World Review of Business Research
Vol. 3. No. 1. January 2013 Issue. Pp. 115 – 125

The Influence of Social Dominance Orientation and Hegemonic Power on CEO Excess Compensation

Basu Sharma*, Mohamed Drira* and Muhammad Rashid*

This paper proposes a social dominance orientation prompted hegemonic power framework for study of CEO compensation by integrating personality traits in economic analysis as suggested by Heckman (2011) and Allund et al. (2011). This new framework explains how hegemonic CEO activities can create less efficient corporate governance system and why a subset of CEOs is able to get paid excess compensation. The article's main contribution to extant executive compensation literature is that it provides a new lens to analyze CEO excess compensation.

JEL Codes: *G34, J44, M52*

1. Introduction

Executive compensation is a topic of both theoretical and practical interest which has spawned a vast body of literature. More specifically, the spectacular increase in executive compensation in the last three decades has generated a debate around the reasons behind this phenomenon (Frydman and Jenter, 2010). According to the principle-agent theory, corporate governance mechanisms are presumed to monitor executive actions in order to limit rent extraction by CEOs from the firm in terms of disproportionately high compensation. However, arguments following managerial power theory initially proposed by Bebchuk and Fried (2004, p. 4) stipulate that the method of determining executive compensation is based on a system of corporate governance structure that serves the interest of the CEOs rather than that of other stakeholders in the corporation. They argue that "…boards can be "captured" by the CEO and made to serve his or her interests." Consequently, the system becomes conducive to rent extraction by CEOs in terms of excess compensation.

Data show that only a small percentage of the chief executive officers' universe commands excess compensation (AFL-CIO, 2012). Given this empirical fact, a more relevant question to address in CEO compensation research would be—why do some executives earn excess compensation? We believe that an answer to this question may become more meaningful in terms of policy developments regarding CEO compensation and corporate governance. The motivation for this paper comes from this belief.

Building on insights from international relations and personality psychology, this paper argues that some CEOs behave like "hegemons" and use different tactics to spread their power all over the organization, establishing hegemony for expropriating

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*Faculty of Business Administration, University of New Brunswick, P.O. Box 4400, Fredericton, NB, E3b 5A3, Canada.
Corresponding author: bsharma@unb.ca

excess power and rent through manipulation of corporate governance mechanisms. More importantly, we complement managerial power theory by stipulating that there may be some personality traits of CEOs which will most probably generate such “hegemonic” behavior that could have a significant implication for corporate governance including excess executive compensation. Personality psychologists call this personality trait promoting CEO’s “hegemonic” nature the social dominance orientation or trait (Sidanius and Pratto, 1999). Using these two constructs, we develop a conceptual model of CEO excess compensation. The model generates a couple of novel hypotheses that can eventually be tested using empirical data. This paper thus makes a contribution to the executive compensation literature in an important way.

The paper is organized as follows. In the following section, we review key arguments of the main theoretical frameworks that have been used to explain underlying process of and rationale for CEO compensation determination. In section three, we present a conceptual framework relating key personality traits of hegemonic CEOs and excess compensation. This section also contains three key hypotheses that can be tested empirically. The concluding section summarizes the arguments and makes some recommendations for policy and research.

2. Literature Review

Since executive compensation is one of the major issues in the debate pertaining to contemporary corporate governance system, a vast body of theoretical and empirical work on this topic exists. Otten (2007) has presented a critical review of existing theories of CEO compensation, identifying three key approaches and 16 different theoretical strands within these approaches. He has also acknowledged that these different strands are overlapping and contradictory at the same time. Against this backdrop, we examine three theoretical perspectives that have remained dominant in the literature.

2.1 Market-based Approach

Demand, supply and wages/prices/compensation are the three key variables related to the market for CEOs. In an equilibrium situation, a given level of compensation should clear the labour market for CEOs. On the supply side, it is generally assumed that there is a shortage of executive talent in the market. This shortage lends to a situation of difficulty for executive recruitment. Pay increases are then the response to excess demand for talent. Hence the high level of compensation paid to CEOs could be considered rational. Kaplan (2008) contends that CEO pay is largely determined by market forces. Here is one quotation from Jack and Suzy Welch as reported in Weissman (2008, p.1), “Yes, most CEOs make a ton of money, and sometimes they make too much, but in a market economy salaries are set by supply and demand. We also live in a market economy where companies that field the best teams win, and, because of global competition, the best teams tend to be expensive.” Moreover, one of the consequences of an increasing use of external labour markets is that CEO compensation may go higher due to spill-over effect. That is to say, compensation increases for CEOs in one industry will affect CEO compensation in other industries.

