into practice (Hollingsworth

and Boyer, 1997). The applications of mechanisms require judgment from society in the sense that they have to adhere to social needs, wants, and acceptance (Perkins and Hendry 2005). More specifically, when national institutions are strongly developed and functionally complementary to firm-level governance mechanisms, the potential of the latter for mitigating managerial power will increase. For example, a firm-level information disclosure policy can be stiffened by a national information regime characterized by widely dispersed independent media and well-trained business analysts (cf. Khanna and Palepu, 2000a: 2000b). In contrast, much of a firm-level governance mechanism's capacity for influencing managerial discretion can be destroyed by weakly developed or counter-purposive national institutions. For example, managerial fiduciary duties towards shareholders lose much of their meaning when courts hide behind a "business judgment rule" or are otherwise unwilling to uphold them (cf. Bebchuk and Fried, 2004; Easterbrook and Fischel, 1991).

In short, managerial power theory is extended through the argumentation and demonstration of how its predictions are contingent on the quality of complementary institutions in a given jurisdiction. This institutional theoretical extension of the theory and theoretical contribution should be evaluated against a) the empirical results that provide more insights into the possible generalization of the theory in a cross-country sample, and b) the in the literature most often neglected influence from contextual factors and the in this study developed theoretical extensions that allows for predictions given the specifics of certain contextual conditions.

#### **3.4.1 Legal institutions and managerial power**

The role of legal institutions in corporate governance has already attracted considerable attention. Prior research has shown that better legal protection enlarges and broadens capital markets (La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1998), leads to higher valuation of the firms listed in a given jurisdiction (La Porta, Lopez-de-Silanes, Shleifer, and Vishny 2002), and generally increases economic growth (Djankov, Glaeser, La Porta, Lopez-de-Silanes, and Shleifer, 2003). One micro foundation that appears to produce these macro outcomes is that well-developed legal institutions help tame influential managers directly. Specifically, differences in the level of legal protection investors enjoy across countries seem to

influence the ability of insiders to expropriate outsiders (Shleifer and Wolfenzon, 2002). Given adequate legal protection, outsiders can sue “tunneling”<sup>8</sup> or “self-dealing” executives in court in the justified expectation that judges will acknowledge their rights and punish the transgressors (Djankov, La Porta, Lopez-de-Silanes, and Shleifer, 2005). An increase in legal protection is therefore expected to decrease managerial discretion, thus lowering pay levels and, at least in principal, make pay more contingent on performance.

*Hypothesis 6a: Executive pay levels will be lower in countries offering better legal protection to investors.*

*Hypothesis 6b: The salary component of executive pay will be lower in countries offering better legal protection to investors.*

However, legal protection also helps tame managers indirectly, by increasing the efficacy of other governance mechanisms that are intended to protect shareholders or by rendering poor firm-level governance situations less harmful. CEO duality may be a case in point. US studies have repeatedly shown that there is a positive relationship between pay and duality (Boyd, 1994; Main and Johnston, 1993; Westphal and Zajac, 1994). Surprisingly, Conyon and Peck found that “CEO duality was not a robust driver of UK management pay” (1998: 154). Apparently, the extent to which CEO duality gives executives power over their own remuneration is contingent upon a different factor, one that varies systematically across the two countries (cf. Barkema and Gomez-Mejia, 1998). This factor might be the legal protection of investors, which is exceptionally high in the UK, but only mediocre in the US (cf. Djankov, La Porta, Lopez-de-Silanes, and Shleifer, 2005). This contingency effect could be generalized as better legal protection of investors that negatively moderates the positive relationship between CEO duality and executive pay levels and structures, as formulated in the following hypotheses:

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<sup>8</sup> Tunneling is transferring assets and profits out of firms, most often assumed to benefit controlling shareholders or executives and not per se smaller shareholders or other stakeholders of the firm (see e.g. Djankov et al., 2005)

*Hypothesis 6c: The relationship between CEO duality and executive pay levels will be stronger in countries offering weaker legal protection to investors than in countries offering stronger protection.*

*Hypothesis 6d: The relationship between CEO duality and the salary component of executive pay will be stronger in countries offering weaker legal protection to investors than in countries offering stronger protection.*

### **3.4.2 Cultural institutions and managerial power**

Compensation scholars have long speculated about the influence of national culture on executive pay levels (Conyon and Murphy, 2000; Gomez-Mejia and Wiseman, 1997). Culture is expected to exert a direct influence on executive pay, because the variation in the amounts of wealth that high-placed officials can extract from the organizations they lead can be seen as an illustration of the way in which different cultures see money and monetary exchange differently (Bloch and Parry (1989) as quoted in Tosi and Greckhamer, 2004). Previous research by Tosi and Greckhamer (2004) has shown that especially the cultural dimension of power distance — the degree to which differences in power and status are accepted in a culture (Hofstede, 2001) — bears a relation to executive pay. Executive pay is likely to be higher in high power distance countries for two reasons. First, because organizations are structures of power and authority they mirror the way power is viewed in society. High power distance societies are likely to have more centralized, taller hierarchies, with higher pay levels towards the top. Second, executives from these societies are likely to have a greater psychological need for power and for clearer evidence that power is reflected by higher pay levels, as pay reflects the executive's mandate, abilities, expectations, and prestige (chapter 2). In line with others (e.g. Tosi and Greckhamer, 2004; Werner and Tosi, 1995), higher power distance in society leads to the social acceptance of executives using their power to increase pay levels, and thus also making pay principally less contingent on performance. Formally stated:

*Hypothesis 7a: Executive pay levels will be higher in countries with higher levels of power distance.*

*Hypothesis 7b: The salary component of the executive pay will be higher in countries with higher levels of power distance.*

National culture is also likely to influence pay indirectly via an effect on firm-level governance mechanisms. According to Hofstede (2001), there is a tendency toward more elitism in societies with higher levels of power distance, implying greater stratification, less direct contact between the strata, and a higher incidence of within-class loyalty and friendship (see also Useem, 1996). This suggests that non-executives play two roles in such societies — namely as: (1) members of the national elite and possibly members of the same social class as executives, and (2) guardians of investor and stakeholder interests — and that these roles can be separated empirically. In a two-tier system, in which non-executives meet independently, their stewardship role towards investors and the firm is more likely to rise to the fore, as their meetings are also called for the specific purpose of safeguarding financiers' interests and they operate as a separate entity in the organization. In a one-tier system, however, non-executives are constantly reminded of the fact that they share an elite position with the executives they are supposed to supervise. Under such conditions, it may be harder for them to separate themselves from their broader cultural frame of reference, which they share with the executives and within which it is considered just and appropriate for those in positions of power to extract more wealth from society — regardless of the performance of the firms they lead. It is therefore expected that one-tier board structures in societies with higher power distance increase executives' ability to influence their pay. Thus:

*Hypothesis 7c: The relationship between one-tiered board structures and executive pay levels will be stronger in countries with higher levels of power distance.*

*Hypothesis 7d: The relationship between one-tiered board structures and the salary component of executive pay will be stronger in countries with higher levels of power distance.*

### **3.4.3 Political institutions and managerial power**

The political power of labor has been a central force in shaping much of the legal and regulatory design of the 20<sup>th</sup> century (Blair and Roe, 1999; Pagano and Volpin, 2005a; 2005b; Roe, 2000). Indeed, most countries around the world by now have developed



complex and overlapping institutions intended to protect workers' interests (Botero, Djankov, La Porta, Lopez-de-Silanes, and Shleifer, 2004). Although these institutions tend to be analyzed frequently from a social efficiency perspective (North, 1990), political theorists tend to remind us that political institutions are not a priori designed to pursue economic efficiency, but rather to shift resources from the powerless to the powerful (e.g. cf. March and Olsen, 1984; Meyer and Rowan, 1977; Roe, 2003). Even though the role of labor has historically been neglected in the corporate governance literature (Blair and Roe, 1999), it is no a mere fancy to assume that employees can use their political influence in the corporate governance arena (cf Botero, Djankov, La Porta, Lopez-de-Silanes, and Shleifer, 2004; Roe, 2003). Traditional triggers to spur them into action could be the height of executive pay raises against a background of wage freezes for the rank-and-file or firm down-sizes (cf. Finkelstein and Hambrick, 1989; Gomez-Mejia, 1994; Jensen and Murphy, 2004; Murphy, 1997), and more generally a possible lack of social acceptance of proportionality between executive and worker pay (cf. Simon, 1957). In general, a direct effect can be expected between the propensity of political institutions to protect employees and executives' power over their pay levels and structures. This leads to the following hypotheses:

*Hypothesis 8a: Executive pay levels will be lower in countries with higher levels of employee protection.*

*Hypothesis 8b: The salary component of the CEO's pay will be lower in countries with higher levels of employee protection.*

Employee protection might also influence executive pay levels and structures indirectly via an additional empowering effect of employees represented on the board. In the US, participation of employees in firm governance has historically been a rarity (Luoma and Goodstein, 1999). In countries like Germany, Sweden, and Japan, however, employee representation is customary, and is typically seen as a cornerstone of competitive advantage and social stability (Aguilera and Jackson, 2003; Brown, Nakata, Reich, and Ulman, 1997). Worker representation alone, however, is insufficient to give labor an important voice in firm governance. Like executives, workers are insiders, who for their income and livelihood depend on the firm whose

fate they co-determine. Even more so than other insiders on the board, workers are in a clear hierarchical relationship with executives who might seek to influence the workers' judgments in matters pertaining to the executives themselves. Thus, employees can only be expected to raise an independent voice when they are adequately protected against dismissal, demotion, and other forms of negative career consequences. Thus the following hypotheses are:

*Hypothesis 8c: The relationship between employee representation and executive pay levels will be stronger in countries with higher levels of employee protection.*

*Hypothesis 8d: The relationship between employee representation and the salary component of executive pay will be stronger in countries with higher levels of employee protection.*

#### **3.4.4 Voice and accountability and managerial power**

The news media have the power to directly influence and shape corporate policy, including corporate governance (Dyck and Zingales, 2002; 2004). They also play an important role in the legitimizing process of pay arrangements (Wade, Porac, Pollock, 1997), as they vent what Bebchuk and Fried (2004; 2006; Bebchuk, Fried, and Walker, 2002) have called "outrage" factors. Public outrage occurs when a particular executive's pay arrangement go so far beyond what could be legitimized that it is "viewed by relevant outsiders as unjustified or even abusive or egregious" (Bebchuk and Fried, 2004: 65). But for the outrage mechanism to work, and to make it possible for independent media to investigate and vent possible "unjustifiable" pay arrangements and to actually do something about it, two requirements must be met. First, if pay is found to be excessive this view must be sufficiently widespread among relevant groups of people whose opinions matter to executives. But the media cannot function without social processes of accountability. This leads to the second factor, that for the process to work it must be backed by social institutions such as civil liberties like freedom of speech, of association, and of holding those with responsibility of social mishaps accountable. Both factors must be in place for the checks on executive power to work and to come from private ordering (cf. Williamson, 1985).

*Hypothesis 9a: Executive pay levels will be lower in countries with higher levels of voice and accountability.*

*Hypothesis 9b: The salary component of the CEO's pay will be lower in countries with higher levels of voice and accountability.*

The news media also shapes executives pay packages indirectly via non-executive directors. Even though board members can sign off on pay packages that go beyond what executives could have extracted from the firm under arms-length contracting, there are limits to the board's willingness to favor executives. It is especially unlikely that non-executives would approve an arrangement that could generate widespread outrage, as this has two serious effects for the non-executives themselves (Bebchuk and Fried, 2004; Bebchuk, Fried, and Walker, 2002). First, outrage has a negative effect on the "high-powered" (Williamson, 1985: 137-141) monetary incentives accruing to non-executives. Directors are selected on corporate boards on the basis of their reputation for expertise and independence in decision-making. Damage to a reputation can diminish a non-executive's chances of being re-elected and of being appointed to other boards. Second, it also affects directors' "low-powered" (Williamson, 1985: 137-141) incentives such as conscience, pride, and social esteem. If these effects are backed up by a society with higher standards on institutions' reflecting "voice and accountability" it may help to constrain executives' power. The first effect is not necessarily less important than the latter, as many outside directors do not join boards for the pay, but rather for the prestige and connections that are associated with these posts (Lorsch and MacIver, 1989). Therefore:

*Hypothesis 9c: The relationship between the number of non-executives on the board and executive pay levels will be stronger in countries with higher levels of voice and accountability.*

*Hypothesis 9d: The relationship between the number of non-executives on the board and the salary component of executive pay will be stronger in countries with higher levels of voice and accountability.*

### **3.4.5 Economic financial institutions and managerial power**

Country-level economic institutions — especially financial institutions — are strongly linked to economic growth in general and firm-level drivers of such growth in particular (Levine, 1997, Rajan, and Zingales, 2003). Financial institutions like stock markets, banks, securities analysts, and rating agencies intervene as intermediaries in less-than-perfect markets, to the effect of lowering information and transaction costs (Khanna and Palepu, 1999; 2000a; 2000b). Financial institutions enter the executive pay arena in two ways. First, they regulate and shape the market for corporate control (Manne, 1965). High excessive pay can be regarded as a sign of weak governance, resulting in more pervasive management shortcomings and chronic underperformance. In turn, this signals to corporate raiders that a firm might be an attractive takeover target (Bebchuk and Fried, 2004). Well-developed financial institutions supply raiders with detailed information for making performance estimates, communication channels towards dispersed stakeholders whom they need to reach in case of a proxy fight, and sophisticated financial instruments for closing appropriate deals. Second, financial institutions control the market for additional capital. Firms occasionally have to return to the market for additional equity capital in order to pay for substantial investments. The prospect of having to sell shares to the public might cause managers to seek a reputation as corporate stewards and conservative self-compensators (cf. Bebchuk and Fried, 2004; 2003; Bebchuk, Fried, and Walker, 2002). Thus, the functioning and importance of financial economic institutions for a country's economy might exert disciplinary pressure on executive pay levels and structures. This is formulated in the following hypotheses:

*Hypothesis 10a: Executive pay levels will be lower in countries with more important financial economic institutions for a country's economy.*

*Hypothesis 10b: The salary component of executive pay will be lower in countries with more important financial economic institutions for a country's economy.*

Financial institutions are also expected to indirectly discipline managers by complementing the control efforts of the corporate board. Walsh and Seward (1990) have described boards and financial institutions as internal and external managerial

control mechanisms, respectively. Internal control mechanisms, such as enlarging the proportion of outsiders on a board (Kosnik, 1987), are “designed to bring the interests of managers and shareholders into congruence” (Walsh and Seward, 1990: 423). Such internal control mechanisms are rendered ineffectual, however, when managers entrench themselves by tampering with the board’s ability to monitor and control their performance (Berger, Ofek, and Yermack, 1997). External control mechanisms, such as the market for corporate control, can then be relied upon as an alternate control mechanism for taming managers’ striving for self-enrichment. Internal control mechanisms such as the proportion of executives to non-executive board members and external control mechanisms such as important financial institutions for a country’s economy can thus be seen as complementary governance options that operate better in tandem — although not necessarily simultaneously (Walsh and Seward, 1990). This results in the next set of hypotheses:

*Hypothesis 10c: The relationship between the proportion of executives to non-executives on the board and executive pay levels will be stronger in countries with more important financial economic institutions for a country’s economy.*

*Hypothesis 10d: The relationship between the proportion of executives to non-executives on the board and the salary component of the executive pay will be stronger in countries with more important financial economic institutions for a country’s economy.*

### **3.5 Testing managerial power theory and its extension**

To be able to test managerial power theory and its extension, that is, to provide generalizations of predictions on managerial power theory, given the specifics of certain institutional contextual conditions, a cross national sample of executive pay packages was compiled. The sample was designed to provide a representative overview of executive pay in the global business landscape, and includes firms from 17 countries. The selected countries are based on their economic impact on the world economy, computed by the average size of their GDP from 1999 to 2003 (data derived from the database World Bank Indicators).

However, some countries have such weak disclosure regimes that reliable pay data was not available. These countries were excluded from the sample, and replaced by

the next in line. The efforts to collect firm-level data were aimed at being broad and in-depth. To realize the former, the aim was to collect 2003 data for all the countries in the sample. The latter aim was reached by adding further observations for firms from 8 countries for the years 2001, 2002, and 2004 to the sample. As for the other 9 countries, data availability was limited before 2003. For reasons of comparability, the aim was to collect data on the largest 30 listed firms in a country. The practical reason for choosing the largest firms is that larger firms tend to disclose more pay data. However, some countries have a relatively limited number of listed firms (e.g. Austria, Denmark, Finland). Moreover, many firms had no, or only sporadically had annual reports or other company reports available that disclosed pay data. As an exception, also for comparison reasons, the aim for the US was to collect data for 50 firms, as the US has many a great number of large listed firms, especially in comparison to many other countries. In all cases, the proportion of financial institutions like banks and insurance companies was deliberately restricted to 20% of a country's sample. Financial firms could be a special case in corporate governance (Adams and Mehran, 2003), and overrepresentation of a single industry could drive the results (see for industry influences on pay e.g. Coles, McWilliams, and Sen, 2001; Gibbons and Murphy, 1990; Garvey and Milbourn, 2003). To increase the comparability of the results across nations and industries and because of the drastic overrepresentation of financial firms in some nations the number of financial firms in the dataset was restricted.

The final sample consists of 3880 pay levels and 1195 pay structures representing 940 firm-year observations from 17 countries. The pay data from US based firms is retrieved from proxy statements, the data from other countries is retrieved from annual reports. Due to data availability on individual executives or executives as a group, the number of observations differ from country to country. To make the data comparable across national contexts and sample years, all monetary variables are purchasing power parity (PPP)-adjusted, with 2000 as the base year and in constant 2000 United States Dollars. Table 1, 2, and 3 provide an overview of the sample of the country specific firm-year observations.

**Table 3.1 Overview of the total sample <sup>a</sup>**

<b>Country</b>	<b>Firm-year observations</b>
Australia*	44
Austria	12
Canada*	99
Denmark	10
Finland	12
France*	94
Germany*	110
Hong Kong	10
Italy	21
Netherlands*	96
Norway	20
South Africa*	96
Spain	30
Sweden	19
Switzerland	20
United Kingdom*	80
United States*	167
<i>Total firm year observations</i>	940

<sup>a</sup> Countries marked with an asterisk are included in the longitudinal (2001-2004) data panel; for the others only 2003 data is available

**Table 3.2 Sample overview year 2003**

<b>Country</b>	<b>Firm observations</b>
Australia	20
Austria	12
Canada	31
Denmark	10
Finland	12
France	30
Germany	30
Hong Kong	10
Italy	21
Netherlands	25
Norway	20
South Africa	30
Spain	30
Sweden	19
Switzerland	20
United Kingdom	30
United States	50
<i>Total firm observations</i>	400

**Table 3.3 Sample overview years 2001, 2002, and 2004**

<i>Country</i>	<i>Firm observations</i>		
	<i>2001</i>	<i>2002</i>	<i>2004</i>
Australia	8	9	7
Canada	21	25	22
France	20	22	22
Germany	26	28	26
Netherlands	24	25	22
South Africa	21	24	21
United Kingdom	16	19	15
United States	37	39	41
<b>Total observations</b>	173	191	176

### **3.5.1 Dependent variables**

Outside the major Anglo-Saxon jurisdictions, pay disclosure is by all means still a novelty. Disclosure is still largely voluntary in many parts of the developed world. Companies in many jurisdictions can choose whether to report individual executive data, whether to report data aggregated for all executives on the board, or whether to report data at all. Reliable long-term pay data (e.g., stock options, restricted stock, and long-term incentive plans) is generally rare. Therefore the collected data is cash data (salary, bonuses, and total cash) for both CEOs individually and for the total of executives on the board (averaged by number). Total cash pay is the sum of salary and bonuses, and is a frequently used measure in studies of CEO pay (e.g. Boyd, 1994; Finkelstein and Hambrick, 1989). Furthermore, the total cash measure has been found to be an excellent proxy for total remuneration (including non-cash components), since the explanatory patterns for both measures do not differ (Core, Halthausen, and Larcker, 1999; Lewellen and Huntsman, 1970). In fact, additional analyses on a 12-country panel (10 of which are also represented in the sample used here) compiled by Abowd and Kaplan (1999) show that in 1996 the proportion of total cash pay to total pay for CEOs ranged from 1.25 (Germany) to 1.66 (UK), averaged on 1.48, and had a standard deviation of only 0.17. Thus, total cash measures serve as a good proxy for total pay (Boyd, 1994; Core, Halthausen, and Larcker, 1999; Finkelstein and Hambrick, 1989). The US pay data was collected from companies' proxy statements; for all other countries pay data was retrieved from annual reports.

CEO total cash was measured as the total of CEO salary and CEO bonuses. Executive total cash was measured as the total of executive salary and executive bonuses, averaged over the number of executives on the board, including the CEO.



The logarithms of pay levels are used as dependent variables in the pay level models. The proportion of CEO salary/total cash and Executive salary/total cash is computed by dividing the salary by the total cash of respectively CEOs and averaged executives. The proportion expresses the relative focus on salary (as compared to bonuses) and is a reflection of the importance of fixed pay, and the at least in theory, less dependence on pay that is at outcome performance risks. Table 3.4 provides an overview of the average pay levels and structures for all the countries in the data set. Because of differences in the availability of pay data the number of observations can differ from country to country and from the different pay components for as well CEOs as executives within a given country. Table 3.5 provides an overview of the descriptive statistics for the dependent variables.

**Table 3.4 Mean pay levels and structures all firm-year observations**

<b>Country</b> <i>(Pay in US\$)</i>	<b>CEO Total cash</b>	<b>Executive Total cash</b>	<b>CEO Salary</b>	<b>Executive Salary</b>	<b>CEO Bonuses</b>	<b>Executive Bonuses</b>	<b>CEO Salary/ Total cash</b>	<b>Executive Salary/ Total cash</b>
Australia	1,818,347	847,187	968,722	493,940	934,587	384,416	0,608	0,596
Austria	544,996	565,358	346,920	337,019	198,077	232,587	0,657	0,601
Canada	1,920,247	1,251,384	781,429	625,829	1,410,775	695,800	0,508	0,601
Denmark	650,712	416,939	584,112	429,295	93,328	132,870	0,862	0,766
Finland	658,390	436,785	562,540	284,791	137,185	131,386	0,801	0,791
France	1,895,236	1,028,609	1,104,743	609,695	1,057,553	563,537	0,516	0,539
Germany	2,072,468	1,331,927	867,172	545,350	1,428,166	831,952	0,428	0,461
Hong Kong	699,721	776,247	788,191	456,059	530,823	320,188	0,598	0,645
Italy	1,369,791		970,578		857,586		0,571	
Netherlands	1,117,233	853,838	662,998	532,239	459,456	330,309	0,667	0,652
Norway	288,837	207,600	269,294	156,780	43,429	20,294	0,886	0,885
South Africa	1,522,656	939,459	853,381	578,051	774,495	401,888	0,595	0,631
Spain	992,191		553,930		1,231,900		0,497	
Sweden	846,845	470,965	611,984	323,323	247,908	171,289	0,747	0,714
Switzerland	1,638,072	777,590	1,409,954	1,138,612	619,260	178,971	0,801	0,786
United Kingdom	1,819,246	1,202,671	1,011,103	672,748	850,677	547,588	0,597	0,617
United States	4,335,054	3,695,394	1,261,363	1,027,420	3,138,628	2,690,207	0,384	0,405
<i>Full sample mean</i>	2,112,076	1,473,971	931,448	655,819	1,393,856	958,340	0,544	0,553
<i>Full sample S.D.</i>	2,198,783	1,680,263	604,764	449,799	2,067,387	1,575,783	0,231	0,214
<i>Full sample N</i>	731	703	688	631	609	583	609	583

**Table 3.5 Descriptive statistics of dependent variables**

<i>Variable</i>	<i>N</i>	<i>Minimum</i>	<i>Maximum</i>	<i>Mean</i>	<i>S.D.</i>
Log CEO Total cash	731	9,828	17,150	14,180	0,938
Log CEO Bonuses	560	8,699	17,117	13,623	1,176
Log CEO Salary	688	9,439	16,009	13,566	0,667
CEO Salary /Total cash	609	0,033	1	0,544	0,231
Log Executive Total cash	703	9,725	16,539	13,815	0,857
Log Executive Salary	631	9,413	15,550	13,223	0,600
Log Executive Bonuses	567	8,409	16,483	13,046	1,254
Executive Salary /Total cash	583	0,036	1	0,553	0,214

### **3.5.2 Independent variables**

The main independent variables that are under investigation consist of firm-level variables, country-level variables, and the interaction variables between the two. Each of the variables is used to test the different hypotheses as stated above. See table 3.6 below for the complete list and descriptive statistics.

#### **3.5.2.1 Firm-level variables**

The CEO duality variable is measured with a dummy variable, which was set to 1 if the posts of CEO and chairman were combined and to 0 if not (Conyon and Peck, 1998; Sanders and Carpenter, 1998; Zajac and Westphal, 2004). The one-tier board variable was also measured with a dummy variable, and was set to 1 for one-tier boards and set to 0 for two-tier board structures. Thus if there was a single board composed of both executives and non-executives the dummy is 1, and 0 if there was a separate supervisory board composed entirely of non-executives (Franks and Mayer, 2001). The variable employee on board was measured also as a dummy variable, and set to 1 if at least one board member was a non-managerial employee of the firm and to 0 if otherwise. The number of non-executives variable was measured as a count variable and expresses the absolute number of non-executive directors on the board (Conyon and Peck, 1998). The proportion executives/non-executives variable was computed by dividing the number of executives on the board by the number of non-executives on the board (Conyon and Peck, 1998; Lambert, Larcker, and Weigelt, 1993; Westphal and Zajac, 1994).

### 3.5.2.2 Country-level variables

As a measure for shareholder protection against insider self-dealing, the anti-self-dealing index from Djankov, La Porta, Lopez-de-Silanes, and Shleifer (2005: 2006) was used. The index measures jurisdictions' scores on both ex-ante anti-self-dealing provisions such as approval and disclosure requirements and ex-post provisions such as the ease of proving wrongdoing, and expresses them as a coefficient ranging from 0 (poor protection) to 1 (excellent protection). The index was recently adapted from a prior "anti-director" index (La Porta, Lopez-de-Silanes, Shleifer and Vishny, 1997: 1998) and shows excellent predictive validity on a number of stock market development criteria (Djankov et al., 2006). To measure power distance, the value scores for this dimension of national culture as they are developed by Hofstede (1980) were used (data retrieved from [www.geerthofstede.com](http://www.geerthofstede.com)). The scale on which these scores are expressed runs from 0 (low power distance) to 100 (high power distance). The Hofstede scores have been replicated in other studies (Hofstede, 2001; Sondergaard, 1994) and power distance in particular has demonstrated its predictive validity in studies of executive pay (Tosi and Greckhamer, 2004). To measure Employee protection, the "employment laws index" compiled by Botero, Djankov, La Porta, Lopez-de-Silanes, and Shleifer (2004) was used. This index measures the economic costs to employers of adopting contracts other than full-time and unlimited duration contracts, of increasing hours worked (i.e. overtime), of firing workers, and the legal constraints of dismissal. The index runs from 0 (poor protection) to 1 (excellent protection). Empirical analyses with this variable subscribe to it being a political factor as well, as countries with longer histories of leftist or centrist governments between 1928 and 1995 imposed heavier regulations on labor markets and on the roles of employees in corporate governance (Botero et al., 2004; Roe, 2003).

The measure of voice and accountability, which measures the freedom of the media in a given jurisdiction and the extent to which this freedom is supported by relevant civil rights and liberties and holds those in power accountable for social processes, is presented by using the index compiled by Kaufmann, Kraay, and Mastruzzi (2005). The index, which is scaled from 0 (poor standards of institutional voice and accountability and low media freedom) to 1 (high standards of institutional voice and accountability and high media freedom) has been used and validated in several empirical studies (Knack and Kiefer, 1995; Rodrik, Subramanian, and Trebbi, 2004). Finally, to proxy for the importance of financial economic institutions for a country's economy the variable "Stock market

capitalization/GDP”, calculated as the value of all listed shares over GDP, was used. The data derives from the World Bank’s “financial development and structure” database. To adjust for temporal economic shocks during the study period, the variable is a calculated average over the years 2001-2004.

### **3.5.2.3 Firm-country interaction variables**

As hypothesized, the firm level variables are expected to interact with country specific variables. The different interaction effects are calculated as the product of a firm level variable and its matched country level variable, resulting in the following 5 interaction variables; 1) Self-dealing \* CEO duality as the product of the anti-self-dealing index and the CEO duality dummy; 2) Power distance \* one-tier as measured as the product of the Hofstede power score and the one-tier board structure dummy; 3) Employee protection \* employee on the board as the product of the employee on the board dummy and the labor protection index; 4) Voice and accountability \* number of non-executives as the product of both the voice and accountability variable and number of non-executive variable; and 5) Stock market capitalization/GDP \* executives/non-executives as the product of stock market capitalization/GDP and proportion executives/non-executives variables.

### **3.5.3 Control variables**

To control for firm-specific and country-specific effects, several firm-level controls and country-level controls are included in the regression analyses. See table 3.6 below for the descriptive statistics for all independent variables as discussed above and control variables as discussed below.

#### **3.5.3.1 Firm-level controls**

Past research has shown that firm size is one of the most important determinants of executive pay (Tosi et al., 2000). To control for firm size effects, the logarithm of firm sales is used, which is the most common measure of firm size in executive pay studies (Tosi et al., 2000). Sales data for all firms in the sample were derived from the Thompson Financial’s “DataStream” database. Many executive pay studies have historically set out to test the performance sensitivity of pay (Gomez-Mejia and Wiseman, 1997). To control for

firm performance, the measure return on equity in the year preceding the one in which a particular pay package was awarded was used, as is common practice in most studies (cf. Tosi et al., 2000). Similarly, performance data was derived from DataStream.

To control for CEOs' life cycle stage-dependent cash needs, CEO age, both as a monotonic and as a quadratic relationship (CEO age<sup>2</sup>) are used in the models, with CEO pay as the dependent variable. The rationale behind these variables is that CEOs' cash needs are higher in the earlier stages of their career and lower in later stages (cf. Finkelstein and Hambrick, 1989). Age data was derived from firms' annual reports. To control for industry effects on pay (Coles, McWilliams, and Sen, 2001; Gibbons and Murphy, 1990; Garvey and Milbourn, 2003; Porac, Wade, and Pollock, 1999), 10 industry dummies are included in the regression analyses (basic industry, consumer goods, consumer services, financials, healthcare, industrials, oil and gas, technology, telecommunications, and utilities; source: DataStream).

### **3.5.3.2 Country-level controls**

To control for the influence of the size of a given country's economy, the measure (a logarithm of) GDP, as an average over the years 2001-2004 was used (Pedersen and Thomsen, 1997; Roe, 2003; Thomsen and Pedersen, 1996; 2000). GDP data was derived from the World Bank's "world development indicators" database. Furthermore, corporate tax rate and income tax rate were controlled for, as the former can influence the net cost of executive pay to the corporation and the latter the net benefit of remuneration for individual executives (cf. Abowd and Bognanno, 1995). Both rates were derived from the Heritage Foundation's (2006) Index of Economic Freedom. In order to control for time-dependent social and economic shocks, year dummies were included for each of the years in the database (2001 through 2004). Table 3.6 reports descriptive statistics for all independent and control variables.

