Board Political Leanings Determine CEO Pay

Directors with conservative proclivities are significantly more generous.

Facebook is the quintessential example of a small company with high value that is becoming more common in the modern economy. How small is small? As of December 2015, it employs 12,000 people. What about Google? 57,000 employees. And if we turn to the other facets of the modern economy, to services and industry, we find Walgreens with 240,000 employees or Ford Motors with 199,000 – these are not the largest employers in their sectors by far, yet they employ hundreds of thousands of workers.

Surely, technology partly explains why Facebook could succeed so spectacularly with such a comparatively modest headcount. Silicon Valley firms are known for their leanness, plus Facebook is at the forefront of algorithmic automation. Yet it's hard to talk about Facebook without summoning the mental image of co-founder and CEO Mark Zuckerberg. And this leads us to a question that goes far beyond any particular firm: Is one Zuckerberg worth tens of thousands of mere mortals? If so, the enormous CEO pay packets that are so often criticised may, in fact, be justified – at least in the case of successful companies.

Political ideology on the payroll

By the above logic, where you come down on the matter of CEO compensation has political resonance. It expresses whether or not you approve of the notion that the welfare of a collective flows from the abilities of a single powerful leader. In a recent study of executive compensation published in ***Administrative Science Quarterly***, Abhinav Gupta (of University of Washington) and Adam Wowak (of University of Notre Dame) found that the different views of leadership held by Republicans and Democrats in the U.S. affect how chief executive officers are paid. The idea is simple – members of the board of directors determine how much the CEO gets paid and they also reveal their political views through donations to the parties (naturally they can donate to none, one, or both). If the board members believe that CEOs are largely responsible for what tens of thousands of people do, they will pay the CEOs more on average, and they will also make the pay more sharply dependent on the company's recent performance.

It is not a secret that Democrats attribute a lot of credit to the collective effort of workers and managers, and less to the CEO. What has become clear recently is that there is a clear authoritarian streak in the Republican Party and, accordingly, a tendency to credit the results to the CEO. Do the results of the study bear this out? Abundantly. A Republican dominance of a board leads to higher CEO pay. Specifically, the authors found that, all else being equal, a +1 standard deviation in board conservatism correlates to a pay lift of about 4 percent for the CEO. To make it even more concrete, they point out that for the median CEO in their sample set, comprising data for 2,435 U.S. firms, a 4 percent salary increase amounts to an extra US$144,000 annually, or triple the average annual wage in the U.S.

Also, conservative boards tie CEO compensation more closely to accounting profit and stock market value increase. Interestingly, the authors suggest that political differences may contribute to the oft-noted **loose connection** between chief executive pay and firm performance, which has confused many observers. Perhaps it's not so much that directors are inconsistent, but that they adhere first and foremost to their political ideology rather than textbook business principles.

Even more revealing: these relations are stronger when the analysis is limited to the compensation committee, which is the subgroup of the board that determines CEO pay (usually with the help of consultants).

In good times, and bad times...

The authors suggest that conservative boards would pay their CEOs 14 to 18 percent more than liberal-leaning boards, given equivalent firm performance. As a corollary, conservative directors display more readiness than liberals to penalise chief executives as performance declines. Even in lean times, though, conservatives are still likely to pay as much or more than liberals, simply because their default setting for CEO compensation is markedly more munificent. If you're a CEO looking for a new home, your most attractive salary package will likely come from a Republican-leaning board.

So now we know that CEO pay is political, in additional to the earlier findings showing that it is customary and performance dependent. Does that make CEO pay unfair? Well, actually the answer to that is political too. Consider how you feel about this issue; it probably fits your political views in general.

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