While there is a labour market for CEOs and market forces certainly play a role in the determination of executive compensation, there are debates and doubts about efficient functioning of this market. In fact, an empirical study by Nagel (2010) has shown that the labour market hypothesis explains only about a third or less of the rise in CEO pay. If so, how do we explain for the remaining two-thirds of the CEO compensation? Hamori (2010) has done some evidence-based research by examining a large multinational search firm's detailed records of 2,000 executives working for over 800 corporations. Her findings indicate that CEOs in the search market come from less successful firms with shorter tenures as compared to those targeted ones who decline for consideration. This means that the labour market for CEOs is less than optimal. In a similar vein, Khurana (2002) studied 850 U.S. companies and their CEO recruitment practices. Based on his findings, he has concluded that the labour market for CEOs is far less rational.

In sum, there is no plausible market-based explanation of CEO compensation. Often, the labour market for CEOs becomes constricted due to some corporations' policy of identifying and grooming heir apparent in advance from within the internal labour market of the firm. Even though executive pay is influenced by market, it is set by boards of directors. Hence favours are sometimes exchanged while determining executive compensation (Fee and Hadlock, 2003). Thus, issues related to CEO compensation fall more in the realm of corporate governance rather than the market. That is why we need to go beyond executive labour market analysis to understand excess executive compensation.

2.2 Agency Theory Framework

Agency theory is an aspect of corporate governance. It provides a theoretical foundation for establishing the relationship between executive compensation and firm performance (Dalton et al. 2007). The central tenet of the agency theory is that "the agent will not always act in the best interest of the principal" and that "appropriate incentives" are necessary to limit the potential divergence of interests between the CEO and shareholders (Jensen and Meckling, 1976). And how to bring CEOs interest in alignment with those of shareholders has remained the main problem.

For agency theory, pay levels are given by the market. Therefore, the central concern of the theory is with the structure of pay (Murphy, 1990; Barkema, Geroski and Schwalbach, 1997). That is to say, all that is needed to fix the problem of aligning interests of CEO and shareholders is to structure an optimal incentive contract. Thus incentive contracts become instruments of corporate governance available to boards for aligning CEO's and shareholders' interests (Holmstrom, 1979). And the board will have the responsibility and authority to negotiate a compensation package incorporating appropriate incentive components.

Nevertheless, Bertrand (2009) has pointed out two problems with the use of agency theory. First, there is no apparent correlation between CEO pay and firm performance. Frydman and Saks (2010) found an imperfect fit between CEO pay and firm performance when they examined historical trends in the level of CEO pay in the U.S.A. Secondly, the compensation package is not optimally designed, given the fact that CEOs are allowed to sell stocks and exercise options they are being granted.

All in all, agency theory alone fails to provide an adequate framework to explain CEO compensation determination process. That is why there have been calls on researchers to develop conceptual framework capable of explaining the complex process involved in determining executive compensation (O'Neill, 2007; O'Reilly III and Main, 2010). And managerial power perspective has been one of the responses to this call.

2.3 Managerial Power Perspective

The managerial power perspective is one of critical responses to the inadequacy of agency theory. Its main contention is that the design of CEO compensation will be sub-optimal because of executive influence on board members (Bebchuk and Fried, 2004; Bebchuck and Weisbach, 2010). Following this approach, the ability to influence board members enables CEOs to extract rent in various forms of compensation, challenging the basic tenet of the agency theory. The key argument coming out of the agency theory is that the interests of the CEOs and shareholders need to be brought in alignment. CEO compensation should have an incentive component to do that. However, the task of establishing the alignment appears to be problematic for two reasons. Firstly, optimal incentive contracts are difficult to structure in practice. Mores, Nanda and Seru (2011) have argued that such contracts may themselves become a source of value leakage in the presence of a weak board. Their empirical findings indicate that powerful CEOs rig their incentive contracts for their own benefit. Secondly, managers try to extract rent from the corporations and shareholders whenever possible due to opportunistic behaviour.