**Table 3.6 Descriptive statistics of independent variables**

<i>Variable</i>	<i>Minimum</i>	<i>Maximum</i>	<i>Mean</i>	<i>S.D.</i>
<b>Practices</b>				
CEO duality	0	1	0,311	0,463
Dummy one-tier	0	1	0,693	0,461
Dummy employees on the board	0	1	0,191	0,394
Number of non-executives	4	34	13,167	4,658
Proportion executives/ non-executives	0,045	5,5	0,474	0,481
<b>Contextual determinants</b>				
Self-dealing index	2,5	5	3,573	0,898
Power distance	11	68	42,081	11,368
Employee protection index	0,170	0,746	0,471	0,223
Voice and Accountability index	0,206	1,585	1,279	0,214
Average stock market capitalization/ GDP (years 2001-2004)	0,174	3,808	1,058	0,468
<b>Firm level controls</b>				
Log sales	12,529	19,300	16,396	1,200
Return on Equity (t-1)	-291,33	113,15	11,681	25
CEO age	36	78	54,725	6,267
CEO age <sup>2</sup>	1296	6084	3034,079	686,960
Dummy basic industry	0	1	0,101	0,301
Dummy consumer goods	0	1	0,131	0,338
Dummy consumer services	0	1	0,185	0,388
Dummy financials	0	1	0,197	0,400
Dummy healthcare	0	1	0,028	0,166
Dummy industrials	0	1	0,190	0,393
Dummy oil and gas	0	1	0,057	0,232
Dummy technology	0	1	0,027	0,163
Dummy telecommunications	0	1	0,046	0,209
Dummy utilities	0	1	0,038	0,192
<b>Country level controls</b>				
Log average GDP (years 2001-2004)	39,223	43,188	41,332	1,214
Corporate tax rate	17,5%	35%	29,894	4,318
Income tax rate	16%	60%	41,506	7,950

### **3.6 Estimation method**

Since all the estimated models have continuous dependent variables, pooled ordinary least squares (OLS) regressions are used to test the hypotheses. In line with standard OLS regression assumptions, all relevant explanatory variables are assumed to be included in the model. In more formal terms, this weak exogeneity assumption states that the period  $t$  error term of the regression equation is uncorrelated with any of the explanatory variables measured in the same period. This assumption does not rule out feedback effects, which are highly relevant in a study that assesses the influence of institutional factors on executive pay. An example of such feedback effects could be that policy makers in a given jurisdiction change regulations in period  $t$  in response to public outcry over pay levels in period  $t-1$ . In contrast, fixed effects models assume strict endogeneity, and rule out the possibility of accounting for these highly relevant feedback effects. OLS regressions are thus the appropriate method for estimating consistent coefficients. To compute reliable standard errors for the OLS-estimated coefficients, the possibility is allowed for that the error terms of the regression equations might be correlated within a country and across time (the possible existence of autocorrelation) by using the “cluster” option in STATA, the econometric data analysis program used here. To avoid possible problems of heteroskedasticity, White robust standard errors were calculated and reported.



**Table 3.7 Correlations CEO pay data**

Variable	1	2	3	4	5	6	7	8	9	10	11	12	13
1. Log CEO total cash													
2. Log CEO salary	0,797 <sup>a</sup>												
3. Log CEO bonuses	0,939 <sup>a</sup>	0,558 <sup>a</sup>											
4. Prop. salary/ tot. cash	-0,661 <sup>a</sup>	-0,137 <sup>a</sup>	-0,866 <sup>a</sup>										
5. CEO duality	0,316 <sup>a</sup>	0,246 <sup>a</sup>	0,436 <sup>a</sup>	-0,299 <sup>a</sup>									
6. One-tier	0,269 <sup>a</sup>	0,259 <sup>a</sup>	0,314 <sup>a</sup>	-0,192 <sup>a</sup>	0,447 <sup>a</sup>								
7. Employee on board	-0,184 <sup>a</sup>	-0,134 <sup>a</sup>	-0,156 <sup>a</sup>	0,062	-0,258 <sup>a</sup>	-0,574 <sup>a</sup>							
8. Nr. non-executive	0,182 <sup>a</sup>	0,148 <sup>a</sup>	0,214 <sup>a</sup>	-0,187 <sup>a</sup>	0,084 <sup>b</sup>	0,025	0,421 <sup>a</sup>						
9. Prop. exe./ non-exe.	-0,219 <sup>a</sup>	-0,112 <sup>a</sup>	-0,276 <sup>a</sup>	0,277 <sup>a</sup>	-0,163 <sup>a</sup>	-0,164 <sup>a</sup>	-0,014	-0,192 <sup>a</sup>					
10. Self-dealing index	-0,150 <sup>a</sup>	-0,067 <sup>b</sup>	-0,180 <sup>a</sup>	0,166 <sup>a</sup>	-0,151 <sup>a</sup>	0,517 <sup>a</sup>	-0,414 <sup>a</sup>	-0,107 <sup>a</sup>	0,114 <sup>a</sup>				
11. Power distance	0,015	0,037	0,073 <sup>c</sup>	-0,095 <sup>b</sup>	0,342 <sup>a</sup>	0,304 <sup>a</sup>	-0,349 <sup>a</sup>	0,087 <sup>a</sup>	-0,026	0,106 <sup>a</sup>			
12. Empl. protection	-0,381 <sup>a</sup>	-0,301 <sup>a</sup>	-0,394 <sup>a</sup>	0,264 <sup>a</sup>	-0,254 <sup>a</sup>	-0,670 <sup>a</sup>	0,467 <sup>a</sup>	0,034	0,191 <sup>a</sup>	-0,437 <sup>a</sup>	0,204 <sup>a</sup>		
13. Voice and account.	-0,101 <sup>a</sup>	-0,074 <sup>b</sup>	-0,173 <sup>a</sup>	0,164 <sup>a</sup>	-0,210 <sup>a</sup>	-0,444 <sup>a</sup>	0,273 <sup>a</sup>	-0,229 <sup>a</sup>	0,107 <sup>a</sup>	-0,340 <sup>a</sup>	-0,530 <sup>a</sup>	0,358 <sup>a</sup>	
14. Stock market cap./ GDP	0,206 <sup>a</sup>	0,274 <sup>a</sup>	0,164 <sup>a</sup>	-0,047	0,172 <sup>a</sup>	0,447 <sup>a</sup>	-0,551 <sup>a</sup>	-0,236 <sup>a</sup>	0,174 <sup>a</sup>	0,441 <sup>a</sup>	0,149 <sup>a</sup>	-0,557 <sup>a</sup>	-0,483 <sup>a</sup>

<sup>a</sup> p < 0,01; <sup>b</sup> p < 0,05

**Table 3.8 Correlations average executive pay data**

Variable	1	2	3	4
1. Log CEO total cash				
2. Log CEO salary	0,801 <sup>a</sup>			
3. Log CEO bonuses	0,925 <sup>a</sup>	0,594 <sup>a</sup>		
4. Prop. salary/ tot. cash	-0,717 <sup>a</sup>	-0,223 <sup>a</sup>	-0,888 <sup>a</sup>	
5. CEO duality	0,327 <sup>a</sup>	0,267 <sup>a</sup>	0,390 <sup>a</sup>	-0,246 <sup>a</sup>
6. One-tier	0,175 <sup>a</sup>	0,151 <sup>a</sup>	0,140 <sup>a</sup>	-0,047
7. Employee on board	-0,106 <sup>a</sup>	-0,168 <sup>a</sup>	-0,021	-0,087 <sup>b</sup>
8. Nr. non-executive	0,137 <sup>a</sup>	0,001	0,157 <sup>a</sup>	-0,189 <sup>a</sup>
9. Prop. exe./ non-exe.	-0,233 <sup>a</sup>	-0,128 <sup>a</sup>	-0,252 <sup>a</sup>	0,207 <sup>a</sup>
10. Self-dealing index	-0,166 <sup>a</sup>	-0,095 <sup>b</sup>	-0,267 <sup>a</sup>	0,242 <sup>a</sup>
11. Power distance	0,016	-0,007	-0,009	-0,013
12. Empl. Protection	-0,323 <sup>a</sup>	-0,284 <sup>a</sup>	-0,282 <sup>a</sup>	0,154 <sup>a</sup>
13. Voice and account.	-0,097 <sup>b</sup>	-0,042	-0,030	0,038
14. Stock market cap./ GDP	0,075 <sup>b</sup>	0,161 <sup>a</sup>	-0,012 <sup>a</sup>	0,089 <sup>b</sup>

<sup>a</sup> p < 0,01; <sup>b</sup> p < 0,05

### 3.7 Empirical Results

Tables 3.7 and 3.8 show the correlation matrices of the dependent and main independent variables used in the analysis. Table 3.7 reports correlations for the CEO data, and Table 3.8 for the average executive data.

The results of the regression analyses are presented in two steps of models for both the CEO pay dependent variables and the executive pay dependent variables. The two steps consist of models with: 1) firm-level main effects plus country dummies adjusted for within-cluster correlation; and 2) the full models including all controls and interaction terms and adjusted for within-cluster correlation. Given the two data panels (CEO remuneration data and average executive remuneration data) and four dependent variables (total cash, salary, bonuses, and salary/total cash), a total of 16 (2 steps \* 2 groups CEO- executives \* 4 pay dependent) regression models were estimated. In the discussion of the results, the corresponding model identity number, as can be seen in the tables shown below, serve as a reference to the estimated results of the models for the different steps. Tables 3.9 (models 1 through 4) and 3.10 (models 5 through 8) report step 1, the OLS regression results for the models with firm-level main effects for CEOs and average executives, respectively. Tables 3.11 (models 9 through 12) and 3.12 (models 13 through 16) report the results of step 2, the full models with CEO pay and average executive pay, respectively. The results of the models of the first step will only be discussed shortly. The results of the full models are assessed and discussed more systematically. As robustness checks of the results of the full models, extra models are estimated with the 2003 observations only.

**Table 3.9 CEO pay models with firm-level main effects**  
**OLS regression results with country clusters**<sup>A, B, C</sup>

	<i>Model 1</i>	<i>Model 2</i>	<i>Model 3</i>	<i>Model 4</i>
	CEO Total cash	CEO Salary	CEO Bonuses	CEO Salary / Total cash
CEO duality	0.244 (2.56)**	0.175 (1.50)	0.128 (1.17)	-0.036 (2.86)**
One-tier	0.130 (0.69)	0.359 (1.49)	0.041 (0.19)	0.088 (2.13)**
Employee on board	-0.126 (1.18)	-0.243 (4.88)***	0.019 (0.11)	-0.073 (1.82)*
Nr. non-executives	0.017 (1.45)	0.014 (1.24)	0.001 (0.04)	0.002 (0.45)
Prop. exec/ non-exec.	-0.096 (1.17)	-0.058 (1.09)	0.049 (0.43)	0.006 (0.20)
Sales	0.213 (6.52)***	0.237 (6.60)***	0.271 (3.79)***	0.013 (1.61)
Return on equity	0.001 (0.66)	0.000 (0.52)	-0.003 (1.28)	-0.001 (1.24)
CEO age	0.061 (0.75)	0.069 (1.51)	-0.163 (1.07)	-0.013 (0.46)
CEO age <sup>2</sup>	-0.001 (0.79)	-0.001 (1.56)	0.002 (1.13)	0.000 (0.56)
Constant	9.518 (4.71)***	7.632 (6.78)***	12.892 (2.96)***	0.622 (0.83)
Observations	608	579	483	526
R-squared	0.48	0.42	0.50	0.32
Nr. Clusters	17	17	17	17

A. \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1% .

B. White robust t statistics in parentheses

C. Industry and Country dummies not reported

**Table 3.10 Average executive pay models with firm-level main effects**  
**OLS regression results with country clusters**<sup>A, B, C</sup>

	<i>Model 5</i>	<i>Model 6</i>	<i>Model 7</i>	<i>Model 8</i>
	Executive Total cash	Executive Salary	Executive Bonuses	Executive Salary / Total cash
CEO duality	0.028 (0.63)	-0.030 (0.32)	0.221 (2.14)*	-0.016 (0.49)
One-tier	-0.142 (1.09)	-0.211 (0.87)	-0.091 (0.29)	0.073 (1.88)*
Employee on board	0.561 (2.92)**	0.671 (3.74)***	0.920 (5.77)***	-0.162 (3.99)***
Nr non-executives	-0.002 (0.21)	-0.008 (0.97)	-0.013 (0.86)	0.001 (0.25)
Prop. exec/ non-exec.	-0.008 (0.14)	-0.049 (0.77)	0.077 (0.51)	-0.035 (1.28)
Sales	0.272 (3.71)***	0.232 (6.87)***	0.290 (4.04)***	-0.013 (0.98)
Return on equity	-0.000 (0.26)	-0.000 (0.70)	-0.001 (0.23)	-0.000 (0.51)
Constant	8.146 (8.11)***	8.335 (20.26)***	7.440 (6.28)***	1.220 (8.44)***
Observations	666	596	534	550
R-squared	0.48	0.37	0.51	0.30
Nr. Clusters	15	15	15	15

A. \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1% .

B. White robust t statistics in parentheses

C. Industry and Country dummies not reported

### 3.7.1 Results simple models

As tables 3.9 and 3.10 report, CEO duality seems to positively influence pay levels and negatively influence the proportion of salary over total cash. Possibly, the discretion CEOs in particular have over their pay levels seems to be traded off by less discretion regarding pay that in theory is more contingent on performance. One-tiered board structures seem to have no effect on pay levels, but seem to increase discretion over pay structures. Surprisingly, employee representation on the board limits discretion over CEO pay levels but not over executive pay levels. Furthermore, it seems to limit discretion over pay structures for CEOs and executives, as the salary over total cash coefficients are negative. Both the absolute number of non-executives and the proportion of executives to non-executives seem to have no effect on pay levels and structures. All in all, these results provide a first indication that executive and CEO discretion is mediated by firm-level corporate governance mechanisms, also in a cross-national sample. The results of the full model, as discussed below, will provide further insights into the relationships with specific institutional contexts.

**Table 3.11 CEO pay full models**  
**OLS regression results with country clusters** <sup>A, B, C</sup>

	<i>Model 9</i>	<i>Model 10</i>	<i>Model 11</i>	<i>Model 12</i>
	CEO Total cash	CEO Salary	CEO Bonuses	CEO Salary / Total cash
Self-dealing	-0.062 (1.00)	0.044 (0.81)	-0.267 (2.17)**	0.037 (2.50)**
CEO duality	1.312 (2.81) **	0.938 (2.96)***	0.805 (2.66)**	0.005 (0.09)
Interaction Self-dealing*CEO duality	-0.306 (2.20)**	-0.230 (2.59)**	-0.180 (1.99)*	-0.012 (0.78)
Power distance	-0.008 (1.09)	-0.014 (2.17)**	0.009 (0.67)	-0.004 (1.70)
One-tier	0.308 (0.61)	-0.481 (1.24)	-0.373 (0.68)	-0.014 (0.12)
Interaction Power distance*One-tier	-0.005 (0.57)	0.014 (2.29)**	0.002 (0.21)	0.003 (1.07)
Employee protection	-0.816 (1.10)	-0.652 (0.81)	-3.208 (2.44)**	0.347 (1.84)*
Employee on board	-1.267 (1.20)	-1.284 (1.23)	-4.430 (2.45)**	0.358 (0.78)
Inter. Empl. protection* Empl. on board	1.164 (0.75)	1.210 (0.83)	5.685 (2.34)**	-0.547 (0.91)
Voice and accountability	-0.744 (1.14)	-0.380 (1.20)	-1.945 (2.63)**	0.454 (3.95)***
Nr. non-executives	-0.013 (0.22)	-0.024 (1.14)	-0.085 (1.13)	0.021 (2.19)**
Inter.. Voice and account. * Nr. non-exec.	0.031 (0.68)	0.034 (1.85)*	0.077 (1.28)	-0.017 (1.78)*
Av stock market capitalization/ GDP	-0.339 (1.84)*	-0.112 (0.56)	-0.651 (2.25)**	0.123 (1.92)*
Prop. executives/ non executives	-0.343 (1.40)	-0.286 (2.17)**	-0.612 (1.79)*	0.152 (1.98)*
Inter. Av. stock market/GDP *exec./non-exec.	0.193 (1.01)	0.194 (2.13)**	0.459 (2.11)*	-0.103 (2.11)*
Sales	0.234 (6.82)***	0.244 (6.85)***	0.283 (3.84)***	0.012 (1.16)
Return on equity	0.001 (0.53)	-0.000 (0.00)	-0.003 (1.11)	-0.001 (1.16)
CEO age	0.091 (1.08)	0.074 (1.57)	-0.156 (1.05)	-0.010 (0.36)
CEO age <sup>2</sup>	-0.001 (1.08)	-0.001 (1.57)	0.002 (1.12)	0.000 (0.45)
Average GDP	0.012 (0.15)	-0.032 (0.54)	0.091 (0.78)	-0.057 (2.36)**
Corporate tax	0.002 (0.12)	-0.018 (1.14)	-0.051 (1.22)	0.004 (0.66)
Income tax	0.011 (1.00)	0.019 (1.58)	0.033 (1.20)	-0.003 (0.62)
Constant	8.759 (2.15)**	9.562 (4.59)***	14.579 (2.33)**	2.002 (1.46)
Observations	608	579	483	526
R-squared	0.46	0.40	0.49	0.32
Nr. Clusters	17	17	17	17

A. \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1% .

B. White robust t statistics in parentheses

C. Industry and Country dummies not reported

**Table 3.12 Average executive pay full models**  
**OLS regression results with country clusters**<sup>A, B, C</sup>

	<i>Model 13</i>	<i>Model 14</i>	<i>Model 15</i>	<i>Model 16</i>
	Executive Total cash	Executive Salary	Executive Bonuses	Executive Salary / Total cash
Self-dealing	-0.150 (6.31)***	-0.016 (0.40)	-0.302 (4.29)***	0.062 (3.78)***
CEO duality	0.005 (0.02)	0.720 (1.87)*	-0.160 (0.33)	0.221 (2.49)**
Interaction Self-dealing*CEO duality	-0.002 (0.02)	-0.211 (1.86)*	0.098 (0.77)	-0.062 (2.33)**
Power distance	-0.002 (0.43)	-0.002 (0.22)	-0.021 (1.84)*	-0.003 (1.41)
One-tier	-0.968 (3.06)***	-1.450 (10.05)***	-1.943 (2.15)**	0.066 (0.51)
Interaction Power distance*One-tier	0.012 (2.19)**	0.022 (10.10)***	0.033 (1.91)*	0.000 (0.13)
Employee protection	-2.703 (4.75)***	-2.687 (5.63)***	-4.003 (3.34)***	0.502 (2.68)**
Employee on board	-2.623 (4.70)***	-2.075 (2.47)**	-7.006 (4.82)***	0.431 (1.74)
Inter. Empl. protection* Empl. on board	3.931 (4.96)***	3.174 (3.50)***	9.679 (5.28)***	-0.702 (2.28)**
Voice and accountability	0.006 (0.01)	1.042 (1.83)*	-1.727 (1.49)	0.271 (1.63)
Nr. non-executives	-0.007 (0.23)	0.035 (1.20)	-0.093 (2.42)**	0.024 (3.28)***
Inter.. Voice and account. * Nr. non-exec.	0.002 (0.10)	-0.033 (1.23)	0.070 (1.95)*	-0.020 (3.33)***
Av stock market capitalization/ GDP	-0.146 (1.57)	0.078 (0.64)	-0.591 (1.59)	0.099 (2.15)**
Prop. executives/ non executives	-0.205 (1.51)	-0.225 (1.09)	0.082 (0.14)	0.000 (0.00)
Inter. Av. stock market/GDP *exec./non-exec.	0.144 (1.52)	0.165 (1.08)	-0.015 (0.04)	-0.018 (0.25)
Sales	0.282 (3.84)***	0.250 (6.85)***	0.300 (3.69)***	-0.011 (0.76)
Return on equity	-0.000 (0.08)	-0.000 (0.98)	-0.001 (0.22)	-0.000 (0.48)
Average GDP	0.055 (0.76)	-0.033 (0.45)	0.246 (1.65)	-0.015 (0.70)
Corporate tax	0.025 (1.22)	-0.000 (0.02)	-0.016 (0.38)	-0.006 (0.91)
Income tax	0.008 (0.69)	0.018 (1.45)	0.037 (1.86)*	0.000 (0.05)
Constant	8.437 (3.82)***	10.320 (4.71)***	4.055 (0.90)	0.720 (1.04)
Observations	666	596	534	550
R-squared	0.47	0.36	0.49	0.30
Nr. Clusters	15	15	15	15

A. \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1% .

B. White robust t statistics in parentheses

C. Industry and Country dummies not reported

### **3.7.2 Results full models: Firm-level main effects**

In line with previous research results (Boyd, 1994; Core, Holthausen, and Larcker, 1999; Westphal and Zajac, 1994), CEO duality seems to adequately capture executives' power in relation to setting pay levels and structures. The “duality effect” can be noted for both CEOs (models 9, 10, and 11) and average executives (models 14 and 16). This evidence supports hypotheses 1a and 1b that CEO duality increases pay levels and decreases relative pay that is meant to be contingent on performance. However, duality did not exert a significant influence on CEO salary over total cash and on average executive total cash and bonuses, suggesting that duality is more beneficial for the CEO in setting pay levels than for the group of executive board members in its entirety. It seems that CEO duality provides executives, and to a lesser extent CEOs, with discretion to make their pay less contingent on performance, as model 16 shows that CEO duality is significant and model 12 does not.

No significant effects on CEO pay were noted for one-tiered board structures. For the average executive pay, however, the results on all pay level variables turned out to be significant (models 13, 14, and 15). Surprisingly, however, the effects conflicted with the predictions, indicating that average executives have more discretion to set their own pay in a two-tiered than in a one-tiered board structure, thus disconfirming hypotheses 2a and 2b. A possible explanation for this effect is that two-tier jurisdictions – especially true for Germany and the Netherlands – could also be staunchly managerialist in their orientation (Hansmann et al., 2004). The legal principle of codetermination tends to result in a deadlock in the supervisory board between employees and shareholders, creating a power vacuum which is subsequently filled by management (Pistor, 1999). For instance, in both Germany and the Netherlands, an important consequence of codetermination may be an increase in managerial discretion (Hansmann and Kraakman, 2004).

Employee representation on boards drove down pay levels. It appears to lower CEO bonuses (model 11) as well as average executive total cash, salary, and bonuses (models 13, 14, and 15), providing support for hypothesis 3a. No support for hypothesis 3b was found, as employee representation did not appear to affect the proportion of salary over total cash. An explanation of these findings could be that employee directors are more concerned with aspects of executive pay packages that matter to them as employees (i.e. an equitable difference between executive and

worker levels of pay, especially in the case of the level of cash bonuses; cf. Simon, 1957) than with defending the interests of shareholders (for whom the performance sensitivity of pay might be more important than the absolute level of pay). In the hierarchical structure of the firm, employees are closer to the executives than to the CEO. Employees are possibly more concerned with the pay setting processes of closer, less senior, parties than with determining CEO total cash and salary.

The effect of the absolute number of non-executives on executive pay was modest. The only pay level variable that was significantly affected was average executive bonuses (model 15), thus at best offering rather weak support for Hypothesis 4a. In contrast, the coefficients for both pay structure variables (models 12 and 16) were significant but, alas, conflicted with the hypothesized direction. It seems that adding more non-executives to the board does not make pay more performance-sensitive, but less so, thereby disconfirming Hypothesis 4b. These results could indicate that the concept of “overt monitoring” (i.e. providing too much incentives in combination with increased monitoring) (Finkelstein and D’Aveni, 1994) is supported, as more non-executives are shown to be related with more focus on salary. However, a higher number of non-executives does not seem to lead to lower pay levels in general. Another explanation could be that bigger boards provide CEOs and executives with more discretion in determining performance contingent pay. The non-executives could be less concerned with incentive alignment arguments instead of pay levels, supporting the notion that non-executives only to a certain extent play a role in safeguarding firm interests by — albeit on the basis of relative weak evidence — limiting executive discretion over observable pay levels, but not in making pay potentially more contingent on performance. It seems that there is a certain trade-off between agreeing on lower pay levels and making pay less sensitive to potential risks. Bigger boards may have no, or only decreasing effects in constraining executive discretion in determining pay levels, as only one negative significant effect was found. Expanding the number of non-executives could result in the board becoming unwieldy (Yermack, 1996). Prior research seems to confirm this conjecture, as managerialist countries like Germany and Japan tend to have larger boards with greater number of outsiders (Hansmann and Kraakman, 2004; Miwa and Ramseyer, 2005). It seems that rather than completely limiting managerial discretion, large boards with numerous non-executives could offer executives better opportunities to



influence pay that is potentially contingent on performance, and could also offer them less or no discretion over pay levels.

The ratio of executives to non-executives seems to further strengthen the notion that executives and especially CEOs have more discretion in determining their pay that is potentially contingent on performance, than that they have discretion over their pay levels. A higher proportion of executives to non-executives skims off CEO salary and bonuses (models 10 and 11). Average executive pay levels, however, were unaffected. Model 12, CEO salary over total cash, shows a significant positive effect, suggesting that CEOs have discretion over their pay structure by making it potentially less contingent on performance if the number of executives to non-executives increases. For CEOs it seems to be the case that more executives relative to non-executives limit CEO discretion over their pay levels, but not over their discretion over pay that is contingent on performance. It could be that having relatively less non-executives makes non-executives more aware of having an important “altruistic” role in setting executive pay. Possible negative reputation, esteem or public outcry effects (Bebchuk and Fried, 2004; Monsen and Downs, 1965) for non-executives of setting high observable pay levels could lead them to exercise their influence in setting lower pay levels. There also seems to be support for the “overt monitoring” argument for less performance-contingent pay, as a relatively higher number of non-executives, was found to still have positive effects on the importance of salary as a proportion of total cash but decreasing effects if this proportion was smaller (i.e. it is a ratio of executives to non-executives; more non-executives and the same number of executives lead to smaller negative effects for pay levels and less positive effects for salary over total cash). Non-executives seem to be unable to completely limit CEO discretion but are nevertheless able to limit executive discretion. Possibly, CEOs could use their discretion to accept lower pay levels but negotiate that their pay is then made less contingent on performance.

In general, these results seem to provide us with two possible explanations. First, closer monitoring, either by a one-tiered board structure, by employee representation or by more non-executives, either as a proportion of executives or as absolute numbers, seem to constrain executives and CEOs discretion over pay levels. Closer monitoring could lower the need of incentive pay, i.e. a relatively lower proportion of salary over total pay. This would support the concept that vigilance boards do not

apply overt monitoring by providing too much incentive pay as a proportion of total pay (cf. Finkelstein and D'Aveni, 1994). Second, closer monitoring, also by less non-executives relative to more executives, possibly lowers executive and CEO discretion over observable pay levels in the wake of reputation, or public outcry effects, that subsequently could hamper non-executives (cf. Bebchuk and Fried, 2004). Executives and CEOs, possibly also constrained by these outrage effects, could negotiate and strike a deal with non-executives to trade-off implications of lower pay levels on the one hand with more salary as a proportion of total pay on the other, making their pay a-priori less sensitive to performance outcomes. However, the second explanation seem to be more fitting, because the first explanation seems to rely more on the altruistic role of non-executives, a conceptual problem within a managerial power theory. A strengthening argument for the second explanation, and thus for managerial power theory as advanced here, is that the results of the relationship with CEO duality and pay indicates considerable discretion over pay levels, especially for CEOs themselves, and, albeit to a lesser extend, over pay structures.

### **3.7.3 Results full models: Country-level main effects**

Better protection against self-dealing has a negative effect on pay levels. It lowers CEO bonuses (model 11), as well as average executive total cash and bonuses (models 13 and 15), thereby offering support for Hypothesis 6a. Again, there seems to be some kind of trade-off between pay levels and pay contingent on performance. Models 12 and 16 show opposite results than hypothesized. The results show that increased protection against self-dealing, instead of limiting discretion by making pay potentially more contingent on performance, causes a higher importance of salary as a proportion of total cash for CEOs and executives alike. It seems that the acceptance of lower pay levels is a trade-off with making pay less contingent on performance.

No support was found for Hypotheses 7a and 7b. In contrast with an earlier study by Tosi and Greckhamer (2004), the cultural dimension of power distance was found here to have a negative effect on CEO salary (model 10) and average executive bonuses (model 15). Moreover, no effects on pay structures were found. A possible reason for these inconsistent findings is that, whereas Tosi and Greckhamer use cumulated data (pay averages per country), the data used here is disaggregated firm data. The latter allows to control for known pay determinants like firm size and

performance and uses known within-country variance of pay, something which is impossible to do with aggregated data. In other words, Tosi and Greckhamer's findings could possibly be the result of model misspecification (i.e. the omission of known determinants of pay) and neglect within country variance and possible interaction effects between firm-level corporate governance mechanisms and culture. It appears to be the case that, as Tosi and Greckhamer have indicated, "we cannot rule out the possibility that within-country distributions of countries with similar mean levels of CEO pay could be markedly different" (2004: 668).

The results indicate support for hypotheses 8a. In countries where employees are well protected by relevant legislation (Botero et al., 2004), they appear to be able to more effectively challenge executive pay levels that are disproportional to their own. Better employee protection drives down CEO bonus levels (model 11) as well as average executive total cash, salary, and bonuses (models 13, 14, and 15). However, hypotheses 8b is disconfirmed. Both CEO and executive salary over total cash (models 12 and 16) showed positive effects, implying that a higher protection of employees results in a higher importance of fixed pay. The explanation that employees, as monitoring directors, are reluctant to use overt monitoring by increasing performance-contingent pay is not supported by these results. The results seem to in line with managerial power theory as advanced here to argue that executives and CEOs use their discretion to accept lower pay levels in exchange for less a-priori performance-contingent pay.

Mixed results were recorded for hypotheses 9a. In countries with free news media and stronger standards regarding institutional accountability, CEO bonuses (model 11) were lower, but executive salaries (model 14) were higher. Hypotheses 9b was disconfirmed. CEOs have higher proportions of salary over total cash (model 12) in countries with higher levels of voice and accountability. The effectiveness of the "outrage" mechanism (Bebchuk and Fried, 2003; 2004; 2006; Bebchuk, Fried, and Walker, 2002) and the level of voice and accountability in a given jurisdiction (Kaufmann, Kraay, and Mastruzzi, 2005) seem to be different for executives than for CEOs.

Some support for Hypotheses 10a can be reported. In countries with relative more important stock markets in which financial institutions tend to be better developed (Levine, 1997) and in which financial analysts and intermediaries occupy stronger positions (Khanna and Palepu, 1999; 2000a; 2000b) –measured as the size of the

stock market in proportion to the national economy – executive pay packages appear to be scrutinized more heavily. Interestingly, financial actors appear to be more concerned with CEO pay levels than with average executive pay, as indicated by lower CEO salary and bonuses (models 9 and 11). Apparently, in the eyes of the general public, CEOs are not just figureheads (Ungson and Steers, 1984) but are also individuals who are better able than others to attract the attention of financial analysts and other intermediaries. For CEOs and average executives alike, however, larger stock markets in proportion to a country's economy, indicative of higher standards of financial institutions, seem to put less bounds on the ability to make pay a-priori more contingent on performance (models 12 and 16).

#### **3.7.4 Results full models with country-firm interaction effects**

The interaction effects of protection against self-dealing (hypotheses 6c and 6d) on pay levels and pay structures show that the relationships between CEO duality and pay in countries with higher protection against self-dealing are stronger (models 9,10,11,14, and 16). Executives' ability to exploit the surplus power that comes with duality appears to be restricted significantly by better anti-self-dealing protection. This mostly affects the CEO/Chairs themselves, as is indicated by the lower levels for total cash, salary, and bonuses for CEOs (models 9, 10, and 11). Nonetheless, average executive salary is also negatively affected (model 14) and the security of their pay diminishes (model 16). The combination of duality and good anti-self-dealing protection is common in jurisdictions that have their legal origins in the U.K., like the U.S., Canada, Australia, and of course the U.K. itself (Conyon and Peck, 1998; Goergen and Renneboog, 2001a; 2001b). Overall, CEO duality by itself increases pay levels and results in a focus on salary. Increased protection against self-dealing diminishes executive and CEO discretion. The combined effect of CEO duality and increased protection results in higher pay levels for CEOs and a focus on salary. For executives the combined effects result in lower total cash and bonus levels, but higher salary and relative higher proportions of salary over total pay.