Further, the board is supposed to bargain with CEOs at arm's length in the process of compensation determination to ensure favorable outcomes for shareholders. However, directors are influenced by the CEO. Since the CEO plays a direct or an indirect role in the nomination of candidates and appointment of board members, the executive labour market is entrenched by weakness in the governance structure of corporations. Consequently, "…when the market as a whole is distorted by an absence of arm's length bargaining, general conformity to market terms cannot allay concerns about the amount and structure of executive compensation" (Bebchuk and Fried, 2004, p. 22).

Similar to agency theory predictions, managerial power hypothesis of CEO compensation is confirmed by several pieces of empirical evidence. Frydman and Jenter (2010) have provided a summary of this literature. However, one of the criticisms of the managerial power hypothesis is that it is unable to explain the steady increase in CEO compensation since the 1970s. There is scant evidence that corporate governance has weakened over the past 30 years. In fact, most indicators show that governance has considerably strengthened over this period (Holmstrom and Kapaln, 2001; Hermalin, 2005; Kaplan, 2008). Moreover, "awarding" pay by allowing managers to extract some rents can be optimal only if monitoring is costly. In equilibrium, rent extraction may be compensated for through reductions in other forms of pay. Consequently, "…observing that a CEO receives forms of pay usually associated with rent extraction does not necessarily imply that the CEO's compensation exceeds the competitive level" (Frydman and Jenter, 2010, p.92).

The review of the three main theoretical strands of executive compensation clearly indicates that none of the approaches is adequate in itself to explain excess executive compensation. Previous models fail to distinguish between normal and excess executive compensation. Hence there is a need to fill in this gap in the literature. As Frydman and Jenter (2010, p.76) have convincingly argued, the existing theories have trouble "explaining some of the cross-sectional and time-series patterns in data." O'Neill (2007, p.699) has forcefully stated, "… theory appears unable to move closer to actual boardroom practice ... This impasse is unlikely to be resolved until researchers venture beyond economic efficiency arguments alone and provide a framework that allows for the subjective, judgmental and socially interactive processes in determining CEO remuneration." Similarly, O'reilly III and Main (2010) have pointed out a need for a more comprehensive model of CEO compensation, incorporating insights from both economics and psychology. Using insights from personality traits psychology, more particularly the literature on individual's social dominance orientation, and political science, specifically the literature on hegemonic power, we respond to this call by developing a broader conceptual framework to deepen our understanding of the phenomenon of excess executive compensation.

3. Personality, Politics and Excess Compensation

The review presented above clearly indicates that each of the theoretical approaches makes an important contribution to our understanding of the CEO compensation processes and issues. However, none adequately addresses the issue of excess CEO compensation. This is the point of departure for the framework that we present next. Put differently, some CEOs manipulate the corporate governance system to take undue advantages for themselves, whereas a vast majority of the CEOs are more focused on business development and value creation. The latter category earns a reasonable, fair level of compensation by market and societal standards, whereas the manipulative type gets excess compensation. How can one understand the behavioral traits of the hegemonic type CEOs? What are the methods they use to achieve their objective? Existing models of CEO compensation cannot adequately address these questions. But these are important questions, and the conceptual framework we present in this section is a step towards enhancing our understanding of and seeking an answer to these important questions.

It appears that corporate CEOs commanding excess compensation are like hegemons. Sources of hegemonic power of corporate CEOs may include share ownership, ability to manipulate membership composition of the board of directors, exchange of favors through participation in interlocking directorships and power to reward supporters and punish opponents. And once a hegemonic power base is created, managerial elites become able to perpetuate their power with the help of boards (Zahra and Pearce II, 1989). Westphal and Zajac (1979) used political theories to explain the adoption of long term CEO incentive plans put into actual use. For example, the number of directors of the board appointed by the CEO may be positively related to the CEO's ability to manipulate his/her compensation and that of other senior executives. Shivdasani and Yermack (1999) found that firms appointed fewer independent outside directors when CEOs served on the nominating committee. Core, Holthausen and Larcker (1999) found greater CEO compensation in firms where the CEO was involved in the nomination of new directors. Similarly, Fracassi and Tate (2012) found that companies with powerful CEOs nominate

directors with connections to the CEOs. And firms with more such connections and ties with independent directors undertake more value-destroying acquisitions.