Strong support could also be noted for Hypothesis 7a, but not for Hypothesis 7b. Whereas the main effect of power distance on pay levels may have been small and, surprisingly, negative, this variable appears to interact strongly with one-tiered board structures. CEO salary (model 10) and average executive total cash, salary, and

bonuses (models 13, 14, and 15) were all significantly higher when the additional power executives hold in a one-tiered board went unchecked by fellow-elite directors. Apparently, directors on one-tier boards in high power distance countries see themselves more as peers to executives than as guardians of shareholders' interests, as is typical in insider-controlled systems (cf. Franks and Mayer, 2001). The governance landscapes of France (Bloch and Kremp, 2001) and Belgium (Becht, Chapelle, and Renneboog, 2001) provide cases in point of one-tier/high power distance combination. As stated, no significant effects of the present interaction term on pay structures were found. Overall, two-tiered board structures seem to have higher average executive pay levels. Firms in countries with higher social acceptance of power distance, however, mediate these effects. Firms with one-tiered board structures in countries with higher acceptance of power distance positively influence pay levels.

Surprising results were noted for Hypothesis 8c and 8d. In combination with high levels of legal protection for employees, the representation of employees on boards seems to consistently yield higher bonus levels for CEOs (model 11) as well as higher total cash, salary, and bonus levels for average executives (models 13, 14, and 15). For average executives, the salary component of their pay packages also decreased (model 16). These findings seem to be consistent with recent work by Pagano and Volpin (2005b), who argue that in "corporatist" countries managers and employees can strike a political agreement in which attention to the interests of shareholders is traded off against high employment protection. Examples of countries in which the "corporatist" mixture of employee codetermination, high employee protection, and high managerial discretion flourishes are Sweden (Agnblad, Berglöf, Högfeldt, and Svancar, 2001), Germany (Becht and Böhmer, 2001), and France (Bloch and Kremp, 2001). Overall, the results indicate that the presence of employees on boards limits executive discretion. Protection of employees further limits executive discretion, but having employees on the board that are well protected increases pay levels. Having no employees on the board, but having employees that are well protected indicates a trade-off of lowering pay levels and increasing less pay at potential risk by increasing the proportion of salary over total cash. Having employees on the board significantly decreases this positive effect for executives, but not for CEOs. Apparently, well-protected employees constrain executive discretion more than they constrain CEOs. CEOs have lower bonuses, but are left with enough discretion to have less pay that is

contingent on performance, with or without employees on the board. It seems that the protection of labor is of more importance in order to constrain managerial discretion over pay levels than having employees on the board. Having employees on the board, however, constrains executives, but not CEOs in their discretion over pay that is made contingent on performance.

The results for the voice and accountability variables are mixed. A higher standard of voice and accountability by itself has negative effects on CEO bonus levels (model 11) and positive effects on executive salary levels. More non-executives by itself has only minor effects, as the only significant effect is found to negatively influence executive bonuses (model 15). The interaction term is found to be positive for CEO salary (model 10) and executive bonuses (model 15). Overall, it seems that countries characterized by higher standards of voice and accountability and with higher number of non-executives have higher salary levels for CEOs (model 10) and executives (model 14), but lower bonuses for CEOs (model 11) and executives (model 15). As for the proportion of salary to total cash, higher standards of voice and accountability and more non-executives overall result in a higher proportion of salary for CEOs and executives. Apparently the mechanism of “public outcry” (Bebchuk and Fried, 2004) and institutional voice and accountability mediates the effects of board monitoring to some degree. Although the evidence is relatively weak, the overall relationships seem to indicate that more non-executives and higher standards of voice and accountability leave executives and CEOs with less discretion over bonus levels, but with more discretion to increase salary and importance of salary as a proportion of total cash. Apparently, the unwieldiness of larger boards makes it easier for executives to negotiate higher salary and less pay related to performance. But when countries have strong informational regimes, non-executive directors ought to be concerned about their image as guardians of the firm, and more narrowly, about financial interests, or more broadly, about social efficacy. Thus, they could be more likely to sign off on pay packages that are “disguised” as pay-for-performance arrangements (a form of “stealth compensation” cf. Bebchuk and Fried, 2003, 2004). The results seem to indicate that pay packages in such jurisdictions tend to involve lower bonus levels (models 11 and 15) and higher fixed salary (10 and 14) and higher importance of salary (12 and 16). Possibly, executives and CEOs use their discretion to agree on lower bonus levels as a reflection of possible moderate observable firm performance

and negative public outcry effects also for themselves, but use this as a trade-off to negotiate increases in salary and importance of salary for their total pay.

Interesting results can be noted for Hypotheses 10c and 10d. Once again, it seems evident that financial analysts and intermediaries are more concerned with the discretion of CEOs than with executives. No significant results were noted for average executives, but the combination of larger stock markets and a greater proportion of non-executive directors on the board appears to mediate CEO salary and bonuses positively (models 10 and 11) and makes CEO-pay more dependent on incidental pay (model 12). Overall, the results show that in countries with larger stock markets firms with more executives in proportion to non-executives have lower CEO pay levels and higher proportions of salary to total cash for both CEOs and executives. The interaction between the proportion of executives and the importance of the stock market positively influences CEO pay levels, but influences the proportion of salary for CEOs negatively. Apparently, although a relatively higher number of executives to non-executives by itself is able to limit discretion over pay levels, and the importance of the stock market by itself has a similar effect, the interaction between the two is positive for pay levels, indicating more discretion, and is negative for salary over total cash, indicative of less discretion. Apparently, the internal control mechanism “the proportion of executives to non-executive board members” and the external control mechanisms “the importance of financial institutions for a country’s economy” do not operate better in tandem with regard to pay levels. Possibly, increasing the number of non-executives as representatives of shareholders (Gedajlovic and Shapiro, 1998) could become of more importance when stock markets are more important. Increasing the number of non-executives relative to the number of executives could, however, lead to collective action problems and provide executives with more rather than less discretion over pay levels (cf. Conyon and Peck, 1998; Yermack, 1996). However, it could increase the importance of (observable stock market) performance-contingent pay. This in turn implies even less support for overt monitoring arguments, as the financial markets also provides a monitoring role. Again, this further strengthens a trade-off between pay levels and potential pay contingent on performance. Jurisdictions with large stock markets and a high proportionality of outsiders on boards include the UK (where the best practice guidelines of the Cadbury and Greenbury reports have caused a steady increase in the proportion of non-executive directors on boards; cf. Conyon and Peck, 1998) and the

US (where most companies have had a majority of nominally independent directors since the 1970s; cf Weisbach and Hermalin, 2003).

### **3.7.5 Results full models: Robustness checks**

Tables 3.13 and 3.14 below report the results of the full models with only observations of the sup-sample from the 2003 observations. The results further support the overall conclusions of the full sample. Most of the significant results that are found with the full sample are also found with the 2003 sample. However, there are further significant results to be found in the sample. In the models 21, 23, and 24, the overall results of the voice and accountability variables and the number of executives and the interaction variables further support the notion that higher institutional standards of voice and accountability and more non-executives lower executives' discretion over pay levels, but increases discretion over pay structures. This further strengthens the conception that executives can use their discretion to trade-off implications of pay levels with implications when their pay is potentially more contingent on performance. Similarly, the importance of the stock market for a country's economy limits executive discretion over pay levels but not over pay structures (models 19, 21, 23, and 24). The overall effects of the proportion of executives to non-executives and the importance of stock markets show that more executives over non-executives in countries with relatively bigger stock markets have lower pay levels for CEOs and executives but have executives with pay packages that have higher proportions of salary. These results further strengthen results reported earlier that a) more executives to non-executives could indicate that a relatively smaller number of non-executives would be more inclined to pay executives lower pay levels, possibly as a result of reputation or outcry effects, as individual non-executives in this case are in the center of attention more than when more non-executives are on a board; b) executives are able to trade-off implications of pay contingent on performance with implications of pay levels, that possibly include negative outcry effects for their "partners in crime", i.e. non-executives; and c) more non-executives and monitoring by financial markets does not seem to support overt monitoring arguments.



**Table 3.13 CEO pay 2003 sample full models**  
**OLS regression results with country clusters**<sup>A, B, C</sup>

	<i>Model 17</i>	<i>Model 18</i>	<i>Model 19</i>	<i>Model 20</i>
	CEO Total cash	CEO Salary	CEO Bonuses	CEO Salary / Total cash
Self-dealing	-0.071 (0.80)	0.059 (0.72)	-0.113 (0.69)	0.036 (1.80)*
CEO duality	1.848 (2.27)**	1.234 (2.22)**	1.005 (2.46)**	0.018 (0.11)
Interaction Self-dealing*CEO duality	-0.484 (2.09)*	-0.336 (2.12)**	-0.274 (2.28)**	-0.009 (0.22)
Power distance	-0.021 (2.34)**	-0.021 (2.80)**	-0.009 (0.66)	0.001 (0.23)
One-tier	-0.151 (0.31)	-0.583 (1.46)	-0.374 (0.69)	0.156 (1.27)
Interaction Power distance*One-tier	0.005 (0.53)	0.016 (2.27)**	0.009 (1.06)	-0.002 (0.58)
Employee protection	-0.666 (0.84)	-0.474 (0.49)	-2.213 (1.49)	0.257 (1.31)
Employee on board	-1.431 (1.18)	-2.332 (2.28)**	-5.044 (3.69)***	0.492 (1.24)
Inter. Empl. protection* Empl. on board	1.109 (0.59)	2.450 (1.63)	6.729 (3.53)***	-0.738 (1.44)
Voice and accountability	-0.861 (0.88)	0.095 (0.25)	-1.880 (1.76)*	0.682 (3.43)***
Nr. non-executives	0.009 (0.10)	0.046 (0.99)	-0.004 (0.04)	0.040 (1.88)*
Inter.. Voice and account. * Nr. non-exec.	0.025 (0.36)	-0.015 (0.37)	0.000 (0.00)	-0.034 (2.04)*
Av stock market capitalization/ GDP	-0.204 (1.17)	-0.187 (0.84)	-0.855 (2.55)**	0.053 (0.74)
Prop. executives/ non executives	-0.159 (0.57)	-0.363 (1.88)*	-0.954 (2.01)*	0.108 (1.16)
Inter. Av. stock market/GDP *exec./non-exec.	0.117 (0.65)	0.243 (1.85)*	0.708 (2.52)**	-0.081 (1.44)
Sales	0.215 (3.84)***	0.265 (8.55)***	0.260 (3.00)***	0.019 (0.95)
Return on equity	0.002 (0.72)	-0.001 (0.65)	-0.004 (0.94)	-0.001 (1.15)
CEO age	0.208 (2.14)**	0.104 (1.80)*	-0.073 (0.32)	-0.010 (0.25)
CEO age <sup>2</sup>	-0.002 (2.04)*	-0.001 (1.74)*	0.001 (0.40)	0.000 (0.29)
Average GDP	0.044 (0.46)	-0.056 (0.87)	0.236 (1.61)	-0.064 (2.33)**
Corporate tax	0.004 (0.17)	-0.016 (1.00)	-0.047 (0.96)	-0.003 (0.33)
Income tax	0.012 (0.94)	0.017 (1.10)	0.025 (0.88)	-0.001 (0.17)
Constant	4.989 (1.07)	9.282 (3.50)***	6.511 (0.75)	2.051 (1.23)
Observations	252	238	191	214
R-squared	0.60	0.57	0.57	0.36
Nr. Clusters	17	17	17	17

A. \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1% .

B. White robust t statistics in parentheses

C. Industry and Country dummies not reported

**Table 3.14 Average executive pay 2003 sample full models**  
**OLS regression results with country clusters**<sup>A, B, C</sup>

	<i>Model 21</i>	<i>Model 22</i>	<i>Model 23</i>	<i>Model 24</i>
	Executive Total cash	Executive Salary	Executive Bonuses	Executive Salary / Total cash
Self-dealing	-0.140 (1.96)*	-0.030 (0.55)	-0.036 (0.62)	0.022 (1.62)
CEO duality	1.010 (1.40)	1.810 (2.38)**	2.723 (2.81)**	0.053 (0.29)
Interaction Self-dealing*CEO duality	-0.293 (1.45)	-0.555 (2.65)**	-0.680 (2.49)**	-0.020 (0.37)
Power distance	-0.014 (2.17)**	-0.024 (4.07)***	-0.073 (7.59)***	0.005 (2.80)**
One-tier	-0.876 (2.00)*	-1.771 (6.43)***	-2.329 (3.36)***	0.071 (0.68)
Interaction Power distance*One-tier	0.009 (0.85)	0.028 (3.99)***	0.043 (2.96)**	-0.001 (0.30)
Employee protection	-2.683 (4.36)***	-2.744 (7.16)***	-2.309 (2.32)**	0.172 (1.20)
Employee on board	-3.394 (4.35)***	-4.622 (6.47)***	-11.705 (10.77)***	0.982 (4.98)***
Inter. Empl. protection* Empl. on board	5.065 (4.71)***	6.440 (8.96)***	15.428 (13.76)***	-1.478 (7.05)***
Voice and accountability	-1.008 (2.05)*	0.467 (0.93)	-4.612 (4.96)***	0.620 (3.10)***
Nr. non-executives	-0.044 (1.04)	0.043 (1.39)	-0.125 (2.07)*	0.024 (1.54)
Inter.. Voice and account. * Nr. non-exec.	0.026 (0.91)	-0.031 (1.31)	0.075 (1.52)	-0.014 (1.05)
Av stock market capitalization/ GDP	-0.231 (2.91)**	-0.077 (0.65)	-1.363 (4.63)***	0.211 (3.72)***
Prop. executives/ non executives	-0.159 (0.48)	-0.608 (2.63)**	-0.575 (1.06)	0.119 (0.90)
Inter. Av. stock market/GDP *exec./non-exec.	0.130 (0.73)	0.431 (2.80)**	0.445 (1.09)	-0.091 (0.98)
Sales	0.349 (6.48)***	0.288 (6.62)***	0.471 (3.63)***	-0.038 (1.66)
Return on equity	-0.001 (0.36)	-0.000 (0.12)	0.002 (0.57)	-0.000 (0.49)
Average GDP	0.019 (0.27)	-0.062 (0.99)	0.353 (2.92)**	-0.033 (1.62)
Corporate tax	0.020 (0.93)	-0.006 (0.25)	-0.082 (2.18)**	-0.004 (0.52)
Income tax	0.003 (0.23)	0.024 (2.28)**	0.050 (3.06)***	0.003 (1.00)
Constant	11.002 (4.67)***	12.705 (7.81)***	3.354 (0.99)	1.068 (1.59)
Observations	297	257	237	243
R-squared	0.61	0.54	0.59	0.43
Nr. Clusters	15	15	15	15

A. \* significant at 10%;\*\* significant at 5%; \*\*\* significant at 1% .

B. White robust t statistics in parentheses

C. Industry and Country dummies not reported

### **3.8 Discussion and conclusion**

The objectives of this study were twofold. First, to examine the cross-national generalizability of managerial power theory I tested it on a sample of 940 firm-year observations from 17 countries. Second, to extend the existing scope of managerial power theory I assessed the influence of national context – especially that of designated institutions – on the effectiveness of selected governance mechanisms for constraining executive discretion over their pay levels and structures. The results of this study partake in the current debate in the executive pay literature on the role of managerial power, and have several implications for management practice and policy makers.

#### **3.8.1 Generalizing managerial power theory**

The results of this study suggest that managerial power theory can be generalized outside of the national context in which it was formulated (i.e. the US; cf. Bebchuk and Fried, 2003; 2004) – but with caution. At a somewhat elevated level of abstraction, issues of managerial power and managerial control over the pay setting process are shown to also apply to other jurisdictions than the US alone. More concretely, the workings of certain corporate governance mechanisms appear to be generalizable across nations. CEO duality, for example, presents many US CEOs with extra discretionary power, and therefore tends to be associated with higher pay (Boyd, 1994; Main and Johnston, 1993; Westphal and Zajac, 1994). The current study shows that duality is endemic, not only in the US, but also in Canada, Hong Kong, and Spain and also in France – where individuals in the uniquely powerful role of *président directeur-général* can domineer the other directors on the board and may even have the informal power to handpick them (Wymeersch, 1998). In all these nations, chief executives who are also chairman of the board seem to stand to reap the gains of surplus power. Furthermore, higher proportions of non-executive directors seem unable to tame executive discretion over pay structures. This is due to managerial discretion in negotiating trade-offs between implications of pay levels and pay structures, not only in the US, but also in other jurisdictions with a relatively higher number of executives to non-executives like Sweden, South Africa, and Switzerland. In sum, some of the predictions derived from managerial power theory hold equally well in other corporate governance contexts as in the US.

Other predictions must, however, be generalized with greater caution. Employee representation on the board, for instance, may work as an additional check on management in “outsider systems” like the US and the UK, in which ownership is dispersed and in which the controls on managerial discretion, such as the market for corporate control, are supposedly external to the company (Walsh and Seward, 1990). In “insider systems” like Germany (Becht and Böhmer, 2001) and Sweden (Agnblad, Berglöf, Högfeldt, and Svancar, 2001), however, in which ownership is more concentrated and control ought to originate “from within,” employees and managers may strike up a coalition against shareholders (Pagano and Volpin, 2005a; 2005b) in such a way that employee representation simultaneously furthers employee protection and managerial discretion, at the expense of the owners of the corporation. These results should not, however, be seen as evidence against managerial power theory, as they merely specify additional circumstances under which managers can use their discretionary powers. They do call for further research, however, to map with greater precision which conditional varieties of national contexts increase or decrease managerial discretion.

### **3.8.2 Extending managerial power theory**

The current chapter offered and tested an extension of managerial power theory, based on the increasingly important notion that corporate governance mechanisms are critically affected by institutional context (Becht, Bolton and Roëll, 2002; Dyck and Zingales, 2004; La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1997; Roe, 2003; chapter 2). Rather than considering pay merely as an instrument in corporate governance arrangements, this approach argues that the contextual embedded processes of setting pay are of high importance in efforts to explain executive pay (chapter 2). The central theoretical tenet was that the effectiveness of a given firm-level governance mechanism for controlling managerial discretion would be contingent on the quality and makeup of the institutions of the country in which that mechanism is employed. It was expected that strong and functionally complementary institutions would increase control over managerial behavior and decrease managerial discretion over their pay setting process, and that weak or dysfunctional institutions would decrease control and increase managerial discretion.

The results, however, show a mixed picture. Some strong well-functioning institutions are found to mediate the expected relationships where others are found to negatively influence the expected effects. For instance, CEO duality allows executives to extract greater rents from the corporation in countries offering relatively weak protection against managerial self-dealing like the US (cf. Djankov et al., 2005; 2006), but this particular governance dysfunctionality is rendered less harmless when adequate investor protection laws are put in place. Furthermore, in contrast with earlier findings (Tosi and Greckhamer, 2004), little support was found for a main effect of the cultural dimension of power distance on executive pay. What is found, however, is that this dimension enlarges managerial power in situations where control is supposed to emanate from direct peers, such as in a one-tiered board structure. Here, the respect for fellow elite members that is typical of high power distance countries (cf. Hofstede, 2001) diminishes non-executives' willingness or ability to police executives.

On the other hand, higher levels of institutionalized protection of labor and employees representatives jointly increase managerial discretion. Although the separate effects of these variables showed a dampening of managerial power over pay levels, their interaction effect relates positively to pay levels. Similarly, the mediation between bigger stock markets and a relatively higher number of executives to non-executives resulted in counter-intuitive results. Although the separate effects of these two showed to be negatively related to pay levels, their interaction effect is positive. The results in general show the contextual importance of firm-level corporate governance mechanisms. Further research is needed, however, to further comprehend the complex interaction effects between institutions and corporate governance mechanisms. The many possible combinations between (different) institutions and the many different corporate governance mechanisms may be complemented with extensive studies that systemically assess possible combinations and their effects on pay levels and structures. Furthermore, another technique of Set-theoretic Methods, a method that can be used to examine which combinations of attributes lead to specific outcomes, could be used as a complementary method to investigate the contextual makeup and relationships with corporate governance mechanisms and their joint effects on executive pay.

More research is also needed to address the issue regarding to which extent non-executives use their discretion to, on the one hand, set their own pay and to, on the other hand, set the pay of executives. While the focus of this chapter has been on executives, future research could further explore the implications of an institutional managerial power theory and the context in which non-executive pay is set and how non-executives use their discretion to collude with executives. Investigating the implications of non-executive discretion could further shed light on managerial power theory as advanced here that indicate empirical and conceptual concerns with concepts as the altruistic roles of non-executives and of overt monitoring.

Another issue is the extent to which managerial discretion leads to “good” or “bad” behavior. For instance, the result that in a two-tiered system executives seem to have more discretion is arguably an indication that they simply have more responsibilities and decision making freedom over firm resources and organizational slack (cf. Cyert and March, 1963/1992). The fundamental conceptual difference between (mis)using discretion for purely opportunistic behavior, or using it for organizational interests or self-interests with inclined cooperation needs additional research (cf. Gomez-Mejia, Wiseman and Dykes, 2005; Murphy, 2002; Roe, 2003; chapter 2). In contrast to the present study, the view in the executive pay literature is typically normative in the sense that discretion is mostly understood as having negative results for shareholder value (e.g. in the mainstream literature that adheres solely to the contract approach of agency theory, discretion is effectively ruled out and is only considered as a cost). Executive discretion might indicate that executives are in a position to manipulate the system by simply increasing their pay or by influencing their pay structures. However, discretion and related pay levels and structures arguably reflect true responsibilities and decision making freedom, which any actor has in any constructed social system where market forces are limited and actors are constrained to make fully rational, calculated, optimal decisions (cf. Cyert and March, 1963/1992). Actors may thus be more inclined to follow rules of thumb and other cognitive behavior when negotiating executive pay that reflects the appropriateness of certain pay, given the institutional conditions and personal (normative) considerations in the process (cf. Cyert and March, 1963/1992; chapter 2). A broader objective function of the firm as striving for long term firm value, instead of the normative assumption of shareholder value (cf. Jensen, 2001), ought to consider the most likely possibility that discretion also positively contributes to

performance. Future research is needed to make the conceptual (normative) difference more explicit, which may in turn empirically show how executive pay and discretion interact with corporate governance arrangements and institutions, and how these relationships effect and are affected by firm performance.

### **3.8.3 Implications for practice**

The results of this study have several implications for policy makers and for shareholders and their representatives. Policy makers around the globe – including “soft regulators” like stock exchanges and directors’ associations – have recently begun introducing new practices in their existing corporate governance systems, either as a response to globalization or to systemic corporate crises in the post-Enron era (Aguilera and Cuervo-Cazurra, 2004). Similarly, stakeholders and their representatives are pushing for corporate governance reforms, especially in jurisdictions that have suffered from prolonged periods of sub-par economic performance. The current chapter presents at least three lessons for these parties.

First, they should not try to copy elements from more successful jurisdictions directly (i.e. countries with higher economic growth rates, better average firm performance, or broader and deeper stock markets). Especially US-style governance principles have long been heralded as a superior way of distributing corporate wealth and regulating the relations between managers and other constituents (Fiss and Zajac, 2004). Policy makers should not turn a blind eye, however, to the institutional idiosyncrasies of the US economic landscape. Especially if their own institutional makeup is considerably different from the US, they should not count on the effectiveness of US-style governance mechanisms, and are most likely better off selecting governance principles that suit their own context better. Second, when aiming to influence managerial discretion, firm-level governance reforms seem to work best when they go hand-in-hand with jurisdiction-level institutional reforms. Although relationships between certain institutional conditions and corporate governance mechanisms could negatively mediate executive discretion, this does not have to be true for all combinations. Some are found to increase rather than decrease managerial discretion. Amendments to one or the other (i.e. institutions or mechanisms) could therefore have less or less desirable effects on specific pay components and/or pay makeup. When challenging the discretionary powers that

CEO duality harbors policy makers should, for example, push for better shareholder protection at the same time. Focusing on just one of the two is unlikely to yield satisfactory results, as illustrated by the differential experiences of the US and the UK in addressing discretionary powers of CEO-Chairmen (Conyon and Peck, 1998). And third, CEOs and executives seem to have discretion in making trade-offs between positive and negative implications of their pay levels, with negative and positive implications on their pay structures that are potentially more contingent on performance. This implies that certain reforms may limit or increase discretion over pay levels but may simultaneously increase or decrease discretion over pay that is potentially more in line with performance.

In short, the most effective governance reforms are likely to be those that respect the uniqueness of each national system of corporate governance and that work toward the improvement of local governance conditions. More radical reform attempts, in which large parts of foreign governance systems are “transplanted” into a given national context without much regard for the actual mix of extant institutions (a process stimulated by, for instance, the World Bank and the OECD – two organizations promoting their own rather strict principles of corporate governance), are less likely to be successful. More research is needed, however, to come to a better understanding of the effects of the present “governance harmonization movement” led by these supranational organizations on the competitiveness of firms and regions.

#### **3.8.4 Conclusion**

Even though calls for more attention to the role of managerial power in the pay setting process are by no means new (Core, Holthausen, and Larcker, 1999; Finkelstein and Boyd, 1998; Finkelstein and Hambrick, 1989; Grabke-Rundell and Gomez-Mejia, 2002; Hallock, 1997; Jensen and Murphy, 2004; Tosi and Gomez-Mejia, 1989; Useem, 1996; Westphal and Zajac, 1995), managerial power theory (cf. Bebchuk and Fried, 2003; 2004; 2006) offers an important addition to the executive pay literature, because it is the first systematic theory of the processes in which executives set their own pay. It is systematic, first, because it offers an orderly account of how its own assumptions regarding the behavior of executives and non-executives contrast with those of the received optimal contracting approach. Secondly, it is also systematic, because it brings together and integrates a substantial number of previously



disconnected findings on various aspects of the executive pay setting process, such as social influencing processes on the board and the role of public outcry.

In contrast to the mainstream literature, and also in contrast to the single institutional view taken by for instance Bebchuk and Fried, the current chapter has explored the important implications of considering variance in institutional makeup. The chapter has demonstrated the generalizability of this important theory, by showing that managerial power influences executives' pay levels and structures in many economically developed nations. It also offered a straightforward major extension of the theory, by demonstrating how the effectiveness of certain firm-level governance mechanisms is contingent upon the quality and makeup of a given nation's institutional matrix. To further the development of an institutional managerial power theory, future research is proposed that extends this study by exploring the ways in which combinations of (other) governance mechanisms interact with (other) institutional structures; that explores how this interaction impacts executives' influence and remuneration; and explores more ways in which to generalize explanations about the contextual context in which interactions of mechanisms and institutions can positively or negatively influence managerial discretion and how this is influenced by, and has influence on firm and a country's economic performance.



## ***Chapter 4***

### ***Towards a plurality of corporate governance philosophies***

#### **4.1 Introduction**

Corporate governance systems consist of a large variety of different mechanisms that control corporate welfare and regulate the distribution of corporate wealth. Comparative corporate governance scholars have long tried to capture approaches to these systems into two basic categories (Aguilera and Jackson, 2003; Gedajlovic and Shapiro, 1998). The depth of the chasm between the two systems is emphasized by Ahmadjian and Robbins. They argue that “One of the sharpest distinctions among business systems is between the market economies of the Anglo-American countries, and the stakeholder economies as typified by Germany and Japan” (2002: 3). More generally, the dichotomous distinction that these scholars use is intended to help assign a country’s approach to its corporate governance system either to the Anglo-American shareholder-oriented model or the European stakeholder-oriented model (Becht and Roëll, 1999; La Porta et al., 1998). The tendency to argue that “Corporate governance operates in two broadly distinct worlds” (Buck and Shahrim, 2005: 42) is labeled here as the dichotomous world hypothesis of corporate governance.

There are, however, problems with this dichotomous world hypothesis. It is often noted that corporate governance arrangements in regions like South-East Asia (Dore, 2000; Gedajlovic and Shapiro, 2002), Eastern Europe (Filatotchev, et al., 2000; Judge and Naoumova, 2004), and Latin America (Guillén and Tschoegl, 2000; Khanna and Palepu, 2000b) do not easily fit into this dichotomous classification. Nevertheless, defenders of the dichotomous world hypothesis commonly argue that the corporate governance systems in these regions are not truly unique. They argue that these approaches represent some form of hybrid between the two basic thoughts on corporate governance (cf. Bratton and McCahery, 1999; van den Berghe, 2002). They hereby deny the possibility of true variability in the approach to corporate governance arrangements across countries. This is problematic because the wide variety of possible adaptations of different configurations of corporate governance mechanisms do not easily fit into this “two-sizes-fit-all” straightjacket.

Fundamental questions to be asked are what do configurations of corporate governance mechanisms across countries actually look like and how do they differ across countries? By answering these questions a possible classification of different approaches towards corporate governance can be identified. By using content analysis of corporate governance reform codes, this chapter inductively constructs 5 different generalized beliefs on approaching the organization of corporate governance systems. The 5 inductively acquired views are labeled as philosophies, as they reflect 5 different fundamental generalized beliefs and attitudes on how corporate governance arrangements can be structured within a country.

The upside of identifying these philosophies in the way described below is that it offers the possibility to identify measures of distinct views of corporate governance. Many studies show that corporate governance systems are vastly different from nation to nation, and that these differences influence and are broadly influenced by the setup of social, political, and economic institutions (Dore, 2000; Thomsen and Pedersen, 2000; Whitley, 1999). It is not only the identification of philosophies that helps to identify country specific views on corporate governance. We also need better data and data on more countries, as better indicators will facilitate making comparisons on specific dimensions as opposed to looking for wholesale convergence of entire corporate governance systems (Guillén, 2000a). The field of comparative corporate governance is in a sense a “sleeping giant” waiting to be awakened by a set of readily available measures that can explain a fair portion of the variance in corporate

governance arrangement across national jurisdictions.<sup>1</sup> The inductive approach as described in this chapter makes an attempt to answer this call by offering such measures.

#### **4.2 Problems with the dichotomous world hypothesis**

Agency theory's principal-agent approach to corporate governance has greatly influenced the field of economic organization since it was first introduced by Jensen and Meckling (1976). Its employment by finance economists and strategic management scholars has since then shaped the language we employ to describe the modern corporation (Lubatkin, Lane, Collin, and Very, 2005). In fact, the large industrial corporation is often discussed at present in financial terms like debts, assets, and cash flows, both in the business press and by security analysts (Fligstein and Freeland, 1995). In turn, managers and owners of firms have largely begun to see their firms in exactly the same way (Useem, 1993). Firms are therefore most often evaluated according to an agency based financial economics framework, and their governance arrangements are approached in light of the same agency theoretical view on the modern corporation (e.g. Davis and Thompson, 1994; Fama, 1980; Fama and Jensen, 1983; Roe, 1994; Zajac and Westphal, 2004).

Approaches of corporate governance are therefore often typified along the premises of this agency theoretical framework. Approaches of corporate governance systems are typically described as "insider" versus "outsider" systems, as "shareholder" versus "stakeholder" capitalism, or as involving "equity-financed" versus "debt-financed" firms. Approaches of corporate governance that best resemble the theoretical ideal agency framework are often labeled as an Anglo-American shareholder-oriented approach. In contrast, systems that are further away from the ideal agency theoretical framework are labeled as the continental European, "Rhineland" or the Eurasian stakeholder-oriented approach of corporate governance.

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<sup>1</sup> An important parallel can be drawn here with the research field on the influence of national culture on organizational phenomena. For a long time managerial theorists have argued that the national context is of decisive influence on the efficacy with which managerial instruments can be employed. But until the dimensionalizing of national cultures by Geert Hofstede, management scholars largely lacked the means to test this hypothesis. Regardless of the fact that many contributors have criticized the Hofstede scales, it is undeniable that they have provided the field of international comparative studies with an important impetus. (See e.g. Sondergaard, 1994).

The former system is characterized in terms of relative more: (a) equity-based financing, (b) influence of executive directors on corporate boards, (c) dispersed ownership, (d) timid private shareholders, (e) active markets for corporate control, and (f) shareholder oriented apposed to stakeholder orientated. The latter system is subsequently often sketched in terms of relative more: (a) debt financing, (b) independent corporate boards, (c) concentrated ownership, (d) active institutional shareholders, (e) protection against forces from the markets for corporate control, and (f) influence from other stakeholders besides suppliers of finance (see e.g. Aguilera and Jackson, 2003; Becht and Roëll, 1999; Fukao, 1995; La Porta et al., 1998; Shleifer and Vishny, 1997).

The mechanisms described to influence corporate governance outcomes seem very similar in both approaches. Besides the important role of the effectiveness of markets, other mechanisms such as ownership structures, different methods used to finance the firm, the board of directors, and the role of other stakeholders as apposed to financiers are considered to be of importance in both types of approaches. There is also room for categorizing specific mechanisms that are more in line with either one of the approaches (e.g. the presence of labor on the board of directors would be in line with the continental European approach). However, most mechanisms are present in both categories. At first glance the distinction between the two approaches seems to be more based on the relative focus on specific mechanisms (and their subsequent outcomes), rather than the focus on the presence of specific mechanisms.

However, the effectiveness and existence of mechanisms and their operations are highly dependent on the socially constructed context in which the mechanisms are present and developed (e.g. the presence of employee representatives on the board of large German listed firms is regulated by law). In other words, there appears to be a number of different ways of achieving “social peace” (Roe, 2003) and configurations of mechanisms effective enough to “get the job done” (Aguilera and Jackson, 2003; Biggart and Guillén, 1999). Therefore, the makeup of national corporate governance systems is not strictly determined by the outcome of market forces, but rather is shaped and contested by cultural, social, and political factors (e.g. Dyck and Zingales, 2002; Hamilton and Biggart, 1988; Khanna, Kogan, and Palepu, 2006; Kogut and Walker, 2001; Lubatkin et al., 2005; McGuire and Gomez, 2003; Rajan and Zingales, 2003; Roe, 2003). The comparative corporate governance literature provides, for example, detailed studies of how domestic political conditions mediate the effect of

economic conditions on corporate governance outcomes (e.g. Djelic, 1998; Fligstein, 1990; Orru, Biggart, and Hamilton, 1997). The institutional contexts used to explain different corporate governance traditions are thus highly relevant.

The dichotomous world hypothesis argues that the outcome of the makeup of adopting combinations of corporate governance mechanisms leads to two basic thoughts on how corporate welfare can be controlled and how corporate wealth can be distributed. Guillén, for example, concludes on the basis of a comparative study involving 41 nation states that “some countries have adopted certain isolated features of the shareholder-centered model” (2000b: 178). However the problem with the dichotomous world hypothesis is the denial of potential true variance of corporate governance approaches. Within the dichotomous world hypotheses well documented variances of institutional differences across countries in relation to approaching corporate governance (e.g. Barca and Becht, 2001; Gordon and Roe, 2004; La Porta, Lopez-de-Silanes, and Shleifer, 1999; Whitley, 1999) may neglect conceptually different views on using distinct mechanisms, combinations of mechanisms, and focus on certain configurations of corporate governance mechanisms used to achieve economic efficiency within national distinct institutional configurations. The distinction that the dichotomous world hypothesis makes neglects potential conceptually fundamental different views on how corporate governance arrangement besides the dominant agency framework can be structured across countries. In other words, generalizations of corporate governance arrangements based on the agency framework neglect important institutional contexts in which corporate governance arrangements are embedded and developed. Because of institutional differences, the outcome of agency prescribed mechanisms that could be in place in a country’s corporate governance system does not necessarily have to be based on the consequentialist principals of an agency prescribed type of framework. Completely different generalized beliefs about the appropriateness of how corporate governance arrangement ought to be structured could possibly result in the adaptation of certain mechanisms, given the context in which the mechanism can operate effectively and in which it is developed. Important questions that derive from this are: what do corporate governance arrangement actually look like, do countries differ in the makeup of corporate governance mechanisms, do they differ in relative focus on particular configurations of mechanisms, and how can we measure this?

### **4.3 Corporate governance reform codes, their status and development**

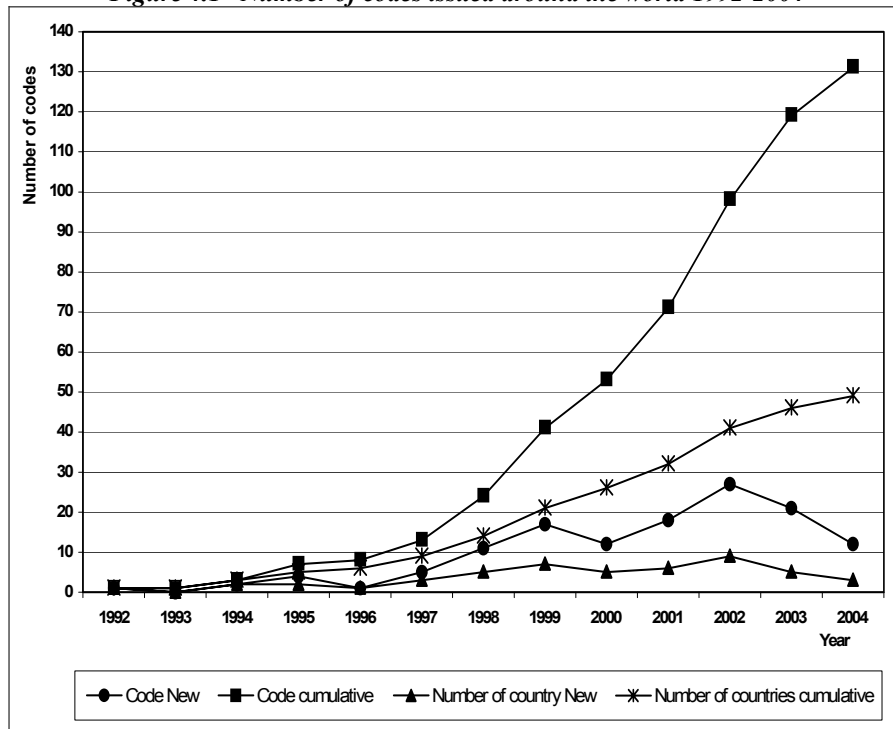
To be able to find answers to these questions corporate governance reform codes are subjected to content analyses. By analyzing reform codes in this manner the possibility is offered to develop measures and inductively demonstrate how national government arrangements can be structured and how they possibly differ.

Corporate governance reforms may be defined as deliberate interventions in a given country's ongoing corporate governance tradition by the state, the local securities and exchange commission, the stock exchange, or other parties, usually with the objective of harmonizing them with both international pressures for institutional change and endogenous (national) institutional evolution (cf. Whitley, 1999; Whittington and Mayer, 2000). These reforms can and most often are formulated in the form of so-called corporate governance reform codes. They are authoritative documents most often with a "soft-law" status, outlining the codified corporate governance approach. They are usually legitimated by the state, Securities and Exchange Commission, or the stock exchange through concrete endorsement, and are typically enforceable through corporate law or via private compliance structures (Aguilera and Cuervo-Cazurra, 2004). These codes of "best practices" are a set of codified corporate governance norms and mechanisms pertaining issues such as the role and composition of the board of directors; the installment of board subcommittees (e.g. audit, remuneration, and nomination committees); the appointment and rules of operation applying to external auditors; the distribution of rights and powers over professional managers, various groups of shareholders, and other stakeholders; the role of the media in information dispersion; and the protection of "whistle blowers" (see also Aguilera and Cuervo-Cazurra, 2004).

Reform codes are now a ubiquitous phenomenon in the corporate landscape. Figure 4.1 reports the historical patterning and spread of reform codes from 1992 to 2004. The figure shows that their diffusion across and adoption by nation states by no means followed a linear path. In the time period shown in figure 4.1, some countries have issued several codes over the years and others have issued their first code.



**Figure 4.1** Number of codes issued around the world 1992-2004



**Source:** Chart based on data from the European Corporate Governance Institute ([www.ecgi.org](http://www.ecgi.org), October 2004).

The 1992 Cadbury Committee Report has an important place in the development of other codes. The corporate governance guidelines as laid down in this report challenged the effectiveness of British corporate governance best practices in the face of a deep recession and a number of unignorable corporate failures. The report became a “flagship guideline” (Stiles and Taylor, 1993) that urged many other countries to critically evaluate their own corporate governance practices. A second impetus for initiating reforms came early in the new millennium. A large number of corporate scandals (accounting mishaps as well as possible unnecessary bankruptcies), of which the Enron fiasco is just one example, shook investor confidence and brought many governments, stock exchanges, and securities and

exchange committees to the verge of despair. The effect of this seemingly worldwide “jolt to the system” (Meyer, 1982) also shows up in Figure 4.1. Several nation states updated their existing codes, and many states that did not yet have a code adopted one. At the end of 2004, at least 49 countries had codified their corporate governance traditions in the form of a code of best practices.

Most countries that codified their preferred way of organizing corporate governance by adopting a code did not, however, have to go back to scratch to completely (re)designed their corporate governance systems. Some contain little new content, and have rather codified the extant business model of the specific country. To the extent that new provisions are adopted, it is not necessarily the case that these are derived from some type of “global” corporate governance model centered on, say, the prescriptions of an agency theoretical framework. As also indicted above, myriad studies show that global convergence to agency theory based governance is not necessarily the worldwide trend (Hollingsworth and Boyer, 1997; Khanna, Kogan, and Palepu, 2006; Orru, Biggart, and Hamilton, 1997; Whitley, 1999). In this respect it seems that corporate governance reform codes mend and improve upon the existing institutional infrastructure of a given country, rather than that they “transplant” novel institutions in their entirety from abroad. A good example in this respect is the United Kingdom, which has issued 13 codes since the publication of the 1992 Cadbury Committee Report. By frequently referring to it, these codes all build on and accept as an institutional legacy the accomplishments of this earlier report.

To my knowledge, so far no other study has really systematically analyzed the actual content of corporate governance reform codes. Some studies have used the binary event of adapting a code or explain its adaptation decision. Such studies take the rather bold assumption that “the content of codes varies slightly across countries” (Aguilera and Cuervo-Cazurra, 2004: 420). If that were the case it would suggest that there is some form of “global” approach to corporate governance. This would further imply that different institutional contexts would lead to a single view on corporate governance arrangements, and not to two basic or to possibly a larger number of different approaches.

Content analyses on corporate governance reform codes can thus be useful for addressing questions on what corporate governance arrangements look like, how they differ across countries, and how to measure this. The codes reflect the preferred standards of what corporate governance arrangement ought to look like in a specific country. Although they can reflect a mixture of facts and aspirations, they do describe the configuration of possible corporate governance mechanisms that can be used in a specific country. As Khanna, Kogan, and Palepu (2006) have recently argued, although there might be some indication of growing similarities between countries of certain standards regarding corporate governance arrangements these standards have not been implemented across countries.<sup>2</sup> The distinctions between (adaptations) of corporate governance systems and standards found by these authors support the notion that either countries adapt their corporate governance systems appropriately within their own current state of affairs or that efficiency arguments of convergence towards one efficient model are too weak to overcome local arrangements (Khanna, Kogan, and Palepu, 2006; see chapter 5 for further discussion on convergence). Either way, systematically analyzing reform codes allows us to reveal, in a detailed and mutually comparable inductive way, current corporate governance approaches and standards in different institutional contexts.

#### **4.4 Corporate governance reform codes and their content**

The sample of corporate governance reform codes are drawn from the codes made available by the European Corporate Governance Institute ([www.ecgi.org](http://www.ecgi.org)).<sup>3</sup> The potential sample consists of 131 corporate governance codes from 49 countries. This pool is reduced to 38 codes in the final sample by using the following criteria. First, the analysis was limited to only one corporate governance code per country, restricting the sample to a maximum of a feasible set of 49 codes. Second, the codes were judged on their comprehensiveness. Only codes that comment on a given

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<sup>2</sup> Khanna, Kogan, and Palepu (2006) show that the limited standardizations are not driven by the often assumed US standards or by a single model, but rather that counties tend to have similar standards as other countries in the same geographical region.

<sup>3</sup> At the time I started this study (October 2004) the codes from 49 countries were made available on this website. More recently, the number of countries on this website has reached 55. The codes used in this study are based on the earlier listing of 49.

country's entire corporate governance approach were used in the analyses. Partial codifications – such as memos commenting strictly on executive pay or on the role of independent directors on corporate boards – were discarded as non-representative for a country's complete corporate governance approach. Third, for countries with more than one comprehensive code, the authoritativeness of the codes was assessed. Only codes that were officially commissioned, either by the state, the local Securities and Exchange Commission, or a stock exchange where allowed in the sample. Fourth, in the case that more than one comprehensive and authoritative reform code could be identified (e.g. in the UK or the US), only the most recent document was opted for. Applying these criteria resulted in a sample of 38 country reform codes. See table 4.1 for the list of countries in the sample.

**Table 4.1 List of 38 countries in coding study**

Australia	Macedonia
Austria	Malta
Belgium	Mexico
Brazil	Netherlands
Canada	Norway
Cyprus	Pakistan
Czech Republic	Peru
Denmark	Poland
Finland	Portugal
France	Romania
Germany	Russia
Greece	Slovakia
Hong-Kong	South-Africa
Iceland	Spain
Ireland	Sweden
Italy	Switzerland
Japan	Turkey
Kenya	United Kingdom
Lithuania	United States

Content analysis is an appropriate analytical technique to explore the underlying meaning of rich and voluminous narrative sources (Carney, 1972; Holsti, 1969). Content analysis commences with a set of concepts in relation to which relevant messages can be classified. These concepts were inductively arrived at by a thorough reading of all 38 reform codes. Tables 4.2a and 4.2b report the 17 concepts on which the actual text was codified. For converting the coded text into numerical measures for subsequent use in statistical analysis procedures of the qualitative data analysis software package Nvivo was used.

**Table 4.2(a) Definitions of codified constructs**

<i>Name construct</i>	<i>Description</i>
Short term bonus	% of coded text devoted to executive pay in the form of cash bonuses and other forms of short-term incentive pay
Long term incentive plans	% of coded text devoted to executive pay in the form of (restricted) stock options and shares and other forms of long-term incentive pay
Board of directors	% of coded text devoted to the appointment, composition, and rules of operation of a company's entire board of directors (BOD)
Nominating committee	% of coded text devoted to the appointment, composition, and rules of operation of the BOD's subcommittee involved with the selection and training of new BOD members
Audit committee	% of coded text devoted to the appointment and composition of the BOD's subcommittee that oversees the principal (financial) information flows and selects an external auditor to verify the content of that information
Remuneration committee	% of coded text devoted to the appointment, composition, and rules of operation of the BOD's subcommittee involved with determining the company's overall executive pay policy as well as the specific amount of monetary incentives to be paid out to executives in a given year
Shareholder voting	% of coded text devoted to a description of all issues on which shareholders are allowed to vote during the shareholder's meeting, as well as the rules of operation pertaining to that meeting in general and the voting process in particular
Shareholder rights	% of coded text devoted to a description of all ancillary rights granted to shareholders, including the right to call shareholder meetings, the right to be informed about important corporate decisions, and the right of interpellation
External auditor appointment	% of coded text devoted to the selection and appointment of the external auditor including the rules of operation the external auditors follow
Auditor rules of operation	% of coded text devoted to the rules of operation to be followed by the internal audit committee

**Table 4.2(b) Definitions of codified constructs (continued)**

<i>Name construct</i>	<i>Description</i>
Institutional investors	% of coded text devoted to a description of institutional investors as a separate category of investors, usually in contradistinction with dispersed shareholders, with distinct rights and obligations such as the right to engage in a direct dialogue with executives and the obligation to actively monitor them on behalf of all shareholders
Social reporting	% of coded text devoted to a description of all social, health, and environmental issues about which firms are expected to report, either integrated with or separated from their report of key financial indicators and results
Treatment of financial equity holders	% of coded text devoted to a description of all rules of operation firms must follow in order to ensure the equitable treatment of all parties with a financial or competitive stake in the company (including minority shareholders)
Stakeholder equity	% of coded text devoted to a description of all rules of operation firms must follow in order to ensure the equitable treatment of all parties with a social or political stake in the company (other than shareholders)
Employee ownership	% of coded text devoted to a description of all rules of operation firms must follow in order to provide executives and other salaried employees with the opportunity to become co-owners of the firm
Whistleblower protection	% of coded text devoted to a description of all rules of operation firms must follow in order to ensure the protection and economic independence of employees that seek to publicly address corporate wrongdoings
Media information rights	% of coded text devoted to a description of all media channels firms ought to utilize to inform shareholders and other stakeholders of important corporate decisions and results

To account for any a priori size differences between the codes, the number of characters coded for each concept are expressed as a percentage of the total length of a given code (the average length of the codes was: 75,520 characters; standard deviation: 56,449 characters; range: 20,038 – 246,918 characters). On average, 57% of a given code was assigned to the used concepts (standard deviation: 17%; range: 15% – 93%). Table 4.3 reports the descriptive statistics and table 4.4 reports the Pearson correlations of the 17 concepts.

**Table 4.3 Descriptive statistics constructs**

	<i>Construct</i>	<i>Minimum</i>	<i>Maximum</i>	<i>Mean</i>	<i>Standard</i>
		<i>(%)</i>	<i>(%)</i>	<i>(%)</i>	<i>deviation</i>
1	Short term bonus	0	2,72	0,19	0,01
2	Long term incentive plans	0	75,25	3,59	0,13
3	Board of directors	0	65,62	32,23	0,14
4	Nominating committee	0	8,44	1,46	0,02
5	Audit committee	0	26,63	4,94	0,06
6	Remuneration committee	0	10,37	1,88	0,03
7	Shareholder voting	0	10,93	1,74	0,03
8	Shareholder rights	0	10,90	2,59	0,03
9	External auditor appointment	0	5,81	0,67	0,01
10	Auditor rules of operation	0	6,80	1,33	0,02
11	Institutional investors	0	5,22	0,65	0,01
12	Social reporting.	0	7,67	1,61	0,02
13	Treatment of fin. equity	0	10,69	1,32	0,02
14	Stakeholder equity	0	3,63	0,23	0,01
15	Employee ownership	0	25,00	1,06	0,04
16	Whistleblower protection	0	1,26	0,08	0,00
17	Media information rights	0	5,04	1,45	0,01

Table 4.3 shows that reform codes differ in addressing certain parts of corporate governance arrangements. The descriptive statistics show, for instance, that the concept of Remuneration Committee (the percentage of coded text devoted to the appointment, composition, and rules of operation of the board committee involved with determining the company's overall executive pay policy) has a range from 0% to 10,37%. This indicates that at least one certain code pays no attention to this mechanism where another code pays 10,37% of the codified text to this mechanism.



Table 4.4 Correlations constructs<sup>a</sup>

Variable	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1. Short term bonus																
2. Long term incentive plans	-.059															
3. Board of directors	.023	-.464**														
4. Nominating committee	.298	-.042	-.063													
5. Audit committee	.081	-.170	.082	.572**												
6. Remuneration committee	.094	.085	.105	.379*	.562**											
7. Shareholder voting	-.209	-.109	-.080	-.271	-.215	-.301										
8. Shareholder rights	-.272	-.023	-.197	.014	-.299	-.258	.231									
9. External auditor app.	-.162	-.122	.259	-.148	.069	-.215	-.080	-.231								
10. Auditor rules of operation	-.199	-.116	.058	-.028	.138	-.350*	.084	.238	.186							
11. Institutional investors	.387*	.123	-.010	-.151	.002	.201	-.010	.016	-.092	-.088						
12. Social reporting	-.206	-.056	.309	-.326*	-.024	-.231	-.076	-.168	.416**	.142	.172					
13. Treatment of fin. Equity	.174	-.049	-.085	.016	-.032	.012	.426**	.528**	-.143	.262	.454**	.034				
14. Stakeholder equity	.552**	-.062	-.027	.013	.002	-.068	.237	.058	-.133	.112	.401*	-.069	.381*			
15. Employee ownership	-.002	.596**	-.425**	.022	-.156	-.011	-.086	.192	-.109	-.171	.049	-.079	-.033	-.003		
16. Whistleblower protection	-.042	-.073	-.166	.517**	.668**	.390*	-.192	-.123	-.008	.107	-.078	-.216	-.104	-.045	-.075	
17. Media information rights	.314	-.074	-.079	.053	-.210	-.213	.216	.215	-.048	.103	.322*	.162	.361*	.522**	.217	-.080

<sup>a</sup> \*\*  $p < .05$ , \*\*\*  $p < .01$

Table 4.4 reports that certain concepts are correlated with each other and others are not. This implies that addressing a certain concept could be related to the discussion of another concept and visa versa. See, for instance, Whistleblower Protection (a mechanism that regulates the protection of parties that signal possible malfeasances) and Audit committee (a mechanism that regulates procedures of the appointment and composition of firm internal auditors) and their significant correlation (0.668, significant at  $p < 0.01$ ). This suggests that there may be a pattern in the makeup of addressing certain concepts. Patterns in addressing certain corporate governance mechanisms or a focus on specific sets of configurations of the concepts could reveal a certain preferred focus of a country's corporate governance arrangements. To analyze this potential pattern, factor analyses was performed on the data.

#### **4.5 The identification of 5 patterns**

To explore possible patterns a principal components analysis is used. Visual inspection of the Scree plot (not reported) showed that a five-component solution was desirable. In a second round of analyses, five components were extracted. Each component had an Eigenvalue  $> 1.0$ ,<sup>12</sup> and the five components jointly explained 67% (66,58%) of the variance. Subsequently the constructs were subjected to a Varimax rotation to increase the interpretability of the findings. Table 4.5 displays the results of this exploratory factor analysis.

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<sup>12</sup> Eigenvalues of  $>1.0$  indicate that the joint construct of the underlying variables contribute to the explained variance. An Eigenvalue  $<1.0$  would indicate that the underlying variables jointly contribute less than if they were to be used as separate constructs.

**Table 4.5 Exploratory factor analysis <sup>a</sup>**

	<b>Factor 1</b>	<b>Factor 2</b>	<b>Factor 3</b>	<b>Factor 4</b>	<b>Factor 5</b>
Eigenvalue	3,126	2,627	2,260	1,896	1,409
% Variance Explained	18,39	15,45	13,30	11,15	8,29
% Cumulative Variance Explained	18,39	33,84	47,14	58,29	66,58
Nominating committee	<b>0,754*</b>	0,053	-0,012	-0,013	-0,275
Audit committee	<b>0,891*</b>	-0,011	-0,063	-0,163	0,139
Remuneration committee	<b>0,638*</b>	0,067	-0,341*	0,038	-0,187
Whistleblower protection	<b>0,833*</b>	-0,123	0,071	0,017	-0,016
Short term bonus	0,095	<b>0,688*</b>	-0,461*	-0,117	-0,273
Institutional Investors	0,014	<b>0,759*</b>	-0,029	0,136	0,136
Stakeholder equity	-0,012	<b>0,808*</b>	0,162	-0,113	-0,137
Media information rights	-0,121	<b>0,696*</b>	0,293	0,090	0,057
Shareholder voting	-0,348*	0,086	<b>0,544*</b>	-0,167	-0,203
Shareholder rights	-0,154	-0,087	<b>0,735*</b>	0,175	-0,250
Auditor rules of operation	0,135	-0,040	<b>0,606*</b>	-0,140	0,384*
Treatment of fin. equity	0,028	0,430*	<b>0,733*</b>	0,015	-0,019
Long term incentive plans	-0,050	-0,010	-0,137	<b>0,854*</b>	0,014
Board of directors	-0,060	0,026	-0,205	<b>-0,681*</b>	0,309*
Employee ownership.	-0,065	0,083	-0,026	<b>0,842*</b>	-0,039
External auditor appointment	0,031	-0,130	-0,066	-0,139	<b>0,742*</b>
Social reporting	-0,204	0,114	-0,029	-0,055	<b>0,830*</b>

<sup>a</sup> Extraction method: Principal Component Analysis; rotation method: Varimax rotation with Kaiser normalization; rotation converged in 6 iterations; \* significant factor loadings (> 0.3); highest factor loadings for each variable are printed in bold.

The results in Table 4.5 show an interpretable factorial solution: all variables have a clear and consistently high loading on a primary factor (all primary loadings are > 0.5, average 0.74); relative few variables (6) have significant loadings on secondary factors;<sup>5</sup> and each factor consists of at least a pair of variables with negligible loadings on other factors (cf. Thurstone, 1947).

Table 4.6 reports the inter-reliability of the factors. As a reliability of the underlying measures, Cronbach's alphas on standardized items are reported (lies between 0-1, with 0 as indicative for unreliable). Furthermore the highest variance explained by a variable and its Eigenvalue are reported. All other Eigenvalues of the variables that make up a factor are smaller than 1.

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<sup>5</sup> There are 5 factors times 17 variables is 85 possible significant loadings. 85 minus 17(those with the highest significant loading) is 68 possible secondary loadings. There are only 6 significant secondary loadings representing 8,8%

**Table 4.6 Inter reliability of the factors**

	<i>Factor 1</i>	<i>Factor 2</i>	<i>Factor 3</i>	<i>Factor 4</i>	<i>Factor 3</i>
Cronbach Alpha	0,81	0,74	0,63	0,75	0,59
Variance explained	64%	57%	48%	66%	71%
Highest Eigenvalue	2,56	2,26	1,93	1,99	1,42

Table 4.7 shows the aggregated scores of each country on a patricidal factor. The numbers represented in this table were obtained by adding the scores for each country on each of the underlying items of the factor loadings (i.e., adding up each concept that has the highest loading on one of the 5 factors.) Table 4.7 also provides the labels on how the different factors are interpreted. This will be further discussed in the next section (4.6).

**Table 4.7 Countries and aggregated system scores <sup>a</sup>**

<b>Country</b>	<b>Factor 1</b>	<b>Factor 2</b>	<b>Factor 3</b>	<b>Factor 4</b>	<b>Factor 5</b>
	<b>Organizational Design</b>	<b>Ownership Concentration</b>	<b>Ownership Dispersion</b>	<b>Managerial Empowerment</b>	<b>Esteem Responsiveness</b>
Australia	.17	.05	.02	-.25	.01
Austria	.03	.00	.14	-.33	.02
Belgium	.13	.04	.01	-.34	.01
Brazil	.08	.01	.15	-.31	.03
Canada	.18	.00	.06	-.34	.06
Cyprus	.19	.06	.13	-.41	.03
Czech Republic	.08	.01	.09	-.32	.03
Denmark	.00	.00	.04	-.28	.00
Finland	.09	.00	.01	-.40	.02
France	.26	.03	.01	-.33	.00
Germany	.02	.06	.07	-.45	.05
Greece	.03	.06	.08	-.22	.05
Hong Kong	.05	.01	.00	.00	.00
Iceland	.19	.00	.00	-.44	.01
Ireland	.03	.02	.01	.86	.01
Italy	.13	.02	.05	-.54	.01
Japan	.05	.15	.00	-.37	.01
Kenya	.03	.00	.05	-.66	.02
Lithuania	.03	.03	.10	-.38	.02
Macedonia	.02	.03	.15	-.14	.01
Malta	.10	.00	.04	-.54	.03
Mexico	.00	.02	.01	-.51	.13
Netherlands	.03	.01	.05	-.14	.01
Norway	.06	.03	.24	-.14	.00
Pakistan	.13	.01	.04	-.44	.09
Peru	.05	.10	.32	-.25	.02
Poland	.00	.03	.03	-.34	.05
Portugal	.00	.01	.15	-.25	.00
Romania	.00	.00	.05	-.48	.01
Russia	.07	.01	.07	-.39	.03
Slovakia	.02	.00	.11	-.23	.00
South Africa	.04	.02	.02	-.24	.02
Spain	.04	.01	.01	-.24	.01
Sweden	.05	.04	.10	.41	.01
Switzerland	.07	.00	.04	-.21	.01
Turkey	.03	.04	.13	-.30	.02
U.K.	.25	.01	.06	-.36	.01
U.S.	.45	.01	.01	-.20	.01

*a Values represent aggregate scores for each construct per country, expressed as percentages of total coded text and obtained by adding the scores for all individual items comprising that construct. The negative scores for most countries on the Managerial empowerment construct result from one of its items – Board – being reversely coded (due to that item's negative loading on Factor 4).*

The analyses indicate a pattern of 5 distinct approaches to corporate governance. In other words, countries differ in the relative focus on combinations of corporate governance mechanisms. As can be seen in table 4.7 some countries (e.g. Mexico) pay no attention to factor 1, which is indicative of paying no attention to corporate governance mechanisms such as nominating, audit, and remuneration committees. Other countries such as Australia preferred corporate governance configurations focus very much on the mechanisms captured in factor 1 and 4 and less on the mechanisms in factors 3 and 5. The relative scores of countries provide the possibility to use these as measures to identify a country's preferred configuration of corporate governance.

#### **4.6 Interpreting the patterns: towards 5 corporate governance philosophies**

The inductive analysis of a country's preferred configuration of corporate governance has resulted in 5 different focus areas of corporate governance mechanisms. To capture the underlying fundamental generalized view of a preferred configuration of corporate governance mechanisms and the apparent relative focus on these views, the term philosophy is used. Each philosophy captures a generalized view on specific sets of corporate governance mechanisms. As can be seen in table 4.7, each country differs in relative focus on configurations of these philosophies. Each country seems to reflect a certain preferred makeup of their corporate governance system indicative by a relative focus on certain philosophies.

The analyses in the section above (4.5) provide statistical support for the identification of these 5 philosophies (i.e. the 5 factors). The interpretation of the factors is based on a specific view of the corporate governance mechanisms underlying each factor and can be traced back to the literature on these mechanisms. In that sense, the identification and labeling of the philosophies provide further validity of each philosophy in different domains of the corporate governance literature.

##### **4.6.1 Philosophy 1: Organizational design**

Factor 1 consists of 4 different corporate governance mechanisms (see table 4.5). This first factor references a structural conception of corporate governance and is label Organizational design (e.g. see Dalton et al., 1998; see Table 4.7 for the scores

of the sampled countries on this philosophy). The four mechanisms making up this factor are (1) Nominating Committee, a mechanism that ensures that the selection of new board members is fair and balanced, and that these new members are appropriately equipped before they take on the job; (2) Audit Committee, a mechanism guaranteeing the availability and verification of crucial financial and operational information; (3) Remuneration Committee, a mechanism that guarantees an equitable pay policy for executives, such that the company is able to hire and retain capable leaders without overpaying them; and (4) Whistleblower Protection, a mechanism ensuring that employees who desire to question (mis)conducts of the organization that employs them can do so openly without fear for managerial retaliation.

Seemingly, what this philosophy espouses is that the best way to arrange corporate governance is to make sure that firm operations are structured in an environment in which all structural checks and balances are firmly in place. The main environment that is addressed in this philosophy pertains to the internal organization. In principle, the most powerful of these structural mechanisms emanate from the Board of Directors (Gedajlovic and Shapiro, 1998). Table 4.5 shows that the first philosophy references three of these Board of Directors-related corporate governance mechanisms. The fourth relates to the protection of whistleblowers, reflecting that employees can be in a good position to directly overview executive actions (cf. Dow 2003; Hansmann, 1996). The focus on this philosophy in designing corporate governance systems in many nation states around the world could be indicative of its comprised set of strictly internal mechanisms that could be less costly to operate than strictly external ones (e.g. the market for corporate control and the market for executives) or mixed (combining internal and external mechanisms) alternatives (Gedajlovic and Shapiro, 1998; Walsh and Seward, 1990).

In brief, the organizational design philosophy rests on the inclination that a well coherent set of internally designed mechanisms define the organizational boundaries of managerial discretion (Michael and Pearce, 2004) in controlling corporate welfare and distribution of corporate wealth.

#### **4.6.2 Philosophy 2: Ownership concentration**

The second factor represents a dominant philosophy, which is labeled Ownership concentration (e.g. see Shleifer and Vishny, 1986; see Table 4.7 for the scores of the sample countries on this philosophy). Table 4.5 shows that the second philosophy references four mechanisms that are commonly associated with ownership concentration. The first is Institutional Investors, a mechanism that provides large investors with additional rights (such as the right to call shareholder meetings and the right of privileged access to top management) and responsibilities (such as the duty to take an active role in the governance of the corporation, especially by means of casting votes at the annual shareholders' meeting). The second is Stakeholder Equity, a mechanism that ensures a company's non-financial stakeholders of an equitable treatment. This mechanism coheres well with concentrated ownership, since: (a) the most important stakeholder group mentioned in codes of corporate governance are by far the employees of the firm, and (b) many countries with concentrated ownership traditions grant employees special privileges such as co-determination and lifetime employment (Roe, 2003). The third mechanism is Short Term Bonus, a mechanism that controls managerial self-interest seeking behavior by strictly regulating the amount of cash bonuses and other pecuniary short-term incentives managers can grant themselves (as managerial pay tend to be significantly lower in firms with concentrated ownership and more linked to performance than in their more dispersedly owned counterparts (Gomez-Mejia and Wiseman, 1997)). The fourth and last is Media Information Rights, a mechanism that controls the number of media channels through which firms ought to inform interested outsiders. This mechanism is known to be correlated with the ability of controlling shareholders to divert corporate resources to their sole advantage (e.g. "tunneling") (Dyck and Zingales, 2002; 2004).