Acharya, Gabaro and Volpin (2011) provide evidence that better quality CEOs are more likely to be appointed by firms with weaker governance systems and receive higher pays than lower quality CEOs who are matched to better governed firms. Moreover, following a CEO turnover, the governance system becomes weaker if the new CEO is better than the previous one. These surprising results might be explained by the fact that stronger managers are more hegemonic and prefer firms with weaker governance systems where they can establish their hegemony easily. Thus, excess compensation is the result of hegemony implementation opportunity available to the CEO. The Evidence pertaining to interlocking directorships shows that CEOs nominate each other to sit on their respective boards, and a board member friendly to the CEO reciprocates the “gift exchange” when the role reversal takes place (Bertrand, 2009, p.133). In such situation, board members work as “lapdogs” as opposed to “watchdogs” (Tirole, 2005). It is thus apparent from the findings of recent research that that CEOs getting excess compensation tend to be more hegemonic. However, we need to explain why some CEOs are more hegemonic than others.

Hegemony or hegemonic ambition is related to personal traits. As Borghans, Duckworth, Heckman and Ter Weel (2008) have indicated, personality traits can predict many behavioral outcomes such as altruism, social dominance and social preferences. Researchers studying managerial behavior have empirically tested the impact of a number of personality traits on CEOs actions and decisions. For example, Brown and Sarma (2007) find that “both CEO overconfidence and CEO dominance are important in explaining the decision to acquire another firm”. Graham, Harvey and Puri (2010) provide evidence that personality traits such as optimism and risk-aversion influence corporate financial policies. Malmendier, Tate and Yan (2011) find that overconfident CEOs are less likely to issue equity for fund raising as compared to others. They also find that overconfident CEOs issue about 33 percent more debt than their peers. This trait is also positively related to debt conservatism.

According to Roberts (2009, p.140), “Personality traits are the relatively enduring patterns of thoughts, feelings, and behaviors that reflect the tendency to respond in certain ways under certain circumstances.” While there are a lot of positive personality traits such as altruism, benevolence and moral uprightness, there are also some negative personality traits that influence behavior. One of the negative traits relevant for our purpose is social dominance orientation (SDO). It is related to an individual’s desire for group dominance and promotion of inequality (Pratto, Sidanius and Levin, 2006).

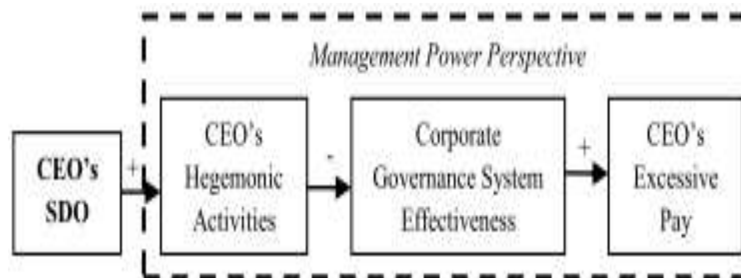
Sidanius and Pratto (1999) regard social dominance as one's preference for hierarchy and stable status differentials in any given social system. Altemeyer (1998) has found SDO moderately related to the desire for and the use of power. Lippa and Arad (1999) have observed that people high in SDO feel superior to and are more dominant than others. Also, as compared to people low in SDO, high SDO people desire a higher social status and more economic benefits (Pratto et al.1997). Furthermore, people higher in SDO are more tough-minded, less concerned with others, less warm, and less sympathetic as compared to people low in SDO (Duckitt,

2001; Heaven and Bucci, 2001; Lippa and Arad, 1999). Finally, the higher the score on SDO, the higher will be the score on Machiavellianism and on psychoticism, and the lower will be the score on measures of morality (Altemeyer, 1998; Heaven and Bucci, 2001).