The logic behind this philosophy is that the best way to govern a firm is to reduce the degree of separation between ownership and control by concentrating the ownership of the corporation in the hands of one or a few powerful investors (Berle and Means, 1932/2004). Due to the concentration of ownership, these investors will then both have the means and the motive to monitor and control managers (Shleifer and Vishny, 1997). The incentive to monitor is high because the controlling shareholder is the ultimate residual claimant of the firm (Alchian and Demsetz, 1972), whereas the ability to monitor is also high because the controlling shareholder can



often control the corporate board (Dahya, Dimitrov, and McConnell, 2005; Fama and Jensen, 1983; Tosi and Gomez-Mejia, 1989).

Prior studies have shown that ownership concentration is a preferred philosophy in many nations across the globe, as it seems to serve as a sort of “second-best” solution to the “first-best” solution of strong legal protection of minority shareholders (La Porta et al., 1999; but see Roe (2003) for a competing explanation rooted in political corporate governance antecedent variables). The ownership concentration philosophy touches upon a highly relevant content domain in comparative corporate governance, which underwrites its content validity. For example, Shleifer and Vishny (1997) discuss the construct as an alternative governance mechanism in regimes where legal protection of minority shareholders fails; Dyck and Zingales (2002; 2004) focus on the amount of private benefits controlling shareholders can extract from the companies they run; and Pivovarsky (2003) explains how ownership concentration can lead to better corporate performance in countries with weakly developed background institutions. In brief, the ownership concentration philosophy rests on a coherent set of mechanisms that jointly reduce the chasm that separates ownership from control (cf. Berle and Means, 1932/2004).

#### **4.6.3 Philosophy 3: Ownership dispersion**

The third factor represents another ownership-oriented conception of corporate governance, which is labeled ownership dispersion (e.g. see Grossman and Hart, 1980; see Table 4.7 for the scores of the sample countries on this philosophy).

Table 4.5 shows that this philosophy draws on four mechanisms: (1) Shareholder Voting, a mechanism that explicates all issues on which shareholders may vote during the annual shareholders meeting; (2) Shareholder Rights, a mechanism listing all ancillary rights bestowed on shareholders (including the right to call shareholder meetings and the right to receive information on the performance of the firm and any intended changes to its corporate strategy); (3) Auditor Rules of Operation, a mechanism that ensures that shareholders not only receive information on the corporation’s policy and finances, but that this information is also checked for veracity; and (4), Treatment of financial equity, a mechanism that makes sure that blockholders are not privileged over minority shareholders (for example, by not

allowing shareholders to obtain control rights in excess of their cash-flow rights; Grossman and Hart, 1988).

The concept behind this philosophy is that the best way to solve corporate governance problems is to render the separation between ownership and control more or less harmless by making sure that the rights of all shareholders (and not just those of blockholders) are explicated and legally enforceable (Jensen and Meckling, 1976). The dispersed ownership philosophy rests on a coherent set of mechanisms that make management accountable to all parties with an equity stake in the firm – regardless of the size of that stake. It is probably fair to say that the dispersed ownership philosophy plays a major role in most modern studies of corporate governance, and it thus evidences strong content validity. The focus on this third philosophy could be popular in many countries worldwide, as prior research has shown that strong (legal) protection of minority shareholders is likely to contribute to more efficient investment allocation, better developed financial markets, higher-valued publicly listed firms, and even higher economic growth in general (Beck, Levine, and Loayza, 2000; Djankov et al., 2005; La Porta, Lopez-de-Silanes, and Shleifer, 1997; 1998; 2002; Rajan and Zingales, 1998).

#### **4.6.4 Philosophy 4: Managerial empowerment**

The fourth factor that emerged from the data analyses is different from all other factors in that it reflects an alternative conception of corporate governance, which is labeled managerial empowerment (e.g. Donaldson, 1995; Davis, Schoorman, and Donaldson, 1997; see Table 4.7 for the scores of the sample countries on this philosophy). Table 4.5 shows that this fourth philosophy draws positively on two mechanisms that empower rather than constrain managers: (1) Employee Ownership, a mechanism that empowers managers by giving them control rights in excess of their negotiated managerial mandate; and (2) Long Term Incentive Plans, a mechanism ensuring that in the long run managers are rewarded for their good deeds. But, the third factor is bipolar in that it also evidences a strong negative loading on (3) Board of Directors, a mechanism that normally acts as an internal mechanism for monitoring managers, but that apparently has no place in a philosophy that relies on placing confidence and trust in the organizational leadership.

The guiding idea behind this corporate governance philosophy is that real-life managers are far from the self-interested sharks that agency theory (and the Neo-Hobbesian tradition in organizational economics more generally; cf. Bowles, 1985)<sup>6</sup> holds them to be (Donaldson 1995). Many managers are in fact benevolent stewards whose interests are naturally aligned with those of their principals, because both parties take pride in and wish to contribute to the greater social system in which they are embedded (Lee and O'Neill, 2003). The best way to ensure that these stewards contribute as much as possible to the goals and objectives of the firm is to make their mandate as broad as possible, and thus “stewardship theorists focus on structures that facilitate and empower rather than those that monitor and control” (Davis et al., 1997: 26). The managerial empowerment philosophy denotes a small but distinct domain of content in the corporate governance field, and thus evidences satisfactory content validity (see e.g. Davis, Schoorman, and Donaldson, 1997; Donaldson and Davis, 1991; Donaldson, 1995).

In brief, the managerial empowerment philosophy stimulates contribution to the greater good of the corporation by means of a coherent set of mechanisms that reward good deeds rather than crowd-out good intentions by monitoring behavior or punishing mistakes (Frey, 1997a; 1997b)

#### **4.6.5 Philosophy 5: Esteem responsiveness**

The fifth and final factor emerging from the data entails a conception of managerial control that is labeled Esteem responsiveness (e.g. Brennan and Petit, 2004; see Table 4.7 for the scores of the sample countries on this philosophy). Table 4.5 shows that the Esteem Responsiveness philosophy derives from two complementary mechanisms: (1) External Auditor Appointment, a mechanism that regulates the amount of praise and blame received by showing a wider audience that the financial and operational results of the firm are reliable; and (2) Social Reporting, a mechanism that influences the amount of esteem and disesteem by informing outside parties about the non-market performance of the firm in which they take an interest.

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<sup>6</sup> The Neo-Hobbesian tradition incorporates a number of highly influential theories, which have in common (and owe their predicate to the fact) that they share the behavioral assumption of managerial opportunism. These theories include, amongst others, agency theory, transaction cost theory, and team-production theory (see Perrow, 1986).

The idea on which this philosophy rests is that corporate governance functions best by controlling the flow of blame and praise that can be received. The controlling effect of esteem has intrinsic and extrinsic components. The intrinsic component consists of the fact that all individuals are to some extent “hardwired” to desire the esteem of others (Fodor, 1983). Thus, one would expect that corporate executives try to lead their organizations into excellence, as this would entitle them to praise from outside audiences. The extrinsic attraction of esteem lies in what can potentially be gained from it. Under this conception, governing the firm will be done in the best possible way by all of those with interest in the firm, because seeking a good reputation for having exceptional abilities and performance could also entitle them to higher pecuniary compensation (see chapter 2 for the symbolic approach on executive pay).

Because of its self-enforcing and self-policing qualities esteem responsiveness can be a relatively quick and inexpensive philosophy for ensuring that executives keep the promises they make (Elster, 1989). The esteem responsiveness philosophy references a small but promising stream of research in comparative corporate governance, which underwrites its content validity. For example, Dyck and Zingales (2004) have recently discovered that a high level of diffusion of the press (which they consider a “non-traditional” governance mechanism) helps put a check on power abuse by dominant shareholders (see also Dyck and Zingales, 2002); similarly, Khanna and Palepu (1997; 2000a; 2000b; 2004) have repeatedly stressed that one of the most important factors for explaining the limited economic development of countries like India and Chile is the fact that their capital markets are surrounded by weak informational regimes with limited opportunities for exposing and correcting malfeasance. Furthermore, media attention for executive pay has implications for the legitimizing process of executive pay arrangements (Bebchuck and Fried, 2004; Core, Guay, and Larcker, 2005; Wade, Porac and Pollack, 1997). In short, the esteem responsiveness philosophy reduces corporate governance problems by means of a coherent set of mechanisms that make corporate governance more transparent and interpretable to outside observers. More specifically, executives and firms are expected to be responsive to the ebb and flow of esteem, in the sense that they will work towards goals that bring them esteem and avoid results that cause them to accumulate disesteem, because of the intrinsic and extrinsic rewards that esteem harbors.

#### **4.7 Implications and conclusions**

Many contributors to the literature on comparative corporate governance implicitly or explicitly endorse what is labeled here as the dichotomous world hypothesis: the idea that corporate governance arrangements around the globe are characterized by limited true variability, and that all systems are largely based on either the Anglo-American shareholder-oriented model or the Eurasian stakeholder-oriented model. The inductive analyses in this chapter goes beyond this hypothesis by proposing the concept of corporate governance philosophies – complementary systems of beliefs on whether and how corporate governance arrangements are structured. Under this conception, no national system of corporate governance can be classified as purely shareholder or stakeholder-oriented. Instead, every country can be seen as having a distinct and truly unique corporate governance tradition, evidenced by and expressed as its relative endorsement of the philosophies identified. Each philosophy is comprised of different configurations of corporate governance mechanisms. Countries focus on different arrangements of these mechanisms. Thus, countries' corporate governance systems can only be classified in a relatively nuanced sense as systems of relative preferences for different corporate governance philosophies – and thus not by using the overly crude shareholder-versus-stakeholder dichotomy.

The conceptual contribution of this chapter resides in the identification of five such philosophies: (1) a structural conception of firm internal corporate governance mechanisms, labeled organizational design (e.g. see Dalton et al., 1998); (2) a corporate governance approach organized around the rights and responsibilities of parties that own large parts of the firm, labeled ownership concentration (e.g. see Shleifer and Vishny, 1986); (3) an approach oriented towards the protection of (minority) shareholders, labeled ownership dispersion (e.g. see Grossman and Hart, 1980); (4) an alternative conception of governance, rooted in the idea that executives often act as benevolent stewards rather than as potentially opportunistic agents, which is labeled as managerial empowerment (e.g. see Donaldson, 1995; Davis, Schoorman, and Donaldson, 1997); and (5) an approach of corporate governance that is structured around the flows of blame and praise, which is labeled esteem responsiveness (e.g. see Brennan and Pettit, 2004).

The interaction between the institutional contexts in which the philosophies are formed, developed, and adopted and possible “jolts to the system” could require the development of renewed corporate governance arrangement or amendments to existing institutions. A fitting metaphor in this respect seems to be that of “rebuilding the ship at sea” (Elster et al., 1998). Corporate governance traditions could be a rather sticky, ongoing affair, and it seems far easier to make amendments and to “patch up” existing institutions than to design entirely new ones (cf. Aguilera and Jackson, 2003; Roe, 2003). It does not seem too far fetch to say that countries make their amendments based on a relative focus on a preferred underlying philosophy about what corporate governance arrangements ought to look like given certain institutional configurations. By considering this institutional view on corporate governance it becomes apparent that the agency approach and the subsequent dichotomous world hypothesis are not followed when formulating corporate governance reform codes.

It is not only the conceptual identification of corporate governance philosophies that contributes to the literature. Also, the relative scores of countries on these philosophies can possibly be used as measures, which in turn could further facilitate developments in the comparative corporate governance literature.

Like any other study, the present endeavor is limited in several ways. One limitation is a possible small sample bias. Although comparative corporate governance studies often undergo analyses based on even smaller samples (see e.g. Biggart and Guillén, 1999; Charkham, 1994; Gedajlovic and Shapiro, 1998; Lubatkin et al., 2005; Prowse, 1995; Roe, 1993; 2003; Rubach and Sebora, 1998; Thomsen and Pedersen, 1996), analyzing more codes from different countries could further corroborate the findings presented. Thereby a larger, independent sample could use applicable statistical techniques to confirm the five identified factors. The findings presented are qualitative and exploratory in kind, and only future studies will be able to reveal whether the taxonomy of corporate governance philosophies developed here has any value as a classificatory instrument.

The focus on corporate governance reforms, rather than on extant corporate governance systems does to a certain degree mix fact with aspiration. A potential avenue for further research is to explore the impact of the philosophies (and their underlying mechanisms) on outcomes of corporate governance arrangements. An example of this type of research could be to explore to which extent firms adhere to

the philosophies and what the implications are for governance outcomes such as executive pay or board compositions.

Another avenue for further research that seems more consonant with the current comparative literature on corporate governance is to explain the philosophies from a deeper set of corporate governance antecedent variables or institutional configuration of a country. A more concrete example of this second kind of research could commence with the selection of an archetypical antecedent variable like aggregate corporate ownership structures. One could then assess whether ownership is related to a specific corporate governance philosophy. It is arguable, for example, that policy makers from countries in which dispersed ownership is the norm, and where external governance mechanisms such as the market for corporate control are traditionally strong, have a preference for the organizational design philosophy to repair or modernize their national corporate governance arrangements. Similarly, in countries dominated by family ownership, policy makers may have a preference for the esteem responsiveness philosophy, if only because they will understand the importance of strengthening the informational regimes surrounding their capital markets.

All in all, future research can assess whether the taxonomy of corporate governance philosophies as developed here have any potential demonstrable value as predictors of corporate governance outcomes. Future research can also assess whether the five constituting philosophies can serve as a corporate governance classificatory instrument predicted by institutional or corporate governance antecedent variables. What is however clear from the research presented here is that preferences of corporate governance arrangements do differ from country to country, also after the latest reforms. They not only differ in how they address the presence of specific mechanisms in a country's corporate governance arrangements, but also how they differ in relative focus on configurations of different corporate governance mechanisms.





**Chapter 5**  
***Where you sit is where you stand.***  
***Dominant ownership patterns and corporate governance***  
***philosophies***

**5.1 Introduction**

The dominance of an agency theory's principal agent corporate governance model as introduced by Jensen & Meckling (1976) has largely formed the way by which the modern corporation is described. Based on the Berle and Means (1932/2004) model of separation between ownership and control, scholars have argued that the securing of stakeholder rights and a sharp separation of dispersed ownership from managerial control will lead to an "efficient" and "modern" state of affairs in which stock markets play a central role (see e.g. Hansmann and Kraakman, 2004; Kerr, Dunlop, Harbison, and Myers, 1960; Rajan and Zingales, 2003). Not only finance economists and strategic management scholars, but also the business press, security analysts, executives and firm owners mostly evaluate the modern corporation in terms of debts, assets, and cash flows, that fits the premises of a financial agency based framework (Fligstein and Freeland, 1995; Lubatkin, Lane, Collin, and Very, 2005; Useem, 1993). Not only this, but also corporate governance arrangements are most often described in

light of the same framework (e.g., Fama, 1980; Fama & Jensen, 1983; Roe, 1994). Within this framework, solving governance problems such as agency problems (Jensen and Meckling, 1976), distribution of (quasi) rents (Roe, 2003; Zingales, 1998) and sunk investments (Shleifer and Vishny, 1997), the dispersion of firm ownership is most often considered as the first best solution (Davis and Thompson, 1994; Hansmann and Kraakman, 2004; Rajan and Zingales, 2003). And ownership concentration is often considered the next best solution to these problems (La Porta et al, 1999; La Porta et al, 1997; 1998; Shleifer and Vishny, 1997; Roe, 2003).

Known differences between countries' corporate governance systems have led to a similar dichotomous categorization of national corporate governance systems. Corporate governance arrangements that most resemble the ideal efficient agency framework characterized by firm ownership dispersion (e.g. UK and US) are categorized as an Anglo-American shareholder model. Systems further away from the ideal framework characterized by concentrated ownership (in regions such as continental Europe, Asia, and South and Central America) are labeled as the European stakeholder model (e.g. Ahmadjian and Robbins, 2002; Barca and Becht, 2001; Becht and Roëll, 1999; Buck and Shahrim, 2005; Guillén, 2000a; 2000b; La Porta et al., 1999; La Porta et al., 1997; 1998; Shleifer and Vischny, 1997)

Although there are problems of neglecting possible true variance between corporate governance systems if applying this dichotomous world hypothesis (see chapter 4), a central question that has occupied comparative corporate governance scholars is whether national corporate governance arrangements converge to either one of these two systems. Economic reasoning serves to argue that (increased) global competition, especially on stock markets, will lead to the single most efficient corporate governance model that arguably is best resembled by the US and the Anglo-American system (cf. Hansmann and Kraakman, 2004; Gilson, 2001). Others argue that even though there are compelling arguments of economic efficiency, complete convergence will not occur because of local institutional constraints (e.g. Bebchuk and Roe, 1999). Somewhere in the middle are those that argue that there will be some functional convergence of standards, but no formal convergence of institutions (Coffee, 1999; Gilson, 2001; Khanna, Kogan, and Palepu, 2006).

Arguments of efficiency and the role attributed to stock markets and the increased globalization and competition on these markets seem, however, to indicate some common ground among the different views. Whether or not local institutions constrain convergence towards a single corporate governance model, corporate governance arrangements seem to be based on a common ideal of economic efficiency with a central role for stock markets (cf. Gilson, 2001; Khanna, Kogan, and Palepu, 2006; Milhaupt, 2003; Roe, 2003). Extending on this, and under the notion that corporate governance reforms are local repairs to existing national corporate governance systems, it does not seem far fetch to assume that the direction of reforms are made in a light of a global ideal of economic efficiency in which stock markets play a central role. This assumption is strengthened by the inclination that corporate governance reforms, especially in former Eastern-European communist states, have been predisposed with an aim to increase ownership dispersion (Becht et al., 2002; Estrin, 2002; Shleifer, 1998).

Policy makers are in the difficult position of proposing and implementing a set of corporate governance reforms that aim to bring the local system of corporate governance closer to the assumed global ideal of economic efficiency, that focus on the influence from the globalization of stock markets, and that also have to deal with firm owners that owe their prosperity to current arrangements, and thus may oppose to actions that could hamper their positions and interests. Nevertheless, “jolts to the systems” of corporate governance around the world (e.g. Enron in the US and Ahold in the Netherlands) and the globalization tendencies of stock market developments (cf. Milhaupt, 2003; and as indicated by (intended) mergers of stock markets such as The London Stock Exchange with the Germany’s Deutsche Boerse, the formation of Euronext and Euronext with the New York Stock exchange) show that firm shareholders are also aware of the need for reforms. The aim of this chapter is to investigate how a country’s dominant ownership structures relate to preferred ideal approaches to corporate governance arrangements as described in national corporate governance reform codes. A content analysis of a country’s “code of best practices” reveals the ideal way of how corporate governance arrangements are structured in a country. This analysis also results in possible measures to identify to which extent they can differ from country to country. This analysis shows 5 corporate governance philosophies, 5 different ideal approaches of how corporate governance systems can be structured. By relating dominant ownership structures with these 5 philosophies an

attempt is made to reveal how countries make local repairs to their corporate governance systems in light of a possible global ideal of economic efficiency and central role for stock market depth and breath.

## **5.2 Neither convergence nor persistence?**

One central question in the literature on comparative corporate governance is: will national systems of corporate governance converge towards a single most-efficient system, or will national institutional differences remain “sticky”, leading to no convergence or to hybrid forms of convergence (e.g. Aguilera and Jackson, 2003; Gilson, 2001; Guillén, 2000a; 2000b; Kogut and Walker, 2001; La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1998; La Porta et al., 1999; Rubach and Sebora, 1998)? In the comparative corporate governance literature different answers exist to this question. As sketched by Pagano and Volpin (2005b) and Khanna, Kogan, and Palepu (2006) some argue that the evolution of corporate governance systems across countries will converge to one system (Hansmann and Kraakman, 2004), will show persistent formal diversity, but with some functional convergence (Coffee, 1999; Gilson, 2001) or will show no convergence (Bebchuk and Roe, 1999).

The arguments for convergence are compelling and rest on economic efficiency arguments. Since the emergence of corporate governance as a field of academic study, scholars have argued that the securing of stakeholder rights and a sharp separation of dispersed ownership from managerial control will lead to an “efficient” and more “modern” state of affairs, in which stock market depth and breadth play central roles in starting and terminating corporations and in acquiring (relatively cheap) capital to finance firm growth (e.g. Berle and Means, 1932/2004; Kerr, Dunlop, Harbison, and Myers, 1960; Rajan and Zingales, 2003). Under the notion that the shareholder-oriented model is nowadays regarded as the normative consensus (Hansmann and Kraakman, 2004), the protection of shareholders’ rights should be more central than other stakeholders’ rights. Ultimately, or so the argument goes, countries favoring shareholder oriented models of corporate governance will outperform countries adopting other models resulting in converge to a single model (Hansmann and Kraakman, 2004).

Although economic efficiency arguments are compelling, others take “the immovable object of path dependence” into account (Khanna, Kogan, and Palepu 2006: 69). The centuries old problems of corporate governance<sup>7</sup> and the remaining differences between corporate governance arrangements around the world severely hamper the view that convergence is near. Although there may be indications that strong (legal) protection of minority shareholders contributes to efficient investment allocation, better developed stock markets, higher-valued publicly listed firms, and higher economic growth in general (Beck, Levine, and, Loayza, 2000; Gedajlovic and Shapiro, 1998; La Porta et al., 2002; Rajan and Zingales, 1998; 2003), global market forces are however not strong enough to overcome path dependency. The make-up of national corporate governance systems are shaped and contested by cultural, social, and political conditions under which certain corporate governance arrangements can be effective for achieving the “social peace” (Roe, 2003) needed to overcome governance problems (Aguilera and Jackson, 2003; Biggart and Guillén, 1999; Hamilton and Biggart, 1988; Kogut and Walker, 2001; Roe, 2003). In the comparative corporate governance literature there are detailed studies that show, for instance, how domestic political conditions mediate the effect of economic conditions on corporate governance outcomes (Djelic, 1998; Fligstein, 1990; Orru, Biggart, and Hamilton, 1997, Roe, 2003). La Porta and his colleagues (1998, 1999) have further argued that the internationalization of capital markets is not strong enough to break down existing ownership structures. Firm ownership around the world has always been concentrated in the hands of a few powerful individuals, with the notable exception of ownership structures in the contemporary United States and the United Kingdom. La Porta, Lopez-de-Silanes and Shleifer (and with them many others, e.g., Biggart and Guillén, 1999; Fligstein and Freeland, 1995; Kogut and Walker, 2001) remain “skeptical about the imminence of convergence of corporate ownership patterns, and of corporate governance systems more generally” (La Porta et al, 1999: 513).

Others use the differences in development of corporate governance arrangements across countries and the strengths of economic efficiency to argue that convergence of corporate governance arrangements can occur in two forms: formal and functional

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<sup>7</sup> See Frentrop (2002) for a historical perspective on corporate governance dating back to 1602 to the founding of the Dutch VOC, the first publicly traded firm in the world.

(Coffee, 2000; Gilson, 2001; Khanna, Kogan, and Palepu, 2006). Formal (or *de jure* convergence) refers to the adaptation of formal legal rules and convergence of institutions across countries. Functional (or *de facto*) convergence refers to the convergence of adopting practices of “good corporate governance” within different configurations of institutions (Khanna, Kogan, and Palepu, 2006). Since corporate governance arrangements are shaped and contested in different institutional make-ups that change slowly over time, functional convergence dominates formal convergence (Coffee, 2000; Gilson, 2001). However, the question remains of what constitutes “good corporate governance practices”. Socially constructed differences across countries and the normative differences in protection of stakeholders’ interests (and the subsequent power stakeholders have in developing reforms) hamper the formulation of “good” global corporate governance practices. As Khanna, Kogan, and Palepu describe: “Even if there were a single universally optimal corporate governance system, political resistance would pose a major obstacle to governance reform” (2006: 72). The interests of stakeholders such as dominant shareholder groups could influence the outcome and formulation of these reforms (cf. Bebchuck and Roe, 1999; Coffee, 1999). Possible reasons for this are that these elites are possibly able to steer the outcome of the formulation of best practices and that every system of corporate governance is characterized by a different dominant ownership structure, each of which seems to be accompanied by governance problems of its own. This implies that corporate governance systems are shaped and contested by national institutional conditions. This latter issue is under investigation in the current chapter. The question dealt with here regards how the individual nations description of their good corporate governance practices are related to dominant firm ownership structures, given the potential increased central role of competition on stock markets, and the seemingly strengths of a global ideal of economic efficiency.

### **5.3 Corporate governance reform codes**

The views as described above point out that countries can differ in their fundamental views on how corporate governance arrangements ought to be structured. The institutional configurations, under which a dominant firm ownership pattern could be categorized, influence the way in which good governance practices are formulated. As also indicated by others (Guillén, 2000a; Khanna, Kogan, and Palepu, 2006) the

literature is in need of measures to capture differences between corporate governance arrangements. To investigate possible differences between countries preferred corporate governance arrangements, we can submit corporate governance reform codes to systematic content analyses. These analyses reveal countries' preferred beliefs about the structure of corporate governance arrangements, given the context in which these codes are developed. Content analyses hereby provide the possibility to develop measures for identifying differences between national corporate governance approaches.

Many countries have codified their "best practices" in corporate governance reform codes. Corporate governance reforms may be defined as deliberate interventions in a given country's ongoing corporate governance traditions by the state, the local securities and exchange commission, the stock exchange, or other parties, usually with the objective of harmonizing them with both international pressures for change and endogenous (national) institutional evolution (cf. Whitley, 1999; Whittington and Mayer, 2000). The reforms are formulized in "codes of best practices". These codes are authoritative documents, most often with "soft-law" status. They outline the preferred codified corporate governance approach, usually legitimated by the state, Securities and Exchange Commission, or the stock exchange, through concrete endorsement, and are typically enforceable through corporate law or private compliance structures (Aguilera and Cuervo-Cazurra, 2004). The codes are a set of codified corporate governance norms and mechanisms pertaining to such issues as the role and composition of the board of directors; the installment of board subcommittees (e.g. audit, remuneration, and nomination committees); the appointment and rules of operation applying to external auditors; the distribution of rights and powers over professional managers, various groups of shareholders, and other stakeholders; the role of the media in information dispersion; and the protection of "whistleblowers". In the time period from 1992 until 1999 at least 21 countries issued 41 codes and in the time period 2000 until 2004, at least 28 countries issued 90 codes (see also Aguilera and Cuervo-Cazurro, 2004; and chapter 4 figure 4.1).

The content of these codes describe the view of what ideal corporate governance arrangements in a given country ought to look like. Quotes from a small part of a number of these codes illustrate that a global ideal of economic efficiency and a

description of the central role of stock markets are important in the formulation of best practices.<sup>8</sup> 1) “The significance of corporate governance is now widely recognized, both for national development and as part of international financial architecture, as a lever to address the converging interests of competitiveness, corporate citizenship, and social and environmental responsibility (...) [T]here are international standards that no country can escape in the era of the global investor” (*South Africa’s King Committee on Corporate Governance*); 2) “The continued success and optimal functioning of our economic system requires the confidence and trust of investors, employees, consumers, and the public at large” (*Americas, the US-based Conference Board*); 3) “[T]he appropriate operation of corporate governance for listed companies is a vitally fundamental demand for enhancing corporate value on a continuous basis (...) Above all, it is crucial that the rights and interests of shareholders be protected and equally secured” (*Japan’s Tokyo Stock Exchange*); and 4) “Maintaining an informed and efficient market and preserving investor confidence remain the constant imperatives” (*Australia’s Australian Stock Exchange*).

Systematic content analyses of these codes provide the possibility to reveal how a country’s preferred beliefs and corporate governance structure is shaped. In line with the path dependency views of corporate governance, and under the assumption that countries develop their corporate governance system with an ideal of economic efficiency in mind, reform codes intervene in local problems and are formulated in order to find efficient solutions to the problems in the existing institutional context. Whether the reforms are implemented by firms and whether the solutions offered are truly efficient under the national conditions are, however, other issues. These are not addressed in the current chapter, but are left as important issues for further research.

It is taken as a given that different institutional circumstances have led to certain formulations of “good corporate governance practices”. Under investigation here is how national dominant ownership structures relate to local repairs that are assumed to be made in light of a certain global ideal of economic efficiency.

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<sup>8</sup> Only 4 codes have been chosen. There is no particular reason for these specific 4. All codes indicate that economic efficiency and/or growth and increased central roles for stock markets are of importance for formulating corporate governance reforms.



### **5.3.1 Governance reforms in countries with dispersed ownership**

Some of the most far-reaching attempts at corporate governance reform have taken place in countries that are known for their market based economies in which stock market depth and breadth already play a major role. The best example is the US with its market based economy, lively stock markets, high levels of firm ownership dispersion, and corporate governance systems that often serve as a role model for other corporate governance systems (cf. Coffee, 1999; Gilson, 2001; Hansmann and Kraakman, 2004; Khanna and Palepu, 2004). According to the agency framework a reform of these systems would be needed as the traditional weakness of dispersed ownership at the firm level is the diminished incentives that owners have to exercise control (Fama, 1980; Thomsen and Pedersen, 2000; Pedersen and Thomsen, 2003). In turn, this means that executives are not convincingly kept in check by means of internal control mechanisms. Shareholders in these systems inevitably become passive investors who have difficulty intervening with the day-to-day operations of the firm. Instead of intervening, shareholders do “the Wall Street Walk” and vote with their feet if they disagree with the way in which the company is developing and governed (Rubach and Sebor, 1998). Firms in countries with dispersed ownership are therefore traditionally governed by means of what Walsh and Seward (1990) call “external” governance mechanisms (in the sense of being external to the firm’s internal hierarchy and influence structure). These external mechanisms include the market for corporate control (Jensen & Ruback, 1983), the product market, and the managerial labor market. Like any other governance arrangement, the dispersed ownership/external control system does not provide perfect protection for shareholders and other stakeholders, and neither is it foolproof. One only has to point at issues of operational mismanagement and managerial entrenchment and at the financial obfuscation scandals at for instance Enron, WorldCom, Tyco, and Arthur Andersen to show that in countries with dispersed ownership it is precisely the internal governance mechanisms that require substantial reinforcement. Traditionally, internal mechanisms are expected to involve rules of operation and guidelines that pertain to the composition of the board of directors and its standing committees. Also, employees are often thought of being in a much better position to oversee executives’ actions than shareholders are (Dow, 2003; Hansmann, 1996). Therefore better rules on the protection of whistleblowers might also contribute to better internal

governance. Internal governance mechanisms help to demarcate the boundaries of managerial discretion. To overcome the apparent problems of dispersed ownership in countries with strong stock markets, and in order to maintain this position in terms of achieving economic efficiency and key roles for stock markets, policy makers in countries with strong ownership dispersion traditions will opt for reinforcement of internal governance mechanisms:

*Hypothesis 1: Countries with higher levels of ownership dispersion will focus their governance reforms on the reinforcement of internal governance mechanisms.*

### **5.3.2 Governance reforms in countries with concentrated family ownership**

In significant parts of the world public companies are not owned and controlled by dispersed shareholders, but by elite families (La Porta et al., 1999).<sup>9</sup> In such countries, control over even the largest corporations tends to be concentrated in the hands of a few wealthy individuals who are associated via kin relationships. It has been noted that the concept of corporate governance takes on a rather counter-intuitive connotation in the context of the family-controlled firm (Schulze, Lubatkin, Dino, and Buchholtz, 2001). As ownership is not separated from control – families typically manage the firms they control and tend to enjoy control rights, significantly in excess of their cash flow rights (La Porta et al., 1999) – a straightforward agency theory analysis would suggest that agency costs for these firms ought to be minimal (Jensen and Meckling, 1976).

Nevertheless, Schulze and his colleagues (2001), and also Gomez-Mejia et al. (2003), have argued that these firms are not by any means “safe from agents’ harm,” but face agency problems of a different kind. Family-controlled public firms largely lack the disciplinary force of the market for corporate control, due to, for instance, anti-takeover protections like preferred stockholdings and pyramid schemes. The owner-manager may also experience “agency problems with oneself” (Jensen, 1998:

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<sup>9</sup> Family control is especially prominent in countries where shareholder protection is low (La Porta et al., 1999). No less than 50 percent of the medium-sized firms in these countries are controlled by families. Apparently, the additional influence on management stemming from blockholdership is used as a substitute for legal protection in these countries (La Porta et al., 1998).

48) or a “family handcuff” (Gomez-Mejia et al., 2003) due to, for instance, protection of family executives, hubris, or limited self-knowledge (Elster, 1979). Altruism may make even well-intending family managers “bad agents” in the sense that their generosity towards their own family can lead to the exploitation of non-family shareholders, a good example of so-called principal-principal agency problems (Wright et al., 2005). Family controlled public firms limit the influences from external markets by e.g. providing job security for the family executives and anti-takeover protections, which subsequently decreases interests from external markets to invest (Gomez-Mejia et al., 2003; Schulze et al., 2001).

Private investors in countries dominated by family ownership thus face considerable disincentives with regard to investing in the equity of public firms. This in turn could reduce the influence from stock markets on the increase of economic growth (cf. Rajan and Zingales, 2003). To offset the relative frailty of the stock markets through which they seek to attract capital, ruling families must convey the message to potential investors that their investments will be well protected. Perhaps the greatest obstacle facing these families is breaking the *omertà*-like cordon of silence that typically surrounds family-owned enterprises, by making the executives of these firms more accountable and responsive to outside pressures.<sup>10</sup>

From an agency cost-minimizing perspective it is critical to control the flow of blame and praise that family executives receive. There are three reasons for this. First, most individuals are to some extent “hardwired” to desire the esteem of others, which tends to make their behavior more norm-abiding once it is brought in public (Brennan and Pettit, 2004; Fodor, 1983). Second, since the purity of the family name is sacrosanct in the eyes of many family members, greater openness provides them with an incentive to refrain from public deeds that might taint it. Third, internal governance mechanisms are also likely to gain effectiveness from greater information disclosure, because it provides family agents with the means to better calculate the short- and long-term (market) value of their efforts (Bergstrom, 1989). Policy makers in countries dominated by concentrated family ownership will opt for governance

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<sup>10</sup> Schulze and his colleagues (2001) found, for example, that roughly one-third of all U.S. family-controlled enterprises in their sample prefer not to disclose what they deem “sensitive” information, such as their succession plans.

mechanisms limiting the negative affects of family ownership by promoting a wider distribution of policy-related information:

*Hypothesis 2: Countries with higher levels of concentrated family ownership will focus their governance reforms on the reinforcement of governance mechanisms that promote greater openness and transparency.*

### **5.3.3 Governance reforms in countries with concentrated state ownership**

After WWII – when many companies were nationalized for strategic or political reasons and when many state firms grew rapidly because of war-related manufacturing opportunities – the world was left with massive state ownership. La Porta et al. (1999) show that 70 percent of the largest traded firms in Austria, 45 percent in Singapore, and 40 percent in Israel and Italy are state-controlled. Nevertheless, the trend towards privatization appears unstoppable, as governments are trying to reduce state supervision costs, turn assets into revenues, increase the efficiency of operations by exposing them to market forces, and spend less on deficit activities (Filatotchev et al., 1992).

However, privatization comes with problems of its own, especially in emerging markets. When no or only partially competitive state firms are privatized, there is a danger of social collapse. The provision of essential services and utilities could be harmed, and mass lay-offs may be hard to prevent. Furthermore, when substantial state assets are rapidly passed from public to private hands, the ones most likely to benefit are incumbent enterprise managers and well-connected ministry officials (Filatotchev et al., 1992). This could lead to the creation of a few very wealthy and powerful individuals, rather than a vibrant and socially resilient Mittelstand. The development of a truly private sector could be hampered in countries with state-dominated economies due to burdensome taxation laws, a lack of entrepreneurial credits, and delays in payments for orders delivered to public-sector firms (Kornai, 1992). The private sector often responds in kind with tax evasion, off-the-books payments to workers, and lagging capital investment (Stark, 1996).

To deal with these circumstances, and borrowing arguments from institutional economists (e.g. Buchanan, 1986; Coase, 1992), a promising road to institutionalizing private property seems to reside in the development of a broader class of private

proprietors. Public policy could first of all aspire to facilitate truly private ventures by lowering the barriers to entry for small and medium-sized ventures, in recognition of the fact that entrepreneurs are the basic building block of an emerging market economy (Stark, 1996). But in the longer run, policy makers ought to ensure that the rights of minority shareholders and other stakeholders are well protected. Only when smaller investors are assured that their investments will be safeguarded by law and by dominant economic institutions from others, such as executives and larger, controlling shareholders, can stock markets be expected to significantly broaden and deepen to achieve economic growth and efficiency (Rajan & Zingales, 2003; La Porta et al., 1998; Zingales, 1995). To overcome governance problems in countries dominated by state ownership, policy makers thus promote the protection of investments of all shareholders, including those made by smaller minority investors:

*Hypothesis 3: Countries with higher levels of state ownership will focus their governance reforms on the reinforcement of governance mechanisms protecting the rights of dispersed shareholders.*

#### **5.3.4 Governance reforms and dominant non family/ non state blockholders**

Numerous empirical studies have demonstrated that very few of the publicly-owned, especially medium-sized, firms around the world are widely held. This fact has been established by independent studies of Germany (Edwards & Fischer, 1994), Japan (Prowse, 1992), Italy (Barca, 1995), a panel of 12 European countries (Pedersen & Thomsen, 1997), and a panel of 27 wealthy economies from several continents (La Porta et al., 1999). Agency theorists tend not to be too surprised by this pattern, because they see ownership concentration (“blockholdership”) as an efficient response to governance problems in governance regimes lacking appropriate minority shareholder protection mechanisms. They argue that in such regions blockholdership is the most powerful way of reducing the agency costs of separated ownership and control, as blockholders have greater incentives to monitor managers than dispersed shareholders do, they often enjoy greater informal access to the top management team, and can have larger influence in the selection and appointment of board members (Fama and Jensen, 1983; Shleifer and Vishny, 1997).

But ownership concentration is an imperfect substitute for formalized shareholder protection mechanisms (such as one-share-one-vote rules or a legal ban on pyramid schemes). It comes with numerous hidden costs which could hamper (especially medium-sized) corporations in acquiring capital to finance further growth (cf. Rajan and Zingales, 2003). Blockholders are, to some extent, able to control corporate decision making through the exercise of direct and informal control over executives and over the decisions these executives make. However, different categories of shareholders can differ in terms of their interests and preferences. What is good for a blockholder (e.g. a focus on the longer term, a governance arena in which to exercise influence by blockholders) may not be good for a small minority investor (who may have a greater need for short-term results, a liquid stock market through which shares may be sold efficiently, and a governance arena in which small investors have the ability to influence the board directly or informally and are protected from powers of their bigger counterparts).

Financiers contemplating on making investments in a closely held (medium-sized) firm thus not only face potential managerial opportunism, but also the kind of self-interested behavior by more influential classes of shareholders, which Perrow refers to as “owner opportunism” (1986: 227). Strengthened by the indications that strong (legal) protection of minority shareholders contributes to efficient investment allocation, better developed stock markets, higher-valued publicly listed firms, and higher economic growth in general (Beck, Levine, and Loayza, 2000; Gedajlovic and Shapiro, 1998; La Porta et al., 2002; Rajan and Zingales, 1998; 2003), policy makers in countries dominated by (medium-sized) enterprises controlled by blockholders are expected to do away with mechanisms that were once especially designed to protect the interests of blockholders.

*Hypothesis 4: Countries in which (medium-sized) firms are dominantly owned by blockholders will focus their governance reforms on the abandonment of governance mechanisms protecting the privileges of these large firm owners.*

### 5.3.5 Governance reforms and managerial empowerment

No current study of corporate governance reforms can ignore the influence of managerial malfeasance and associated accountancy scandals like those at Enron and WorldCom in the US, Parmalat in Italy, Elf in France, Ahold in the Netherlands, and Yukos in Russia. These “incidents” have painfully unearthed the weaknesses of national systems of corporate governance around the world, as they demonstrated that traditional mechanisms of corporate governance no longer seem sufficient to control the opportunism of persons in positions of authority. Unsurprisingly, these scandals have had major effects on governance reforms around the world.<sup>11</sup>

In previous years, however, a number of scholars have argued against the bleak image that the “Neo-Hobbesian” (Bowles, 1985)<sup>12</sup> tradition in organizational economics and the development of “Anti-Management Theories of Organization” (Donaldson, 1995) had painted of the professional manager (see for example, Davis, Schoorman, and Donaldson, 1997; Donaldson, 1995; Ghoshal, 2005; Ghoshal and Moran, 1996; Perrow, 1986: 1991). The argument put forward was that most managers are quite unlike the ruthless a-moral self-interested individuals that feature so prominently in many organizational theories, and that many managers are in fact benevolent stewards who will do many good things for corporations once they are relieved from the ties of control that prevent them from doing so.

Regardless of whether the executives in whom these managerial empowerment scholars have put their trust have categorically betrayed them or whether a relatively minor fraction of the population has tainted every executive, the recent wave of scandals has seriously hurt confidence in professional managers, regardless of the dominant ownership patterns in a country. Policy makers are therefore expected to

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<sup>11</sup> The decisive date for the Enron collapse – a trigger of the most recent wave of managerial malfeasance – is October 16<sup>th</sup> 2001. On this date, Enron officials reported a \$618 million third-quarter loss and a \$1.2 billion reduction in shareholder equity, partly related to off-balance sheet partnerships run by the company’s CFO Andrew Fastow. Enron itself never recuperated from this blow, and – as the steep numerical increase in corporate governance reform codes since this date demonstrates (see Figure 4.1 Chapter 4 and section 5.3 above) – it most likely triggered many governments to investigate and make amendments to their own corporate governance systems to prevent this from happening in their own country and triggered them to restore or increase trust in their capital markets.

<sup>12</sup> The Neo-Hobbesian tradition incorporates a number of highly influential theories which have in common (and owe their predicate to the fact) that they share the behavioral assumption of managerial opportunism (usually in conjunction with the assumption of bounded rationality). These theories include, amongst others, agency theory, transaction cost theory, and team-production theory (see Perrow, 1986: 1991).

seek mechanisms to stop or at least further limit “managerial empowerment”. To restore investor confidence in stock markets and regain trust in governance arrangements, policy makers are doing away with mechanisms that facilitate and empower managers:

*Hypothesis 5: All countries, regardless of their dominant ownership pattern, will focus their governance reforms on the abandonment of governance mechanisms that facilitate the empowerment of professional managers.*

#### **5.4 Methods and sampling**

To be able to test the hypotheses, an empirical study is conducted in two parts. First, to develop measures to capture structural beliefs about what good governance practices can look like across countries, a content analysis of countries’ reform codes have been made. A systematic analysis of these codes resulted in the identification of 5 thoughts on ideal approaches of corporate governance arrangements. These 5 thoughts are labeled as corporate governance philosophies. Second, the relative score from each country on each of these philosophies, and controlling for relevant factors such as income per capita and stock market size, are related to readily available national dominant ownership patterns.

##### **5.4.1 Data and sample**

Reliable comparative data on national systems of corporate governance is difficult to obtain, and most contributors have therefore limited their analyses to a small sample of nation states. Many studies are restricted to an analysis of three (Lubatkin et al., 2005; Roe, 1993; Rubach and Sebora, 1998), four (Biggart and Guillén, 1999; Prowse, 1995), five (Charkham, 1994; Gedajlovic and Shapiro, 1998), or six (Thomsen and Pedersen, 1996) national jurisdictions. Furthermore, a fairly limited set of countries has attracted the bulk of the research attention (these are the United States, Germany, and Japan), whereas other nations have more often than not been left unexplored. The major challenges facing comparative corporate governance scholars are therefore to (a) expand the scope of their studies, and (b) develop better comparative measures for corporate governance mechanisms. As Guillén argues, we



“need better data on more countries” (2000a, 23). Better indicators will facilitate making comparisons on specific dimensions as opposed to looking for wholesale convergence of entire corporate governance systems (Guillén, 2000a).

In order to both expand the scope of the observations beyond that of many comparative studies and to develop a set of more finely grained indicators that will allow for a study on the approaches of what constitute “good corporate governance practices”, corporate governance reform codes are analyzed. These reform codes may be defined as authoritative documents with “soft-law” status, which outline a comprehensive series of corporate governance practices, are usually legitimated by the state, Securities and Exchange Commission, or the stock exchange through concrete endorsement, and are typically enforceable through corporate law or via private compliance structures (see e.g. Aguilera and Cuervo-Cazurro, 2004). The European Corporate Governance Institute keeps track of these codes and makes them available on their website ([www.ecgi.org](http://www.ecgi.org)). In total, 131 of such codes, derived from 49 countries where available.<sup>13</sup>

This pool is reduced to 38 codes in the final sample by using the following criteria. First, the analysis was limited to only one corporate governance code per country, restricting the sample to a maximum of a feasible set of 49 codes. Second, the comprehensiveness of the codes was assessed. Only codes were used that comment on a given country’s entire corporate governance approach. Partial codifications – such as memos commenting strictly on executive compensation or on the role of independent directors on corporate boards – were discarded as non-representative for a country’s complete corporate governance approach. Third, for countries with more than one comprehensive code, the authoritativeness of the codes was assessed. Only codes were used in the sample that were officially commissioned, either by the state, the local Securities and Exchange Commission, or a stock exchange. Fourth, in the case that more than one comprehensive and authoritative reform code was identified (e.g. in the UK or the US), the most recent document was opted. Applying these criteria resulted in a sample of 38 country reform codes.

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<sup>13</sup> At the time of study October 2004, codes from 49 countries where available. More recently, the number of countries on this website has reached 55 ([www.ecgi.org](http://www.ecgi.org)).

The construction of the dependent variables derived from the inductive systematic content analyses of these codes is explained in the next section. The content analyses resulted in the identification of 5 ideal corporate governance approaches, labeled as 5 corporate governance philosophies. The relative scores of each country on these 5 corporate governance philosophies serve as the dependent variables. The relative focus on each of these 5 philosophies is interpreted as the relative focus on a preferred approach of “good corporate governance practices”. These 5 philosophies are related to readily available ownership data.

The independent variables that are used are the available country-level ownership data derived from La Porta, Lopez-de-Silanes, and Shleifer (1999). The focus of this data is on voting rather than cash flow rights. The data is divided into four clusters, based on two sets of criteria. The first set of criteria entails the size of the controlling stake (20 percent or 10 percent). It divides up a sub-sample of the listed firms in a given nation into a group that has an ultimate owner (recognizing the identity – family, state, or other – of that owner) and a group that lacks one (i.e. the share of widely-held firms). The second set of criteria is concerned with firm size. It both samples for the 20 largest firms in a given country and for the 10 smallest firms with a market capitalization of at least \$500 million. The first data cluster thus entails ownership fractions (dispersed, state, family, or other) for the largest firms in a given nation, using the 20 percent control criterion; the second cluster also focuses on the largest firms, but reports ownership fractions using the 10 percent control criterion; the third cluster reports 20 percent ownership fractions for medium-sized firms, and the fourth cluster reports 10 percent fractions for medium-sized firms. Each of the hypotheses is tested on each of these four clusters of data. La Porta et al. (1999) provide data on 27 countries and on 5 of these countries no corporate governance reform code was available. Therefore, the regression analyses are based on 22 countries (table 5.4 provides an overview of the relative scores of the 22 countries on each philosophy).

The size of the countries equity market and GDP per capita are used as control variables. The size of the equity market captures the level of development of a given country’s equity market in 2001. It is measured as the aggregated market capitalization of all listed firms in a given nation, divided by that specific country’s

gross domestic product.<sup>14</sup> Controlling for equity market size is important, because this variable is known to correlate positively with levels of dispersed ownership (La Porta et al., 1999). It furthermore controls for the relative importance of a country's equity market for its economy and capital structure (Pedersen and Thomsen, 1997; Thomsen and Pedersen, 1996; 2000). GDP per capita was controlled for to capture the overall level of economic development in a given nation.<sup>15</sup> It represents an important control, because wealthier countries are likely to have larger equity markets with higher extents of ownership dispersion (Barca and Becht, 2001). Furthermore, this variable is likely to capture specific effects of the affluence of an economy on ancillary corporate governance variables (Pedersen and Thomsen, 1997; Roe, 2003; Thomsen and Pedersen, 2000).

#### **5.4.2 Construction of the dependent variables**

Content analyses (Carney, 1972; Holsti, 1969) start with the identification of constructs.<sup>16</sup> Each construct measures a highly specific aspect of a nation's preferred corporate governance arrangements. For example, mechanisms include "media information rights", a measure for determining the extent to which a given nation's preferred arrangements involve the news media in corporate governance; "remuneration committee", an indicator expressing the degree of attention paid to the appointment, composition, and rules of operation of the board committee overseeing executive compensation; and "auditor rules of operation", a mechanism expressing the extent to which preferred arrangements attempt to bind external auditors through rules controlling their behavior. The 17 constructs and their definitions are reported in tables 5.1a and 5.1b.

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<sup>14</sup> The data is from the World Bank: New database on financial development and structure (2002).

<sup>15</sup> The data is from the World Bank: World Bank World Development Indicators (2002)

<sup>16</sup> Each construct was developed using a two-step procedure. The first step, which was inductive, was oriented towards grounding each construct in the data. Those potential constructs were identified by going through a thorough reading and rereading of all corporate governance reform codes, carefully tracking and selecting those constructs that recurred throughout several of the codes in the sample. This ensured the appropriateness of each construct for comparative research. The second step, which was theoretical, was oriented towards grounding each construct in the relevant literature. For each construct, one or more relevant research articles were identified that had previously defined and used that construct to calibrate the interpretation of a given construct with its prior usage in the field.

**Table 5.1(a) Definitions of codified constructs**

<i>Name construct</i>	<i>Description</i>
Short term bonus	% of coded text devoted to executive compensation in the form of cash bonuses and other forms of short-term incentive pay
Long term incentive plans	% of coded text devoted to executive compensation in the form of (restricted) stock options and shares and other forms of long-term incentive pay
Board of directors	% of coded text devoted to the appointment, composition, and rules of operation of a company's entire board of directors (BOD)
Nominating committee	% of coded text devoted to the appointment, composition, and rules of operation of the BOD's subcommittee involved with the selection and training of new BOD members
Audit committee	% of coded text devoted to the appointment and composition of the BOD's subcommittee that oversees the principal (financial) information flows and selects an external auditor to verify the content of that information
Remuneration committee	% of coded text devoted to the appointment, composition, and rules of operation of the BOD's subcommittee involved with determining the company's overall executive pay policy as well as the specific amount of monetary incentives to be paid out to executives in a given year
Shareholder voting	% of coded text devoted to a description of all issues on which shareholders are allowed to vote during the shareholder's meeting, as well as the rules of operation pertaining to that meeting in general and the voting process in particular
Shareholder rights	% of coded text devoted to a description of all ancillary rights granted to shareholders, including the right to call shareholder meetings, the right to be informed about important corporate decisions, and the right of interpellation
External auditor appointment	% of coded text devoted to the selection and appointment of the external auditor including the rules of operation the external auditors follow
Auditor rules of operation	% of coded text devoted to the rules of operation to be followed by the internal audit committee

**Table 5.1(b) Definitions of codified constructs (continued)**

<i>Name construct</i>	<i>Description</i>
Institutional investors	% of coded text devoted to a description of institutional investors as a separate category of investors, usually in contradistinction with dispersed shareholders, with distinct rights and obligations such as the right to engage in a direct dialogue with executives and the obligation to actively monitor them on behalf of all shareholders
Social reporting	% of coded text devoted to a description of all social, health, and environmental issues about which firms are expected to report, either integrated with or separated from their report of key financial indicators and results
Treatment of financial equity holders	% of coded text devoted to a description of all rules of operation firms must follow in order to ensure the equitable treatment of all parties with a financial or competitive stake in the company (including minority shareholders)
Stakeholder equity	% of coded text devoted to a description of all rules of operation firms must follow in order to ensure the equitable treatment of all parties with a social or political stake in the company (other than shareholders)
Employee ownership	% of coded text devoted to a description of all rules of operation firms must follow in order to provide executives and other salaried employees with the opportunity to become co-owners of the firm
Whistleblower protection	% of coded text devoted to a description of all rules of operation firms must follow in order to ensure the protection and economic independence of employees that seek to publicly address corporate wrongdoings
Media information rights	% of coded text devoted to a description of all media channels firms ought to utilize to inform shareholders and other stakeholders of important corporate decisions and results

Content analysis is then used to systematically code the messages communicated in the corporate governance reform codes. By going through each corporate governance code, the parts of the text dealing with one of the 17 constructs were assigned to the relevant construct. Using NVivo 2.0 — a qualitative data analysis software package — each text assigned to a relevant construct is then converted into numerical measures. This resulted in a 17 traits/constructs by 38 stimuli/countries matrix, for subsequent use in statistical procedures. The matrix was then subjected to a factor-analytical procedure yielding a clean and interpretable five-factor solution (see Table

5.2 for the factor analyses results and labels of the factors). To test whether each factor could be treated as an independent multi-item measure for a specific dimension of corporate governance its theoretical interpretability as well as its empirical reliability and unidimensionality were assessed (see table 5.3 and subsequent text).

**Table 5.2 Exploratory factor analysis <sup>a</sup>**

	<i>Factor 1</i>	<i>Factor 2</i>	<i>Factor 3</i>	<i>Factor 4</i>	<i>Factor 5</i>
Eigenvalue	3,126	2,627	2,260	1,896	1,409
% Variance Explained	18,39	15,45	13,30	11,15	8,29
% Cumulative Variance Explained	18,39	33,84	47,14	58,29	66,58
Nominating committee	<b>0,754*</b>	0,053	-0,012	-0,013	-0,275
Audit committee	<b>0,891*</b>	-0,011	-0,063	-0,163	0,139
Remuneration committee	<b>0,638*</b>	0,067	-0,341*	0,038	-0,187
Whistleblower protection	<b>0,833*</b>	-0,123	0,071	0,017	-0,016
Short term bonus	0,095	<b>0,688*</b>	-0,461*	-0,117	-0,273
Institutional Investors	0,014	<b>0,759*</b>	-0,029	0,136	0,136
Stakeholder equity	-0,012	<b>0,808*</b>	0,162	-0,113	-0,137
Media information rights	-0,121	<b>0,696*</b>	0,293	0,090	0,057
Shareholder voting	-0,348*	0,086	<b>0,544*</b>	-0,167	-0,203
Shareholder rights	-0,154	-0,087	<b>0,735*</b>	0,175	-0,250
Auditor rules of operation	0,135	-0,040	<b>0,606*</b>	-0,140	0,384*
Treatment of fin. equity	0,028	0,430*	<b>0,733*</b>	0,015	-0,019
Long term incentive plans	-0,050	-0,010	-0,137	<b>0,854*</b>	0,014
Board of directors	-0,060	0,026	-0,205	<b>-0,681*</b>	0,309*
Employee ownership.	-0,065	0,083	-0,026	<b>0,842*</b>	-0,039
External auditor appointment	0,031	-0,130	-0,066	-0,139	<b>0,742*</b>
Social reporting	-0,204	0,114	-0,029	-0,055	<b>0,830*</b>

<sup>a</sup> Extraction method: Principal Component Analysis; rotation method: Varimax rotation with Kaiser normalization; rotation converged in 6 iterations; \* significant factor loadings (> 0.3); highest factor loadings for each variable are printed in bold.

**Table 5.3 Inter reliability of the factors**

	<i>Factor 1</i>	<i>Factor 2</i>	<i>Factor 3</i>	<i>Factor 4</i>	<i>Factor 5</i>
Cronbach Alpha	0,81	0,74	0,63	0,75	0,59
Variance explained	64%	57%	48%	66%	71%
Highest Eigenvalue	2,56	2,26	1,93	1,99	1,42

Factor one is labeled as the organizational design philosophy, as it is exclusively composed of mechanisms referencing to internal governance mechanisms (see e.g. Dalton et al., 1998; Gedajlovic and Shapiro, 1998; Walsh and Seward, 1990). Three of its mechanisms pertain to prescriptions considering the appointment, composition, and rules of operation of the board of directors' standing committees (i.e. the nominating, audit, and remuneration committees). The fourth mechanism is also clearly related to the internal functioning of a corporate governance system, as it involves measures to protect employees who "blow the whistle" when unethical conduct is displayed (see Dow, 2003; Hansmann, 1996). Seemingly, what this philosophy espouses is that the best way to arrange corporate governance is to make sure that it operates in an environment in which all structural checks and balances are firmly in place. The main environment that is addressed in this philosophy pertains to the internal organization. In brief, the organizational design philosophy rests on the inclination that a well coherent set of internally designed mechanisms define the organizational boundaries of managerial discretion (see Michael and Pearce, 2004) in constructing good corporate governance.

The organizational design philosophy displayed favorable measurement properties. It is sufficiently reliable, as evidenced by a Cronbach's alpha statistic (on standardized mechanisms) of .81. A principal components analysis revealed the construct's unidimensionality, as the first component explained 64 percent of the variance contained in the four mechanisms (no other component had an Eigenvalue > 1.0). The organizational design philosophy is used as a dependent variable to test Hypothesis 1.

The second factor is labeled as the ownership concentration philosophy, as it is clearly composed of mechanisms regulating and facilitating blockholdership. In brief, the ownership concentration philosophy rests on a coherent set of mechanisms that jointly reduce the chasm that separates ownership from control (cf. Berle and Means, 1932/2004). An important mechanism is "institutional investors," which codes for blockholding institutions as a separate category over and above dispersed shareholders, regulating their specific rights and responsibilities (see e.g. Shleifer and Vishny, 1997; Dahya, Dimitrov, and McConnell, 2005; Fama and Jensen, 1983; Tosi and Gomez-Mejia, 1989). Another important mechanism is "stakeholder equity," which describes how a blockholder ought to behave vis-à-vis non-shareholding

constituencies, whose interests the blockholder is sometimes argued to represent in the governance arena (see e.g. Roe, 2003). The final two mechanisms were “short term bonus,” and “media information rights”. The former refers to the blockholders’ obligations to directly monitor executives and provide adequate compensation policy. This mechanism fits within the ownership concentration philosophy because managerial compensation tends to be significantly lower in firms with concentrated ownership and more linked to performance than in firms that are dispersedly owned (Gomez-Mejia and Wiseman, 1997). The latter, “media information rights,” which establish the public information rights of all shareholders to prevent principal-principal agency problems between blockholders and dispersed shareholders, fits within this philosophy as this mechanism is known to be correlated with the ability of controlling shareholders to divert corporate resources to their sole advantage (Dyck and Zingales, 2002; 2004).

The ownership concentration construct is reliable (Cronbach’s alpha of .74), and is unidimensional (the first component explains 57 percent of the variance and none of the Eigenvalues of the other components > 1.0; see table 5.3). A country’s score on the ownership concentration philosophy is used as dependent variable for testing Hypothesis 4.

The third philosophy is labeled as dispersed ownership, as it is composed of mechanisms stimulating and facilitating dispersed shareholdings. A first mechanism, “shareholder voting,” codes for all substantive issues dispersed shareholders can vote on during the shareholder meetings. A related mechanism, “shareholder rights,” codes for all ancillary rights (other than voting rights) extended to dispersed shareholders. The mechanism “auditor rules of operation” also seeks better protection for dispersed stakeholders, as it regulates the conduct of the mandatory external auditor. Finally, the “equal treatment” mechanism seeks to directly address principal-principal agency problems by giving dispersed shareholders rights similar to those of blockholders. The intuition behind this philosophy is that the best way to solve corporate governance problems is to render the separation between ownership and control more or less harmless by making sure that the rights of all shareholders (and not just those of blockholders) are explicated and legally enforceable (see Grossman and Hart, 1980; Jensen and Meckling, 1976).



The dispersed ownership philosophy was measured with acceptable reliability (Cronbach's alpha of .63), and unidimensionality (the first component explaining 48 percent of the variance, while all other components had Eigenvalues  $< 1.0$ ). The scores on the dispersed ownership philosophy are used for testing Hypothesis 3.

The fourth factor is labeled as the managerial empowerment philosophy, as it appeared to follow the dictums of stewardship theory (Davis et al., 1997) quite closely. First of all, this factor scored negatively on the mechanism "board of directors."<sup>17</sup> Given the fact that the board is seen by many as the foremost instrument of managerial control (Gedajlovic and Shapiro, 1998), it is evident that the present construct seeks to loosen the bonds that normally restrict managerial autonomy. The factor also consists of two positively empowering mechanisms. "Long term incentive plans" are a component of managers' variable compensation packages that limit managers less to specific controllable targets, but rather reward them for (long-term) overall performance (cf. Lee and O'Neill, 2003). Similarly, the "employee ownership" mechanism codes for enabling more extensive ownership of the firm by its employees, which in turn empowers them through the transfer of greater control rights. In brief, the managerial empowerment philosophy stimulates contribution to the greater good of the corporation by means of a coherent set of mechanisms that reward good deeds rather than crowd-out good intentions by monitoring behavior or punishing mistakes (Frey, 1997a, 1997b)

The managerial empowerment philosophy was measured with a good reliability (Cronbach's alpha on standardized items of .75) and sufficient unidimensionality (the first component explaining 66 percent of the variance with all other components possessing Eigenvalues  $< 1.0$ ). The managerial empowerment philosophy is used to test Hypothesis 5.

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<sup>17</sup> A negative factor loading in an exploratory factor analysis on several conceptually related items may be interpreted in a similar fashion as an inverse-coded item in a psychometric measurement scale.

Factor 5 only consisted of two mechanisms, but was readily interpretable and labeled as the esteem responsiveness philosophy. The idea on which this philosophy rests is that corporate governance function best by controlling the flow of blame and praise that can be received (cf. Brennan and Pettit, 2004). Both mechanisms are clearly aimed at improving upon weaker informational regimes and at making corporate governance arrangements more responsive to outside pressures. “Auditor appointment” codes for all regulations related to the selection and appointment of the mandatory external auditor. The mechanism stiffens existing informational regimes by improving upon the quality and reliability of disclosed information about a firm’s conduct and performance. The “social reporting” mechanism controls the flow of blame and praise received in non-market arenas (cf. Baron, 1995), as it urges firm performance on health, safety, and environmental issues to be reported.

The measurement properties of the esteem responsiveness philosophy are as follows: Cronbach’s alpha on standardized items of .59; variance explained by the first component is 71 percent while the second component had an Eigenvalue < 1.0. A country’s score on the esteem responsiveness philosophy is used to test hypothesis 2.

## 5.5 Results

After matching the sample of 38 countries on which the construction of the dependent variables are based with the 27 countries covered in La Porta et al. (1999), 22 countries are left to make up the sample used for the regression analyses.<sup>18</sup> Table 5.4 reports the aggregated scores for all dependent variables, for each country in the final sample of 22 countries. Table 5.5 reports the person correlations of the variables used in the subsequent regression analyses.

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<sup>18</sup> As already indicated, La Porta et al. (1999) report data on 27 countries. The construct of the dependent variables is based on 38 countries. Matching the two samples resulted in 22 countries with complete data; as for the other 5 countries in the La Porta et al. (1999) data, no reform code was available.