4. A New Conceptual Framework

It follows from the discussion presented in section three that a CEO with a high SDO will act like a hegemon and develop hegemonic power. This hegemonic power will adversely affect the effectiveness of the corporate governance system. Such an adverse effect will come through structuring of compensation committee with membership of highly paid CEOs to justify their own pay (Hermanson et al. 2012), engaging in moral hazard behavior characterized by empire-building, stealing and slacking off (Baker and Wurgler, 2012; Tirole, 2005), exercising resoluteness, overconfidence and arrogance (Kaplan, Klebanov and Sorensen, 2012), and perpetuation of footprints in setting the compensation (Graham, Harvey and Puri, 2010). The CEO overpowered corporate governance system will be amenable to excess CEO pay. These relationships following from the arguments discussed above are presented in Fig. 1 below.

Figure 1. Conceptual framework for excess CEO compensation



This framework uses insights from psychology for understanding of CEO personality characteristics. These characteristics explain the extent of the exercise of hegemonic power by CEOs. This, in turn, influences the governance structure, allowing them to bring their opportunistic behavior in play. Thus it integrates the personality trait "SDO" into the analysis of CEO's excessive pay to distinguish between those CEOs with excess pay and those without it. To that end, we follow the approach taken by Hackman (2011) and propose that CEO's hegemonic activities depend on personality traits such as the presence or absence of "SDO". In other words, the higher the CEO's SDO, the higher will be his/her hegemonic power which will lead to expected excess CEO compensation. Thus the following three hypotheses follow from this analysis:

Hypothesis 1: The higher the level of social dominance orientation of a CEO, the higher will be his/her desire to develop a strong hegemonic power base.

Hypothesis 2: The stronger the hegemonic power base, the weaker will be the corporate governance system.

Hypothesis 3: The weaker the corporate governance system, the higher will be the excess executive pay.

These are novel hypotheses in that they point out the influence of personality traits of CEOs on excess compensation through corporate governance system. One can test these hypotheses by collecting data on CEO personality traits, corporate governance structure, and CEO excess pay. There are various psychological instruments available to measure personality traits. Data pertaining to governance are in the public domain for publicly traded companies. So is the case with respect to CEO excess compensation.

5. Conclusion

While acknowledging the respective contributions of the agency theory, managerial power hypothesis and labour market approach to analysis of executive compensation, this paper has proposed a new conceptual model where social dominance orientation (SDO) and hegemonic power are used as two key constructs to explain the phenomenon of excess executive compensation. The framework explains why some CEOs are hegemonic and others are not. It also explains why some CEOs demand excess compensation while millions are content with a reasonable level of compensation. Thus the SDO-hegemonic power perspective that we have presented in this paper could serve as a complementary lens to explain excess executive compensation within the framework of a corporate governance system.

Since the system of corporate governance structure as practiced, particularly in the U.S. allows for CEO excesses, it may be time to rethink about its efficacy. Only a meaningful reform of the existing corporate governance system can neutralize the social dominance oriented corporate hegemons from being indulged in too much excess in terms of power and compensation. One area of such balancing act could be CEO recruitment, and our model has an important implication for this process. As demonstrated in the paper, hegemonic CEOs have strong social dominance orientation. Corporate governance matters including fair executive compensation are negatively impacted by this trait. As Hing et al. (2007, p. 80) have suggested, “Organizations should be cautious about selecting people high in SDO for leadership positions when contextual factors (e.g., reward systems) encourage unethical decision making.” Hence corporations can benefit from an early detection of SDO trait in potential candidates for CEO position who may come from external CEO labour market or from within the organization through succession planning. Valid and reliable instruments for detecting SDO are available. Corporations and head-hunters can easily administer these instruments.

The SDO propelled hegemonic power perspective may provide not only a meaningful optic to understand the nature and scope of CEO excess compensation, it may also open up a promising venue for further research. However, it is important to note that this study has some limitations. Firstly, we dwelt upon only one personality trait, social dominance orientation. There could be some other psychological traits that may have bearing on CEO compensation and corporate governance. Secondly, we spelled out three testable hypotheses in the paper. Further research could generate

more such testable hypotheses. Thirdly, empirical testing of these hypotheses is essential for a more solid foundation of the model.

Last, but not least, the paper also attempts to integrate relevant concepts from psychology and political science in developing the conceptual framework, thereby broadening the optics for analysis of CEO excess compensation. We believe theoretical frameworks derived from such a multidisciplinary approach will help not only to enhance our ability to understand complex socio-economic issues such as executive compensation but also to improve practices in terms of CEO compensation determination. It is indeed a platitude to say that good practices most certainly follow from good theories!

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