**Table 5.4 Countries and aggregated system scores <sup>a</sup>**

<i>Country</i>	<i>Factor 1</i>	<i>Factor 2</i>	<i>Factor 3</i>	<i>Factor 4</i>	<i>Factor 5</i>
	<b>Organizational Design</b>	<b>Ownership Concentration</b>	<b>Ownership Dispersion</b>	<b>Managerial Empowerment</b>	<b>Esteem Responsiveness</b>
Australia	.17	.05	.02	-.25	.01
Austria	.03	.00	.14	-.33	.02
Belgium	.13	.04	.01	-.34	.01
Canada	.18	.00	.06	-.34	.06
Denmark	.00	.00	.04	-.28	.00
Finland	.09	.00	.01	-.40	.02
France	.26	.03	.01	-.33	.00
Germany	.02	.06	.07	-.45	.05
Greece	.03	.06	.08	-.22	.05
Hong Kong	.05	.01	.00	.00	.00
Ireland	.03	.02	.01	.86	.01
Italy	.13	.02	.05	-.54	.01
Japan	.05	.15	.00	-.37	.01
Mexico	.00	.02	.01	-.51	.13
Netherlands	.03	.01	.05	-.14	.01
Norway	.06	.03	.24	-.14	.00
Portugal	.00	.01	.15	-.25	.00
Spain	.04	.01	.01	-.24	.01
Sweden	.05	.04	.10	.41	.01
Switzerland	.07	.00	.04	-.21	.01
U.K.	.25	.01	.06	-.36	.01
U.S.	.45	.01	.01	-.20	.01

<sup>a</sup> Values represent aggregate scores for each construct per country, expressed as percentages of total coded text and obtained by adding the scores for all individual items comprising that construct. The negative scores for most countries on the managerial empowerment construct result from one of its items – *Board* – being reversely coded (due to that item's negative loading on Factor 4).

Table 5.5 Pearson correlation matrix<sup>a</sup>

Variable	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
1. Org. Design	-																	
2. Own. Concentration	-.133	-																
3. Own. Dispersion	-.242	-.087	-															
4. Man. Empowerment	-.149	-.045	.020	-														
5. Ezeem Resp.	-.220	.006	-.097	-.289	-													
6. Widely Large 20%	.555***	.237	-.314	.080	-.296	-												
7. Family Large 20%	-.313	-.123	-.011	-.021	.537***	-.670***	-											
8. State Large 20 %	-.305	-.136	.511**	-.259	-.058	-.478***	-.194	-										
9. Widely Large 10%	.672***	.071	.320	.013	-.186	.921***	.580***	.506**	-									
10. Family Large 10%	-.338	-.091	-.008	.025	.527***	-.650***	.983***	-.199	.568***	-								
11. State Large 10 %	-.295	-.144	.464**	-.277	-.084	-.451***	-.220	.983***	-.499***	-.221	-							
12. Widely Med 20%	.610***	-.129	-.206	.255	-.157	.742***	-.374*	-.545***	.805***	-.371*	-.561***	-						
13. Family Med. 20%	-.262	-.007	.038	-.129	.425**	-.521**	.757***	-.064	-.439***	.800***	-.064	-.503**	-					
14. State Med. 20 %	-.264	-.249	.499**	-.121	-.098	-.448**	-.045	.694***	-.471***	-.091	.635***	-.385*	-.258	-				
15. Widely Med. 10%	.414*	-.031	-.173	.435**	-.055	.538**	-.266	-.528**	.645***	-.243	-.543***	.868***	-.462**	-.358	-			
16. Family Med. 10%	-.069	-.088	.001	-.127	.427**	-.390*	.680***	-.136	-.260	.726***	-.128	-.316	.953***	-.370*	-.314	-		
17. State Med. 10 %	-.269	-.267	.478**	-.148	-.113	-.468**	.057	.743***	-.492**	-.109	.704***	-.427**	-.255	.989***	-.393*	-.357	-	
18. Equity Market	.201	-.213	-.354	.174	-.328	.182	.057	-.379*	.272	.069	-.395**	.213	.133	-.385*	.181	.148	-.407*	-
19. GNP-CAP	.308	.108	.147	.155	-.532	.491**	-.420*	-.132	.398*	-.455***	-.142	.539***	-.519**	-.101	.476**	-.496**	-.139	.311

<sup>a</sup> \*  $p < 0.10$ ; \*\*  $p < 0.05$ ; \*\*\*  $p < 0.01$

In total 20 OLS regression models are reported in tables 5.6 through 5.9 (i.e. 4 data clusters times 5 dependent variables). The 4 data clusters are the distinctions between large and medium sized firms and the controlling cut-off point of 10% and 20% (see section 5.4.1 for the descriptions of the independent variables). The sample size for these models ( $N = 22$ ) is undeniably small, but small sample regressions are certainly not uncommon in studies on comparative corporate governance (see, for instance, the use of 15 countries by Roe (2003)). Furthermore, by using OLS a conservative estimation method is chosen, which will remain unbiased and efficient even at small sample sizes, as long as first-order autocorrelation is absent from the OLS residuals. If residuals are not autocorrelated, valid inferences can still be drawn from  $t$ - and  $F$ -tests, even at smaller sample sizes (Greene, 1993). Reassuringly, the Durbin-Watson statistics for the 20 regression models demonstrate that first-order positive or negative autocorrelations are not a systemic problem in our data.<sup>19</sup> One concern that needs to be mentioned, however, is the possible limited statistical power of the tests – the probability that they will yield significant results (Cohen, 1988). Given low power, it will be difficult to detect meaningful effects, even if they do exist in practice. It is therefore best to interpret the results as a conservative test of the hypotheses, as only very pronounced effects will show up as statistically significant in the results. In general, the mean  $R^2$  across the 20 models is .349. Eight models are significant at conventional levels. Regression results for all four of the data clusters described above are reported in Tables 5.6 through 5.9.

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<sup>19</sup> The Durbin-Watson statistics for the 20 OLS models are (reported in the order in which they appear in Tables 5.6 through 5.9): (1) 1.76; (2) 1.72; (3) 1.61; (4) 2.03; (5) 2.57; (6) 2.09; (7) 1.58; (8) 1.71; (9) 1.77; (10) 2.27; (11) 1.99; (12) 2.33; (13) 1.63; (14) 1.87; (15) 2.27; (16) 1.43; (17) 1.88; (18) 1.49; (19) 1.95; (20) 2.08.

**Table 5.6 Governance reforms & firm ownership large firms 20% cut-off point <sup>a</sup>**

<i>Variables</i>	<i>Organizational Design</i>	<i>Ownership Concentration</i>	<i>Dispersed Ownership</i>	<i>Managerial Empowerment</i>	<i>Esteem Responsiveness</i>
<i>Widely held</i>	.26 (.20)	.03 (.07)	-.05 (.10)	-.70 (.60)	.08 (.05)
<i>Family owned</i>	.08 (.21)	.01 (.07)	-.03 (.11)	-.67 (.64)	.12** (.05)
<i>State owned</i>	.06 (.24)	-.02 (.08)	.12 (.12)	-.67 (.74)	.05 (.06)
<b>Controls</b>					
<i>Equity market</i>	.02 (.04)	-.02 (.01)	-.03 (.02)	.01 (.12)	-.01 (.01)
<i>GNP per capita</i>	.00 (.00)	.00 (.00)	.00* (.00)	.00 (.00)	.00 (.00)
N	22	22	22	22	22
F	1.54	.56	2.49*	.59	4.02**
R <sup>2</sup>	.325	.149	.437	.156	.557

<sup>a</sup> Standard errors are shown in parentheses. \* p< 0.10, \*\* p<0.05, \*\*\* p<0.01

**Table 5.7 Governance reforms & firm ownership large firms 10% cut-off point <sup>a</sup>**

<i>Variables</i>	<i>Organizational Design</i>	<i>Ownership Concentration</i>	<i>Dispersed Ownership</i>	<i>Managerial Empowerment</i>	<i>Esteem Responsiveness</i>
<i>Widely held</i>	.37** (.15)	-.03 (.06)	.01 (.09)	-.66 (0.51)	.07* (.04)
<i>Family owned</i>	.12 (.16)	-.03 (.06)	.09 (.09)	-.51 (.54)	.11** (.04)
<i>State owned</i>	.12 (.17)	-.07 (.06)	.15 (.10)	-.92 (.58)	.03 (.04)
<b>Controls</b>					
<i>Equity market</i>	-.00 (.03)	-.02 (.01)	-.03 (.02)	.04 (.12)	-.02* (.01)
<i>GNP per capita</i>	.00 (.00)	.00 (.00)	.00* (.00)	.00 (.00)	.00 (.00)
N	22	22	22	22	22
F	2.92**	.59	2.18	.70	4.08**
R <sup>2</sup>	.477	.155	.405	.179	.560

<sup>a</sup> Standard errors are shown in parentheses. \* p< 0.10, \*\* p<0.05, \*\*\* p<0.01

**Table 5.8 Governance reforms & firm ownership medium firms 20% cut-off point<sup>a</sup>**

<i>Variables</i>	<i>Organizational Design</i>	<i>Ownership Concentration</i>	<i>Dispersed Ownership</i>	<i>Managerial Empowerment</i>	<i>Esteem Responsiveness</i>
<i>Widely held</i>	.27** (.13)	-.08* (.04)	.02 (.06)	.24 (.43)	.04 (.03)
<i>Family owned</i>	.01 (.13)	-.03 (.04)	.14 (.06)**	-.07 (.42)	.05 (.03)
<i>State owned</i>	.01 (.15)	-.11** (.04)	.18 (.71)**	-.01 (.49)	-.01 (.04)
<b>Controls</b>					
<i>Equity market</i>	.01 (.04)	-.02* (.01)	-.04* (.02)	.07 (.13)	-.02 (.01)
<i>GNP per capita</i>	-.00 (.00)	.00 (.00)	.00** (.00)	-.00 (.00)	-.00 (.00)
N	22	22	22	22	22
F	1.96	2.00	3.64**	.29	2.62*
R <sup>2</sup>	.380	.384	.532	.082	.450

<sup>a</sup> Standard errors are shown in parentheses. \* p< 0.10, \*\* p<0.05, \*\*\* p<0.01

**Table 5.9 Governance reforms & firm ownership medium firms 10% cut-off point<sup>a</sup>**

<i>Variables</i>	<i>Organizational Design</i>	<i>Ownership Concentration</i>	<i>Dispersed Ownership</i>	<i>Managerial Empowerment</i>	<i>Esteem Responsiveness</i>
<i>Widely held</i>	.21 (.19)	-.08 (.05)	.01 (.08)	.89 (.53)	.05 (.05)
<i>Family owned</i>	.04 (.14)	-.04 (.04)	.15** (.06)	-.04 (.38)	.04 (.03)
<i>State owned</i>	-.04 (.17)	-.11** (.05)	.20** (.07)	.12 (.46)	-.01 (.04)
<b>Controls</b>					
<i>Equity market</i>	.01 (.04)	-.02* (.01)	-.04* (.02)	.07 (.12)	-.15 (.10)
<i>GNP per capita</i>	.00 (.00)	.00 (.00)	.00 (.00)	-.00 (.00)	-.00 (.00)
N	22	22	22	22	22
F	.84	1.60	3.73**	.87	2.71*
R <sup>2</sup>	.209	.334	.538	.214	.459

<sup>a</sup> Standard errors are shown in parentheses. \* p< 0.10, \*\* p<0.05, \*\*\* p<0.01

Consistent with the notion that countries characterized by high degrees of ownership dispersion will be more concerned with repairing relatively deficient internal governance mechanisms, rather than stiffening the already adequate external governance mechanisms, the data indicate support for Hypothesis 1. At the 10 percent cut-off point, countries with a greater share of large, widely-held firms concentrate significantly on internal design mechanisms ( $p \leq .05$ ; see Table 5.7). A similar concentration can be found at the 20 percent cut-off point for countries with medium-sized, widely held corporations ( $p \leq .05$ ; see Table 5.8). Countries that focus on the organizational design philosophy seem to be correlated with dispersed ownership patterns.

The data also show some support for Hypothesis 2, that countries dominated by family-owned firms tend to opt for governance reforms that strengthen their traditionally weak information regimes (cf. Khanna and Palepu, 1999; 2000a; 2000b) and focus on the esteem responsiveness philosophy. For the largest firms, a concentration on the esteem responsiveness philosophy may be noted at both the 20 percent ( $p \leq .05$ ; see Table 5.6) and 10 percent cut-off points ( $p \leq .05$ ; see Table 5.7).

Consonant with the idea that countries with strong state ownership traditions focus on the dispersed ownership philosophy, arguably in order to reinforce governance practices promoting a greater degree of dispersed ownership, there is support for Hypothesis 3. Where state ownership of especially smaller firms is considerable, there tends to be a focus on the dispersed ownership philosophy. This effect is observable at both the 20 percent ( $p \leq .05$ ; see Table 5.8) and 10 percent cut-off points ( $p \leq .05$ ; see Table 5.9).

The data also provides indications in support of the idea captured in Hypothesis 4, namely that countries will try to move away from an ownership concentration philosophy, arguably in order to stimulate further growth through wider ownership dispersion. Although, all six effects are in the hypothesized direction, only three of these are significant at conventional levels. It seems that especially countries with relative smaller sized firms focus on of what constitutes good practice on this philosophy, and not on the protection of blockholders. At the 20 percent cut-off point, the effect is significant for countries with high shares of widely held firms ( $p \leq .10$ ; see table 5.8) and those with considerable state ownership ( $p \leq .05$ ; see Table 5.7). At the 10 percent cut-off point, the effect is significant only for countries with a high proportion of state-owned firms ( $p \leq .05$ ; see Table 5.9).



There seems to be no support for Hypothesis 5. Especially for the largest firms, the effects are not trivial, and they are all in the expected direction, but not significant at conventional levels. This could be partly due to two outliers: Ireland and Sweden, as they report rather extreme scores on the managerial empowerment philosophy. However, their scores on all other variables show conventional values, and therefore they were not removed from the dataset.

## **5.6 Discussion and conclusion**

The results seem to indicate three main interrelated conclusions. First, there seems to be no convergence as to what constitutes good corporate governance, but there seems to be certain extents of similarities in possible mechanisms that can be used to solve corporate governance problems across countries. The conceptual identification of 5 corporate governance philosophies shows that regardless of the institutional configurations in which good corporate governance practices are developed, 5 distinct but possibly complementary ideal approaches to corporate governance can be identified. Second, given a global ideal of economic efficiency and a possibly increased central role of stock markets, countries seem to balance their preferred approaches by putting a country specific focus on different configurations of corporate governance mechanisms and thereby on a specific philosophy. And third, hypothesized drawbacks of certain dominant ownership patterns seem to influence the relative focus on particular corporate governance philosophies. However, although there are correlations between ownership patterns and a relative focus on corporate governance philosophies it does not seem to be functional convergence, as countries even after their latest reforms still differ in describing what constitutes good corporate governance. There are conceptually different ideas about structuring “good” corporate governance arrangements. These arrangements consist of a limited set of corporate governance mechanisms that countries actually use. Corporate governance arrangements differ from country to country and path dependency and institutional conditions seem to determine the effectiveness and availability of these mechanisms. Moreover, as countries differ in the degree to which they focus on particular combinations of these mechanisms, each country has a truly unique approach in formulating “good” corporate governance practice.

Thus, in contradistinction with predictions made by proponents of the globalization thesis (e.g. Hansmann and Kraakman, 2004; Gilson, 2001), the results indicate that corporate governance have, as of yet, not resulted in wholesale functional or formal convergence across most of the wealthy nations around the globe. In equally sharp contrast with conjectures made by advocates of the divergent capitalisms thesis (cf. Aguilera and Jackson, 2003; Hollingsworth, Schmitter, and Streeck, 1994; Orrù, Biggart, and Hamilton, 1997; Whitley, 1999), neither do we see blind faith in existing configurations resulting in persistence at the local level. Instead, a “third way” of conceptualizing corporate governance can be perceived — a perspective of local repairs in light of a global ideal.

Given the existence of a global ideal of economic efficiency and the (increasingly) central role that capital markets play in formulating good corporate governance, the institutional changes in a country show similarities in their need to regularly update guidelines on how corporate governance problems should be dealt with. However, this can not be seen as (functional) convergence, since countries still (and arguably always will) differ in formulating what constitutes good corporate governance practices, given a country specific needs, wants, and acceptance of amendments to their systems (cf. Perkins and Hendry, 2005). There tend to be a number of common reservations against the foolhardy “transplantation” of governance policies, as indicated by the relative focus on different identified corporate governance philosophies and their different underlying configurations of corporate governance mechanisms. One objection could be that no national system of corporate governance is inherently superior to all others. A second, more widespread reservation against convergence could be that there is considerable different use, availability, and effectiveness of corporate governance mechanisms across corporate governance systems and multiple fundamentally distinct pathways towards “social peace” and thus also as many distinct definitions of what constitutes good corporate governance (cf. Aguilera and Jackson, 2003; Roe, 2003; Rubach and Sebor, 1998).

So, by and large, countries tend to “stand where they sit” with respect to their corporate governance arrangements. Policy makers have to honor local corporate governance traditions and institutional configurations. They need to be careful not to touch too much of the power basis of the ruling elites in order to maintain social peace. So, in spite of numerous claims to the contrary (e.g. Burt and Doyle, 1993, for

the US; Gordon, 1999, for Germany; and Dore, 2000, for Japan), policy makers do not seem too interested in applying generalized “good corporate governance practices”. Instead, reformers from countries with dispersed ownership traditions tend to seek local (and incremental) changes to their traditionally weaker internal corporate governance mechanisms (Gedajlovic and Shapiro, 1998; Walsh and Seward, 1990). Similarly, policy makers from countries that are dominated by family-controlled firms seem to use mechanisms that help to solve governance problems in exactly these types of firms. They decide to run their governance systems in terms of concentrating on creating stronger informational regimes and on bringing greater openness to firms previously less prone towards disclosure (cf. Brennan and Petit, 2004). Furthermore, where state ownership rules the economic landscape, policy makers try to protect and empower smaller investors in order to protect them from blockholders (Grossman and Hart, 1980; Jensen and Meckling, 1976). Finally, in jurisdictions with especially relative smaller firms, policy makers actively try to discourage blockholdership and protect minority investors, arguably, to increase ownership dispersion and possibly trigger higher economic growth and lower cost of capital (e.g. Rajan and Zingales, 2003).

In sum, the field of comparative corporate governance may have to start asking itself a different set of questions. What is at stake is not whether national systems of corporate governance are engaged in a sweeping process of convergence towards a global ideal state of a single model, nor whether corporate governance systems around the world will continue to show stubborn persistence in local idiosyncrasies. The real challenge is to reconceptualize corporate governance arrangements in a way that does justice to the equifinality of all the different systems of corporate governance. Until we learn to recognize and respect the marvel in each of the corporate governance traditions around the world, we will not be ready to conceive of measures and remedies that are simultaneously capable of making these traditions more effective and legitimate in every respect in the eyes of the ruling elites that will have to endorse them.



## ***Chapter 6***

### ***Concluding remarks***

#### **6.1 Introduction**

In order to demonstrate that mainstream agency theoretical accounts have their limitations I have used an institutional explanation for executive pay and corporate governance reforms. In contrast to the logic of consequence that underlies the traditional agency approach, I have explored the alternative logic of appropriateness for its potential to provide more compelling explanations for both phenomena. The present chapter assesses the implications of my findings. It starts with a brief presentation of the overall conclusions that can be drawn from the different chapters on the two focal phenomena separately, and proceeds with a discussion of the study's implications for theorizing corporate governance in general. The chapter closes with a discussion of the methodological limitations of the study and with a concise agenda for future research.

## **6.2 Conclusions**

The research presented here has revealed that neither the agency approach nor the rational actor model that underlies it can provide a wholly satisfactory explanation for the emergence and effectiveness of corporate governance arrangements. These findings challenge the dominant understanding of how decision making proceeds in the corporate governance arena. Agency theory relies on what Cyert and March call the logic of consequence (1963/1992). It assumes that decision making is a rational, self-interested, maximizing process, rooted in calculus, deliberation, and anticipation of the future. In contrast, the logic of appropriateness suggests that decisions can also be rooted in cognitive behavior that is more or less habitual and reflexive. This alternative logic holds that many decisions are made simply because they are appropriate under given circumstances, or because they are motivated by obligations, duties, and rules. In the present chapter I present the implications of substituting the traditional agency model with a more institutional account for my two focal issues of executive pay and corporate governance reforms.

### **6.2.1 Origins of executive pay: a matter of discretion**

I began my study of executive pay with a comprehensive review of the prior literature on the subject. In chapter 2 I presented a taxonomy comprising 16 theories that are used to explain pay levels and structures. This taxonomy groups these theories in three approaches: the value approach, the agency approach, and the symbolic approach. The theories comprising the value approach reserve a special place for the market as a determinant of executive pay. They assume or seek to demonstrate that a given executive's pay is determined by the market value of his "component characteristics", such as experience and education. The agency approach comprises of two different groups of theories. The first group consists of theories that consider executive pay as a solution to agency problems. Executive pay is considered as an instrument with which to align the interests between shareholders and managers. The second group consists of theories that consider power relationships in setting executive pay. Based on similar assumptions that executive wealth is at risk, these

theories argue that (social) positions of executives could provide them with the discretion to set their own pay.

The third approach, the symbolic approach sees executive pay as a trait that carries significant informational value. According to symbolism theories, executive pay is neither a fully market-driven figure, nor a carefully designed instrument to tame conniving managers, but rather a symbolic token that expresses the exceptional standing of business executives in our contemporary societies.

What is nevertheless largely overlooked in the executive pay literature is the obvious fact that contextual factors influence the setting of executive pay. I believe that it is important to explore how executive pay is driven by socially enacted pay setting practices, which are embedded differentially in the national institutional context from country to country. Institutions such as the legal system, the media, and the political arena shape and are shaped by the actions of influential social actors like, for example, business directors and executives. The discretion that these actors experience in their decision making is contingent on the facilitating and constraining capacities of relevant institutions. These institutions make it possible for actors to use existing corporate governance mechanisms for their own benefit, to alter these mechanisms in their favor, or to develop new mechanisms in their pursuit of selfish or altruistic goals.

One of the problems with agency theory is that it is conceptually incapable of dealing with executive discretion over the pay setting process itself. In line with prior scholarly work, I have used managerial power theory to frame how executives can influence the criteria by which their own pay is set. Managerial power theory follows the lines of agency theory rather closely. One major distinction is that it assumes that executives have discretion over the pay setting process. Pay setting practices should therefore not be analyzed exclusively through the lens of the principal's interests, because the incentive contract is equally likely to be shaped and perhaps even tampered with by the agent. The typical incentive contract is thus not simply a tool to solve agency problems, but rather is representative of the agency problem itself.

In order to test whether managerial power theory can be generalized beyond the US context in which it was first developed, I compiled a dataset that also captures sufficient cross-country variance in pay arrangements. The dataset comprises 3880 executive pay level data points and 1195 executive pay structure data points, representing 940 firm-year observations from 17 different countries. The results of the

study show that even when controlling for known pay antecedent variables, executives seem to have the discretion to influence their own pay. One important conclusion derived from this study is therefore that managerial discretion is omnipresent.

In contrast to conventional managerial power theory as it has appeared so far in the literature and in contrast to the most frequently neglected importance of contextual conditions for setting executive pay, I extend the theory by arguing that managerial discretion is highly contingent on the institutional context in which corporate governance mechanisms are used. I extend on the managerial power theory by arguing that the effectiveness of a given firm-level governance mechanism is contingent on the quality and makeup of the institutions of the country in which that mechanism is employed. The empirical findings support a nuanced application of this thesis. Some institutions positively mediate the effectiveness of certain corporate governance mechanisms, in the sense that they decrease managerial discretion and therefore executives subsequently have lower pay levels, or have pay structures that are more contingent upon performance. Other institutions, however, negatively mediate the effectiveness of governance mechanisms, in the sense that they increase managerial discretion and therefore contribute to higher pay levels, or make pay less contingent upon performance. Some institutions mediate the effectiveness of mechanisms to have effects on pay levels, but at the same time do not or inversely affect pay structures. And, *visa versa*, some institutions have effects on pay structures, but do not influence pay levels, or do so inversely. All in all, this study shows that executive pay is much more an outcome of institutionally embedded pay setting practices than what was previously assumed in the mainstream literature.

### **6.2.2 Origins of corporate governance reform codes: a matter of equifinality**

In an agency theory based account, corporate governance reform codes function as monitoring instruments. Corporations that comply with these codes hereby signal that they are committed to high quality governance, whereas ignoring (parts of) these codes signals poor governance. Assuming that rational financiers take the quality of firm governance into account when making investment decisions, compliant corporations ought to attract more capital against more favorable costs. Given that



many principles of corporate governance seem to appeal to agency theoretical connotations (the important role of (independent) non-executives, the protection of shareholders' rights, and the importance of (global) stock-markets provide cases in point), many scholars have predicted that the implementation of corporate convergence reform codes will lead to a systematic convergence of corporate governance systems around the world, and that the resultant system would excel in efficiency due to its complete embrace of agency theory's principles.

Others have taken issue with this view, and have launched what I called the dichotomous world hypothesis. Other than a full convergence on a single model, corporate governance systems around the world would partially converge on one of two influential models: the Anglo-American shareholder model, in which the emphasis lies on equity financing and control by external markets, or the Eurasian stakeholder model, in which debt financing is much more prominent and in which corporate control emerges "from within" – if at all. The divide separating these systems is unlikely to be closed, as both systems are equally viable, and simply represent alternate ways of achieving what Mark Roe (2003) calls "social peace".

Whereas the dichotomous world hypothesis sounds intuitively appealing, the work presented in this study suggests that the distinction it proposes is not fine-grained enough. A content analysis of corporate governance reform codes has revealed that the various systems of corporate governance in my sample represent no less than five distinct corporate governance philosophies. Each national system differs from all others in terms of its relative enactment of these five philosophies, making the differences between systems more nuanced and subtle than suggested by the dichotomous world hypothesis. The mere fact that countries differ in their prevailing firm ownership structures, that each come with governance problems of their own, and the relationships found in this study between these ownership structures and countries' relative enactment of the five philosophies, shows that even defining what constitute "corporate governance best practices" is contingent on the problems at hand and thus determined by the institutional conditions in which they are formulated. The variance and variety of the content of these codes are shown to pertain to both more complex understandings of shareholder-management relationships as understood by an agency theoretical account, as well as to other doctrines alleviating a wide spectrum of corporate governance problems that do not only refer to the conflict of interests between shareholders and management. In sum, this study shows that even

though more than 400 years have elapsed since the emergence of the publicly traded firm, countries still differ in their approach to corporate governance. Against this background, I believe that it is unlikely that we will see full convergence of “best practices” and corporate governance arrangements across nations in the near future.

### **6.3 Theorizing corporate governance**

Agency theorists typically assume that the public corporation should exclusively tend to the interests of shareholders. However, more and more parties are beginning to see that this assumption is untenable. Even Michael Jensen, one of the founding fathers of agency theory, has recently rejected this premise by arguing that the firm’s governance objective should be to maximize long term firm value and not (short term) shareholder value. He argues that firms cannot maximize their long-term value if they do not adhere to the interests of all stakeholders (Jensen, 2001). This “enlightened stakeholder theory” as Jensen (2001) calls it, argues that the decision to make tradeoffs between the interests of various stakeholders must be based on whether long-term firm value is maximized or not (Jensen, 2001). In other words, not only shareholders and management are involved in the governance processes of an organization, but also other types of stakeholders. Although this change in the firm’s objective function may lead to different framing of preferred solutions to corporate governance problems, theorizing about these solutions is not necessarily beyond the scope of agency theory. One of the core strengths of the theory is the generalizability of its analytical instruments to other types of agency problems.

Yet, one of the fundamental problems of the theory, the untenability of its assumption of fully rational self-interest maximizing actors, prevents its successful application to a broader stakeholder domain and a broader framing of corporate governance problems and problem resolutions. Actors are simply incapable of making fully rational decisions, as they are hampered by different notions and perceptions of appropriate means to make “explicit and timely calculations of optimality” (Cyert and March, 1963/1992: 214). This problem is considerably expanded if we broaden, as Jensen also suggests, the objective function of the corporation. An implication of the view that the modern corporation is a relatively diffuse, multi-stakeholder entity with a correspondingly broad objective function is that it will always be surrounded by an imperfect or ambiguous information regime. The social actors that have a stake in the

firm will therefore always have some discretion to create, deviate or circumvent governance mechanisms, or to bend rules, norms, or values in their own favor – even if we adhere to the strong assumption of perfect market conditions. If this is the case, corporate governance problems can never be resolved completely by employing mechanisms driven by calculative economic efficiency reasons only. Even when serving a particular interest corporate governance problems exist. Corporate governance problems not only pertain to problems of conflicting interests but also pertain to conflicts of opinions, expectations, notions, and perceptions of appropriate actions. Subsequently the wide spectrum of corporate governance problems can only be alleviated for a relative short period of time. Corporate governance mechanisms are employed to mediate problem resolutions and are most likely driven by reasons of aptness in order to overcome the wide spectrum of possible conflicts. Most striking, at least to me, is that Jensen, together with Murphy, also argue that corporate governance problems can only be temporarily “mitigated”, rather than resolved indefinitely, but that their argument still adheres to assumptions of fully rational actors that maximize their self-interests, implying that there is something like a perfect solution to the governance problem of conflict of interests, which they put forward as being the only problem (Jensen and Murphy 2004).

The alternative of an institutional approach trumps the agency perspective, because it relies on a different, less stringent assumption of human behavior. If we assume that social actors are “satisficers” rather than “maximizers” (Cyert and March, 1963/1992), we can better explain why public corporations continue to exist and thrive, even though they fail to maximally represent and further the interests of most of their constituents. Public corporations do not have to maximize the interests of any group in particular; they merely have to provide an acceptable outcome to their most critical constituents. Furthermore, many constituents are more likely to evaluate the firm and its behavior according to the logic of appropriateness, rather than the logic of consequence. If this is true, firms remain in business not because they maximize the interests of their shareholders, but because they are able to maintain an image of being a socially acceptable entity in the eyes of many constituents. The upshot of this analysis is that agency theory may not be the best available alternative for theorizing about governance of the publicly traded firm, but that we should instead be open to further experimentation with institutional models of corporate governance.

#### 6.4 Implications for practice

Policy makers, practitioners, and independent observers should understand that phenomena like executive pay and corporate governance reforms are not merely objective and substantive properties of any corporate governance system. They are simultaneously subjective and symbolic properties of such systems. It can be confusing that the rhetoric used to legitimize corporate governance arrangements and outcomes often pays a symbolic tribute to the logic of consequence. Executive pay is often legitimized by pointing at aspects of corporate life like “targets”, “growth”, “strategy”, “performance” and “market values” of executives services. The point is that such terms invoke the idea for outside audiences that a given pay package was awarded to an executive with the logic of consequence in mind, even though the criteria by which the pay package itself was set relies on other criteria than actual perfect optimal (performance) criteria. Thus, the logic of consequence is often referenced as a legitimizing strategy, rather than used as an actual mode of decision making.

In a similar fashion, a firm’s compliance with corporate governance codes should also be perceived as an institutional signal, which serves to appease a firm’s external audiences rather than fundamentally alter its internal governance operations. Although being in compliance could indicate that certain mechanisms or processes are in place, it says very little about how these mechanisms and processes are used, and even less about their effectiveness towards resolving the contractual hazards that occur in the contracts between managers and the various other constituents of the firm. The widespread adopted “comply or explain” principle may accidentally provide the signal that noncompliance with a code is a sign of bad or poorly functioning governance practices. In contrast, I would argue that the danger of over-compliance in the form of “box ticking” behavior is at least equally large. The corporate board may simultaneously be obsessed with the *pro forma* adoption of all prescribed structural and procedural governance guidelines and careless with respect to their *de facto* implementation and enactment. A firm’s compliance with a code of corporate governance should therefore be understood for what it really signals: a commitment to take institutional forces seriously, and the ability and willingness to create an institutionally telling image in response to institutional forces.

Practitioners must also somehow come to grips with the fact that corporate governance problems can never completely be resolved, simply because social actors will always entertain different opinions about what constitutes appropriate corporate behavior and appropriate division of corporate control and distribution of corporate wealth. Not only do all parties associated with the firm possibly hold different opinions about whose interests the firm should tend to at a certain point in time, they may also hold different opinions about the aptness of which actions to follow when serving a particular interest. The fact that these tensions cannot be taken away does not mean that firms are dysfunctional as a consequence. In fact, these varied opinions provide a balance of powers, and firms can only thrive as long as they serve and manage the changing and normative interests, opinions, notions, perceptions, and expectations of all the parties that influence its decision making and subsequent outcomes. Policy makers should therefore refrain from making all too rigorous amendments to firms' extant corporate governance systems. An externally imposed constraint, which is intended to elevate the interests of particular parties over those of others, may well distort the fragile balance of powers, interests, opinions, notions, perceptions, and expectations in any firm, and consequently make all of the involved parties worse off.

### **6.5 Limitations & future research**

Studying a subject intensively tends to lead to more, rather than less questions. Some of the future research questions that have emerged during the course of this study are a result of clear limitations of the empirical work conducted, whereas others result from the newly acquired insights themselves. Scholars always seem to prefer more data to less data in their empirical studies. I am no different. I would have liked to include and use more reform codes, more pay data, more data on pay practices, and more ownership data. Whether the conclusions of the essays in this study are biased and limited by the samples can only be demonstrated by future research using newer and better data.

Apart from the usual data restrictions, one of the conceptual limitations is the positive approach of this study. It is clear that the notion of corporate governance has many normative connotations and implications, and that these have not been systematically taken into account in this study. Future research could investigate the

‘normative bend’ in corporate governance. We should explore whether corporate governance philosophies, and even the seemingly objective phenomenon of executive pay, are systematically grounded in social values and other institutions.

In any event, this will demand more comparative work. Especially in the executive pay literature, cross-national empirical studies are still a rarity. The studies that do exist tend to use aggregated data at national levels, and thus ignore random unobservable country-specific effects, and they completely disregard within-country variance. An important contribution of the research presented here is that it demonstrates the importance of incorporating both between and within-country variance in our future tests and extensions of corporate governance theories. Future research could go a step further and address successive questions about the development of the identified effects over time. This would demand a stable panel, involving more firms, more countries, and more observation years, which could then also provide attention for possible unobservable firm level effects.

Other lingering questions are whether corporate governance arrangements influence and are influenced by corporate performance, and whether there is a reciprocal effect on national economic performance. An imperative follow-up question is regarding which conditions certain corporate governance arrangements and executive discretion tend to lead to better firm performance. Another issue that is not specifically addressed is to what extent firms actually adhere to nationally subscribed corporate governance philosophies. Deeper knowledge of how corporate governance philosophies influence pay levels and structures could further enrich our understanding of both phenomena. Follow-up research could also explore how these philosophies influence board compositions, executive characteristics, and other firm-level variables. Another issue that I could not address here is whether governance philosophy-inspired choices influence firms’ strategic and investment decisions. In sum, the good news for corporate governance scholars is that the present study, with all its limitations, has demonstrated that there is still a lot of work for all of us in the years and decades to come. This is not in spite of, but rather because of the fact that the dominant explanatory frameworks of especially agency theory are nearing their empirical and conceptual exhaustion.

## **6.6 Concluding remarks**

Although there is still much left to be desired, the research I have presented here has contributed to two major fields in the corporate governance literature; notably to the executive pay literature and the comparative corporate governance literature. The implications of this study have advanced our understanding of corporate governance. As my final conclusion, I would like to give a synopsis of the greatest insights I have gained over the past four years. Corporate governance problems are not only problems of conflicts of interests, but more broadly also pertain to conflicts of expectations, opinions, notions, et cetera of appropriate behavior at different levels in firms and societies. These problems can only be alleviated and not resolved indefinitely. Corporate governance arrangements are driven by reasons of aptness and thus function to mediate problem resolutions. Although economic reasoning could partly drive the formulation of corporate governance arrangements, their true origins derive from institutional forces that simultaneously empower and control those decision making actors that employ, develop, and contest them.

Corporate governance arrangements are complex systems, which are highly reliant on the contexts in which these systems are developed and employed. Any policy maker proposing amendments to such systems should pay careful attention to the possible interaction effects that these amendments are most likely to trigger in the other elements comprising the system and in the institutions in which they are embedded. Copying and transplanting measures and mechanisms from other jurisdictions may seem attractive at first glance, but may well result in unwanted side effects. Making far-reaching amendments to governance systems that have developed over centuries may lead to beneficial outcomes for some. However, it may generate unwanted and unexpected negative effects for others. In lieu of better knowledge of, and deeper insights into these interactions, policy makers are best advised to refrain from making too rigorous amendments to these complex systems of which we still know so little.

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## ***Samenvatting***

Corporate governance wordt met name vanuit de agency theorie benaderd. Het centraal staande probleem in deze theorie is de scheiding tussen eigendom van de onderneming aan de ene kant en het management van de onderneming aan de andere kant. Dit wordt als een probleem gezien, omdat bestuurders verondersteld worden andere belangen te hebben in de onderneming dan aandeelhouders. Door het belang van de aandeelhouders als uitgangspunt te nemen, worden bestuurders verondersteld suboptimale beslissingen te kunnen nemen vanuit het oogpunt van aandeelhouders. Om dit agency probleem op te lossen wordt corporate governance dan ook door de vele aanhangers van de agency theorie beschouwd als die middelen die het belangenconflict tussen aandeelhouders en managers zouden moeten oplossen.

Door te focussen op twee fundamentele corporate governance fenomenen, te weten de beloning van bestuurders en hervormingen van corporate governance in de vorm van codes, laat dit onderzoek zien dat deze benadering echter beperkt is. Deze studie maakt duidelijk dat door middel van het verder ontwikkelen en toepassen van het geboden alternatief van een institutionele benadering, corporate governance problemen en de zoektocht naar mogelijke oplossingen complexer zijn en op andere gronden berusten dan de algemeen geaccepteerde agency theoretische benadering ons wilt doen geloven. Een belangrijk uitgangspunt om tot dit inzicht te komen is door het contrasteren van de criteria waarmee beslissingen genomen worden in beide benaderingen.

In de agency benadering worden beslissingen genomen op basis van wat Cyert en March (1963/1992) de “logic of consequence” noemen. Deze beslissingsredenering houdt in dat beslissingen gewogen worden op basis van de waarde van hun consequenties. Het nemen van beslissingen is een rationeel, calculatief proces, waarin die beslissingen genomen worden waarvan de consequenties de maximale toekomstige waarde zullen hebben.

In een institutionele benadering daarentegen wordt gebruikt gemaakt van een alternatieve beslissingsredenering. Deze redenering noemen Cyert en March (1963/1992) de “logic of appropriateness”. De criteria die in deze redenering als uitgangspunt genomen worden berusten op het feit dat beslissingen op basis van institutionele, cognitieve omstandigheden genomen worden. Hierdoor wordt verondersteld dat het onmogelijk is om alle informatie te hebben of te verwerken om rationele, calculatieve beslissingen te nemen. Beslissingen kunnen dan ook genomen worden op basis van gewoontes, regels, imitatie of autoriteit. Beslissingen worden genomen op basis van de “passendheid” bij de omstandigheden zoals die gepercipieerd worden door de beslissingnemer. Zoals het onderzoek aangeeft kunnen we de fundamenteën van de vele facetten van corporate governance beter begrijpen vanuit het geboden alternatief van een institutionele benadering die deze alternatieve beslissingscriteria hanteert.

Dit inzicht komt tot stand door het beantwoorden van de twee centraal staande vragen in dit onderzoek. Naast de vraag wat mogelijk verschillende benaderingen zijn om corporate governance hervormingen te formuleren, wordt de vraag gesteld hoe de beloning van bestuurders verklaard kan worden. Eerst zal het onderzoek met betrekking tot deze laatste vraag besproken worden. Vervolgens zal het onderzoek besproken worden dat de eerder genoemde vraag adresseert.

Om de vraag te kunnen beantwoorden hoe de beloning van bestuurders verklaard kan worden is er in hoofdstuk 2 een inventarisatie van de bestaande literatuur gemaakt. Ondanks dat de contract benadering van agency theorie veruit de dominante benadering in de literatuur is, worden er ook andere theorieën gebruikt. De literatuurstudie heeft geleid tot een inventarisatie van in totaal 16 theoretische benaderingen die in de literatuur gebruikt worden om de beloning van bestuurders te verklaren.



Deze theoretische benaderingen zijn gecategoriseerd naar drie geïdentificeerde stromingen. De eerst gedefinieerde stroming is de “value approach”. Deze stroming bestaat met name uit theorieën die de vraag *hoeveel* bestuurders betaald moeten worden adresseren. De verklaring die gegeven wordt berust op argumenten van vraag en aanbod op de markt voor bestuurders.

De tweede stroming is de “agency approach”. Deze theorieën adresseren meer de vraag *hoe* bestuurders betaald moeten worden (bonus, opties e.d.) en is onder te verdelen in twee substromingen. Gebaseerd op het agency probleem beschouwt de eerste substroming de beloning van bestuurders als een instrument om tot een oplossing voor dit probleem te komen. De in de literatuur dominante contract benadering van agency theorie maakt onderdeel uit van deze substroming. De tweede substroming beschouwd het vaststellen van de beloning *zelf* als een agency probleem. Deze substroming onderkent dat bestuurders macht hebben tijdens het onderhandelingsproces dat hun beloning bepaalt. De getroffen beloningsregeling is daarmee geen middel om het agency probleem op te lossen, maar is onderdeel van het probleem. Beide substromingen zoeken met name verklaringen op basis van marktwerking en de mate waarin de beloning van bestuurders onderhevig is aan risico's.

De derde stroming is de “symbolic approach”. Deze groep van theorieën beschouwd meer de informatieve waarde die de beloning van bestuurders heeft. De sociale positie die een bestuurder inneemt in de samenleving en/ of in de organisatie wordt gereflecteerd door de beloning. De beloning reflecteert de sociaal gecreëerde rol, verwachtingen en motivatie van de bestuurder. De beloning wordt meer beschouwd als een uitkomst van sociale omstandigheden die de verwachtingen, motivatie of de rol van een bestuurder vorm geven.

Mede op basis van de inventarisatie en categorisering van theoretische stromingen is er een raamwerk gepresenteerd. In dit raamwerk komt naar voren dat: 1) de beloning van bestuurders niet los gezien kan worden van corporate governance systemen, 2) dat de beloning niet zozeer een instrument is binnen corporate governance systemen, maar meer een uitkomst is van dergelijke systemen, en 3) dat corporate governance systemen institutioneel geconstrueerde systemen zijn waarin de actoren discretionaire macht hebben om beslissingen te maken.

Dit moet gezien worden in scherp contrast met de dominante agency benadering in de literatuur. In deze dominante benadering wordt namelijk de beloning gezien als een instrument binnen corporate governance systemen en worden discretionaire macht en instituties categorisch buiten beschouwing gelaten.

Met behulp van het theoretisch raamwerk wordt een verklaring voor de beloning gezocht op basis van het idee dat de beloning bepaald wordt door “pay setting practices”. Deze practices zijn die processen op ondernemingsniveau die als doel hebben om het beloningsbeleid te vergelijken, vast te stellen en te implementeren. Deze processen maken onderdeel uit van corporate governance systemen die gevormd worden door de institutionele context waarin deze systemen worden ontwikkeld. Instituties geven zowel vorm aan de onderhandelingsmacht van de actoren, de afwegingen in het beslissingsproces, de vorming van de practices, als aan corporate governance systemen in het algemeen. Daarnaast worden instituties mede gevormd door de discretionaire macht van invloedrijke spelers en door de getroffen beloningsregelingen. Op basis van dit theoretisch raamwerk zijn er onderzoeksvragen geformuleerd. Een belangrijke geformuleerde vraag is om te onderzoeken wat de mogelijke effecten zijn van de interactie tussen instituties en pay setting practices voor het bepalen van de beloning van bestuurders.

Hoofdstuk 3 gaat verder in op deze vraag. Eerst wordt beknopt de agency theorie en de conceptuele problemen van deze theorie uiteengezet. Mede op basis van de inzichten uit hoofdstuk 2, wordt de managerial power theorie naar voren geschoven als een mogelijk beter alternatief om tot een meer sluitende verklaring van het beloningsfenomeen te komen. Deze theorie is echter ontwikkeld in de Amerikaanse context. Om te onderzoeken of de managerial power theorie generaliseerbaar is buiten deze context, is er een empirische studie verricht die voor het eerst deze theorie toetst op basis van data van verschillende landen. Naast deze toets, wordt de theorie uitgebreid met de extensie dat de discretionaire macht die bestuurders hebben afhankelijk is van de effectiviteit van corporate governance mechanismen die beïnvloed worden door institutionele omstandigheden. Op basis van een samengestelde dataset bestaande uit 3880 observaties van beloningsniveaus, 1195 observaties van beloningsstructuren, uit 17 verschillende landen, is zowel de extensie van de theorie als de generaliseerbaarheid van de theorie getoetst.

De resultaten van de empirische toetsen geven aan dat managerial power theorie inderdaad generaliseerbaar is buiten de Amerikaanse context. Daarnaast is er empirisch bewijs gevonden voor de in deze studie ontwikkelde uitbreiding van de theorie. De resultaten laten zien dat de effectiviteit van corporate governance mechanismen, die ook de discretionaire macht van bestuurders bepalen, afhankelijk is van de institutionele context. Echter, sommige instituties beperken de discretionaire macht van bestuurders positief en sommige negatief, met verschillende gevolgen voor het beloningsniveau en de beloningsstructuur. Waar sommige instituties discretionaire macht positief beperken, in de zin dat bestuurders lagere beloningen hebben of een beloningsstructuur hebben die meer afhankelijk is van prestaties, lijken andere instituties een negatief effect te kunnen hebben voor de samenstelling en/of hoogte van de beloning. Daarnaast lijken instituties de effectiviteit van corporate governance mechanismen en de discretionaire macht van bestuurders zo te kunnen beïnvloeden dat bestuurders de effecten van een hogere beloning kunnen afwegen tegen de effecten van een beloning die in principe meer afhankelijk zou moeten zijn van de prestaties van de onderneming. Sommige instituties lijken zodanige effecten te kunnen hebben waardoor beloningsniveaus lager uitvallen, maar dezelfde instituties kunnen een tegengesteld (of geen) effect hebben voor de beloningstructuur. Het variabele deel van de beloning maakt dan een relatief kleiner deel uit van de totale beloning en is daarmee in principe minder afhankelijk van de prestaties van de onderneming. Maar ook omgekeerd, sommige instituties lijken de effectiviteit van corporate governance mechanismen zo te kunnen beïnvloeden dat bestuurders een beloning hebben die hoger uitvalt, maar tegelijkertijd kunnen dezelfde instituties effecten (of geen effecten) hebben op de beloningstructuur. Het variabele deel dat in principe afhankelijk zou moeten zijn van de prestaties van de onderneming is dan relatief groter.

Het onderzoek laat zien dat zowel de hoogte als de samenstelling van de beloning worden beïnvloed door de institutionele context waarin beslissingen over de beloning worden genomen. Niet alleen wordt de effectiviteit, maar ook het bestaan van corporate governance mechanismen beïnvloed door de institutionele context. De institutionele context in combinatie met corporate governance mechanismen geven bestuurders de mogelijkheid om voor en nadelen van beloningsniveaus of te kunnen wegen met de voor en nadelen van verschillende beloningsstructuren. Er bestaan complexe interacties tussen instituties, corporate governance mechanismen,

discretionaire macht en de beloning van bestuurders. Instituties beïnvloeden enerzijds de hoogte van de beloning en anderzijds de samenstelling ervan. Daarnaast beïnvloeden instituties de effectiviteit van corporate governance mechanismen en de discretionaire macht die de actoren hebben in het beslissingsproces dat de beloning bepaalt. Verandering in instituties of van mechanismen kunnen enerzijds beoogde gevolgen hebben voor de hoogte of samenstelling van de beloning, maar kunnen anderzijds ook leiden tot tegengestelde, mogelijk onverwachte, negatieve effecten voor de samenstelling of hoogte van de beloning.

Geconcludeerd kan worden dat de beloning van bestuurders veel meer een uitkomst is van institutioneel geconstrueerde corporate governance systemen dan een instrument binnen deze systemen. Daarnaast kan geconcludeerd worden dat bestuurders een zekere mate van macht hebben over het bepalen van hun eigen beloning en dat deze afhankelijk is van de context waarin corporate governance systemen ontwikkeld zijn. Deze conclusies moeten gezien worden in scherp contrast met wat tot nu toe voor gangbaar werd aangenomen in de literatuur. In tegenstelling tot de dominante stroming in de literatuur, kan er dan ook geconcludeerd worden dat de fundamentele om tot een omvattende verklaring voor de beloning van bestuurders te komen berusten op discretionaire macht en de invloed van institutionele omstandigheden.

De tweede centrale vraag in het gepresenteerde onderzoek, te weten in hoeverre er verschillen bestaan in de benadering van corporate governance, is onderzocht door nationale corporate governance codes op hun inhoud te bestuderen. Aanhangers van de dominante agency benadering gaan ervan uit dat er maar één efficiënte benadering mogelijk is om codes te formuleren. Op basis van efficiency argumenten beargumenteren zij dat de enige mogelijke benadering een agency benadering is. Deze benadering gaat ervan uit dat de meest ideale situatie gekenmerkt wordt door een wijdverspreid eigendom van de onderneming. Hierdoor worden de risico's van investeringen verspreid over zoveel mogelijk aandeelhouders en daardoor worden de kosten van het investeringskapitaal omlaag gebracht. Om het agency probleem tussen aandeelhouders en management op te lossen wordt er vanuit gegaan dat corporate governance codes geformuleerd worden naar deze situatie van een wijdverspreid aandeelhouderschap. Daarnaast, gegeven de assumpties van de agency theorie, impliceert deze benadering dat codes geformuleerd moeten worden louter en alleen op

basis van het belangen conflict tussen aandeelhouders en het management en het in toom houden van het streven naar het maximaliseren van het eigenbelang door managers. Als de agency theorie daadwerkelijk de enige en beste manier zou zijn om corporate governance te benaderen en daarmee dus de enige benadering is om hervormingen te formuleren, dan zou dit terug te voeren moeten zijn naar de inhoud van corporate governance codes.

Om te onderzoeken of dit daadwerkelijk het geval is, zijn in er in hoofdstuk 4 38 nationale codes inhoudelijk onderzocht. De onderzochte hervorm codes zijn opgesteld door gezaghebbende organisaties zoals stock-exchanges of de staat en reflecteren het gewenste corporate governance systeem in een land. Op het eerste gezicht zijn de codes met name geformuleerd om drie redenen. Te weten: 1) het vergroten of herstellen van het maatschappelijk vertrouwen in financiële markten, 2) condities te scheppen voor het aantrekken van nieuwe investeringen, en 3) het waarborgen dat financiële markten een veilige manier van investeren is.

De inhoud van de codes zijn regels die aangeven hoe corporate governance mechanismen vormgegeven zouden moeten worden. Het betreft bijvoorbeeld regels met betrekking tot de bescherming van kleine aandeelhouders, regels omtrent het stemrecht van aandeelhouders, regels die aangeven wat mogelijk de additionele rol van groot aandeelhouders zou moeten zijn, maar ook hoe bepaalde toezichthoudende commissies, zoals de audit, beloning en benoemingscommissie vormgegeven dienen te worden en hoe deze commissies zouden moeten opereren.

Op basis van systematische inhoudelijke analyses is in kaart gebracht in welke mate bepaalde corporate governance mechanismen in de verschillende codes besproken worden. Het blijkt dat de codes aanzienlijk verschillen in welke mechanismen wel of niet aandacht krijgen in de codes, alsmede in welke mate een bepaald mechanisme wordt besproken. Verdere analyse duidt erop dat er een systematiek bestaat tussen het in meer of mindere mate adresseren van combinaties van bepaalde corporate governance mechanismen in één en dezelfde code. Zo correleert bijvoorbeeld de mate waarin de bescherming van klokkenluiders geadresseerd wordt significant met de mate waarin de regels met betrekking tot de interne audit commissie wordt besproken.

Het bloot leggen van de systematiek waarin bepaalde mechanismen al dan niet in de codes besproken worden, heeft geleidt tot het identificeren van vijf corporate governance filosofieën. Interpretatie van de systematiek waarin corporate governance

mechanismen worden besproken, geeft namelijk gegronde redenen om aan te nemen dat er niet één benadering is, zoals aanhangers van de agency theorie beweren, maar dat er vijf patronen zijn waarin bepaalde mechanismen worden besproken. Deze vijf patronen zijn geïnterpreteerd als corporate governance filosofieën, aangezien zij vijf conceptueel verschillende benaderingen van corporate governance vertegenwoordigen. De vijf filosofieën zijn: “organizational design”; “ownership concentration”; “ownership dispersion”; “managerial empowerment” en “esteem responsiveness”.

De organizational design filosofie berust op de gedachte dat corporate governance zou moeten bestaan uit die mechanismen die de structuur van corporate governance in de organisatie zelf vorm geven. Het zijn mechanismen die intern zijn aan de organisatie, zoals bijvoorbeeld de operationele regels waaraan de beloningscommissie of audit commissie zouden moeten voldoen.

Ownership concentration is een filosofie die berust op de gedachte dat corporate governance zou moeten bestaan uit die mechanismen die toegeschreven kunnen worden aan grootaandeelhouders om hen de middelen en het motief te verschaffen om corporate governance van de onderneming vorm te geven. Deze mechanismen omvatten niet alleen rechten. De gedachte is ook dat groot aandeelhouders de plicht hebben om een actieve en verantwoordelijke rol te spelen in corporate governance. Zij hebben niet alleen rechten en plichten om de financiële belangen te behartigen, maar zij hebben ook de additionele verantwoordelijkheid om de rol van andere partijen, zoals bijvoorbeeld werknemers, te waarborgen en deze derden een eerlijke positie te geven in corporate governance processen.

Ownership dispersion berust op de gedachte dat corporate governance vorm gegeven dient te worden door alle aandeelhouders. Ongeacht of het grote of kleine aandeelhouders zijn, zouden aandeelhouders de expliciete rechten gegeven moeten worden om corporate governance vorm te geven. Centraal in deze filosofie staan de bescherming van gelijke rechten voor alle aandeelhouders en hoe zij deze rechten zouden moeten kunnen afdwingen. Het betreft bijvoorbeeld mechanismen die expliciet het recht op betrouwbare informatie over het reilen en zeilen van de onderneming vastleggen, de stemrechten van aandeelhouders specificeren en wat de regels zijn op de aandeelhoudersvergadering.

De managerial empowerment filosofie is gebaseerd op de gedachte dat managers professionals zijn die volledig in dienst staan van de onderneming. Aangezien managers stewards zijn van de onderneming bestaat er een zeer groot vertrouwen dat zij die beslissingen nemen die in het belang zijn van de onderneming. Zij dienen daardoor ook de belangen van aandeelhouders. Om er voor zorg te dragen dat managers instaat worden gesteld om de juiste beslissingen te nemen, is het van belang om hun mandaat zo groot mogelijk te maken. In deze filosofie wordt corporate governance vorm gegeven door mechanismen, of juist de afwezigheid daarvan, die managers in staat stellen om hun belangrijke rol te kunnen vergroten. Mechanismen zijn bijvoorbeeld het vergroten van eigendom in de organisatie door werknemers, duidelijke regels met betrekking tot het belonen van bestuurders in aandelen en de afwezigheid van de beperkte werkingen van regels en mechanismen die gepaard gaan met het directe toezicht op het opereren van het management.

De esteem responsiveness filosofie berust op de gedachte dat corporate governance het beste vormgegeven kan worden door mechanismen die het wel en wee van de onderneming kenbaar maken aan een groter publiek. De gedachte is dat de mening en waardering van een groot publiek zowel intrinsieke als excentrieke motiverende componenten bevatten die corporate governance mechanismen en uitkomsten beïnvloeden. Binnen deze filosofie passen bijvoorbeeld mechanismen die reguleren hoe de onderneming aan een wijder publiek kenbaar maakt welke (sociale) issues belangrijk zijn en hoe er met deze issues wordt omgegaan. Voorbeelden zijn milieu issues en hoe externe auditors benoemd worden en opereren in het aanleveren van betrouwbare informatie over de financiële resultaten van de onderneming.

In tegenstelling tot de claims van een agency benadering, geeft het identificeren van de vijf filosofieën aan dat er variatie bestaat in de conceptuele benadering van corporate governance. Er is niet één benadering van corporate governance maar er zijn 5 fundamenteel verschillende invalshoeken om corporate governance hervormingen te formuleren. Onverenigbaar met de agency benadering geven de verschillende geïdentificeerde filosofieën aan dat er: 1) mechanismen gebruikt worden die betrekking hebben op de situatie dat eigendom van de onderneming (blijvend) geconcentreerd zou kunnen zijn, 2) er andere partijen dan louter en alleen aandeelhouders en managers een rol spelen in corporate governance en 3) de assumptie dat managers louter streven naar het maximeren van hun eigenbelang niet altijd opgang doet.

Verdere analyses in hoofdstuk 5 tonen aan dat de relatieve focus op bepaalde combinaties van mechanismen, de mate waarin landen verschillende nadrukken leggen in hun codes op één van de filosofieën, correleren met de dominante eigendomstructuur van ondernemingen in een gegeven land. Gegeven dat de codes het vertrouwen in en de werking van financiële markten willen vergroten of herstellen en gegeven de dominante eigendomstructuur van de ondernemingen in een bepaald land, reflecteren de codes een focus op een specifieke filosofie. Aangenomen kan worden dat een bepaalde dominante eigendomstructuur aanstoot geeft aan het formuleren van de codes en daarmee het adresseren van specifieke combinaties van corporate governance mechanismen.

De specifieke condities van bijvoorbeeld een wijdverspreid eigendom van de onderneming over vele aandeelhouders, gekenmerkt door institutionele omstandigheden waarin financiële markten relatief effectief werken en aandeelhouders wettelijk beter beschermd worden, geeft aan dat de codes in dergelijk landen zich focussen op de organizational design filosofie. Juist in dergelijke landen lijkt een oplossing voor de problemen met name te liggen in het aanscherpen van die mechanismen die intern aan de organisatie zijn en niet zozeer in het verlengde liggen in het verder aanscherpen van de institutionele factoren die extern aan de onderneming zijn en relatief al goed functioneren.

Daarentegen wordt bijvoorbeeld corporate governance in landen waarin ondernemingen met name in handen zijn van families gekenmerkt door een institutionele context van relatief grotere informatie problemen aan derden. In landen waar deze vorm van eigendom dominant is, focussen de codes zich op de extern gerichte esteem responsiveness filosofie, waarin een focus ligt op de externe mechanismen die corporate governance vorm zouden moeten geven.

Geconcludeerd kan worden dat de agency theoretische benadering geen sluitende verklaring kan geven voor de fundamentele van verschillende corporate governance benaderingen. De vraag of corporate governance systemen van verschillende landen convergeren lijkt dan ook met neen beantwoord te kunnen worden. Corporate governance problemen zijn al eeuwen oud en zowel het identificeren van de vijf filosofieën, als de analyses van de relaties tussen deze filosofieën en de eigendomstructuren van ondernemingen, geven aan dat er nog steeds grote, en ook conceptueel fundamentele, verschillen bestaan tussen benaderingen om verlichting te bieden aan deze problemen. Na eeuwen van ontwikkeling bestaan er tot op heden nog



steeds grote verschillen in het formuleren van wat goede corporate governance praktijken genoemd zouden kunnen worden. Het bestaan en de effectiviteit van corporate governance mechanismen lijken afhankelijk te zijn van de passendheid van deze mechanismen met de institutionele context waarin hervormingen geformuleerd worden. Deze context beïnvloedt de vorm, het bestaan en de werking van mechanismen. De fundamenteën van verschillende corporate governance systemen lijken daarmee te berusten op equifinaliteit, in de zin dat er meerdere passende benaderingen van corporate governance zijn en dat deze verschillende benaderingen over langere tijd naast elkaar kunnen voortbestaan.

Op basis van het onderzoek zijn er diverse conclusies te trekken voor zowel de theorievorming als voor de praktijk. Corporate governance omvat veel meer dan louter en alleen het belangenconflict tussen managers en aandeelhouders. Dit in tegenstelling tot wat veelal in de praktijk naar voren wordt gebracht en ook in tegenstelling tot beweringen van de vele aanhangers van de agency theorie. Beslissingen die in corporate governance processen worden genomen, zoals het belonen van bestuurders en het formuleren van corporate governance hervormingen, zijn niet volledig te verklaren op basis van de beslissingsredenering en andere assumpties die gehanteerd worden door aanhangers van de agency theorie. Het vaststellen van de beloning van bestuurders en het formuleren van hervormingen zijn onderhevig aan institutionele omstandigheden. Beslissingen worden dan ook genomen op basis van criteria die passend zijn bij de institutionele omstandigheden. Verschillende partijen en instituties beïnvloeden corporate governance systemen en hun uitkomsten. Corporate governance problemen zijn dan ook niet louter en alleen conflicten tussen de belangen van aandeelhouders en managers. Corporate governance problemen zijn ook die problemen die betrekking hebben op conflicten tussen de belangen van andere partijen. Daarnaast zijn het niet alleen conflicten tussen verschillende belangen van verschillende partijen, maar ook mogelijke conflicten over verschillende percepties, opvattingen, verwachtingen, meningen en attitudes die de verschillende partijen kunnen hebben over wat passend gedrag is om een bepaald belang te dienen.

Corporate governance problemen zijn niet volledig oplosbaar. De verschillende spelers hebben institutioneel geconstrueerde discretionaire macht en hebben mogelijk verschillende percepties, verwachtingen et cetera bij het maken van beslissingen.

Corporate governance mechanismen dienen dan ook als middel om te interveniëren of te bemiddelen in het zoeken naar verlichtingen van de problemen. Veranderingen van en verschillen in percepties, opvattingen, attitudes, meningen en het al dan niet (gedeeltelijk) uitkomen van verwachtingen leiden tot slechts een mogelijk tijdelijke oplossing voor een bepaald probleem.

Beleidsmakers moeten er van doordrongen zijn dat er complexe interacties bestaan tussen instituties en de vorming van de verschillende componenten in corporate governance systemen. Verandering in beleid, instituties of van bepaalde componenten in het systeem, bijvoorbeeld door het initiëren van hervormingen of het beperken van discretionaire macht in het proces dat de beloning van bestuurders bepaald, kunnen mogelijk beoogde effecten hebben voor bepaalde elementen of positieve effecten voor bepaalde personen of groepen van personen. Deze veranderingen kunnen echter tegelijkertijd, onverwachte, negatieve effecten hebben voor andere elementen of personen. Rigoureuze veranderingen of het kopiëren van (delen van) corporate governance systemen uit andere landen zijn dan ook niet aan te raden. Een corporate governance systeem is nodig om te bewerkstelligen wat Marc Roe (2003) “social peace” noemt. Het is een resultaat van een broze balans van machtsverhoudingen in een maatschappij om deze relatieve conditie van sociale stabiliteit te onderhouden. Een corporate governance systeem is ontwikkeld door de eeuwen heen en rigoureuze, of niet goed doordachte, veranderingen zouden deze delicate verhoudingen wel eens ernstig kunnen verstoren.

### *Curriculum Vitae*

Johan Adrianus (Jordan) Otten was born in 1974 in Utrecht, The Netherlands and received his primary education in Maarssen. When Jordan moved with his family to Dalfsen, he received his secondary education in Zwolle. After that he started at the Rotterdam School of Management at the Erasmus University Rotterdam. During his master in Strategic Management he also studied at the Stockholm School of Economics. He received his M.Sc. degree (2001) at the Erasmus University with a thesis on the affects of mergers and acquisitions on executive pay. This thesis signifies the start of his interests in doing research on corporate governance. In 2002 Jordan started as the first Ph.D. student at the newly founded Tjalling C. Koopmans Institute, where he also served on the board. This institute is the research institute of the also recently founded Utrecht School of Economics, the economics department of Utrecht University. Currently Jordan is back in Rotterdam where he is an assistant professor at the Rotterdam School of Management. His research interests are (comparative) corporate governance, executive pay, institutional theory and organization theory.

