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# PROS AND CONS OF REWARDING SOCIAL RESPONSIBILITY AT THE TOP

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## Abstract

Overemphasis on financial performance of incentive systems has been blamed as the principal culprit for recent corporate scandals. In response, some scholars and experts have suggested including social performance criteria in top executive pay packages. To date, however, very little is known about the true benefits of this practice. This article critically discusses the implications of including these types of criteria in compensation schemes.

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**Keywords:** social performance criteria, incentive systems, executive compensation.

# PROS AND CONS OF REWARDING SOCIAL RESPONSIBILITY AT THE TOP

## Introduction

Every year, leading newspapers and business magazines compete to see who can appear most outraged about how much the top corporate chief executive officers (CEOs) were paid during the previous year. Thus, headlines like “Despite Poor Performance, CEOs Get Paid More Than Ever,” “The Great Pay Heist” or the provocative “It Paid to Cheat” are not uncommon in the business press.

In 2007, the CEO of a Standard & Poor’s 500 company received, on average, \$14.2 million in total compensation with outliers such as Yahoo’s CEO Terry Semel, who received \$71.7 million in pay, stock options and other forms of compensation. Together, CEOs of these companies received a combined total over \$7 billion.

But the problem is not only that compensation for top executives has grown at an unprecedented rate in the past two decades but also that inequality is on the rise. The gap between the pay company’s chief executive and that of one of their rank-and-file employees has widened. According to existing estimations, CEOs are paid between 250 and 500 times that of the average worker. Not surprisingly, John Mackey, the CEO of Whole Foods, receives positive press for his pay policy, which caps the chief executive’s salary and bonus at 14 times (only!) the average worker’s pay. *The Wall Street Journal*, *Slate.com*, *Harvard Business Review* and *BusinessWeek* have all mentioned the pay cap, generally in favorable terms.

In addition to the stratospheric pay hikes and inequalities issues, there are other aspects that outrage public opinion, such as unusual perks (including airplanes, health club memberships, dinners in five-star restaurants, and the like), golden parachutes for ousted CEOs (which seem to reward failure), and huge sign-on packages of their replacements, all of which have also aided in boosting median CEO pay and raising benchmarks for future pay packages.

Many have blamed incentive schemes as the sole culprit for undesired corporate behaviors such as fraudulent financial reporting, corruption, tax evasion, exploitation of underage workers and other forms of opportunism, malfeasance and white-collar crime. Computer Associates, Qwest Communications Intl., or Tyco International are just a few egregious examples. Unfortunately, this happens everywhere, not only in US companies. Renowned cases in other countries include Parmalat, Elf, and ABB in Europe, and the most recent case in Asia, the indictment of South

Korean Samsung Chairman Lee Kun-Hee for tax evasion and breach of trust. However, despite the cry for reform following the corporate scandals of recent years, CEO compensation continues to rise.

In light of these corporate crimes, governance scholars, compensation advisers, and other business experts have called for corporate reforms and suggested including social performance ratings as part of a new model to “intelligently” incentivize executives. Several benefits have been highlighted with this approach, which includes the promotion of actions that are good for both the firm and society, the enrichment of managerial responsibilities, the safeguard of executives from risk, and a more humanistic approach of the firm. Yet, the perspective on these practices tends to be excessively optimistic, and the potential downsides of these practices have been largely ignored.

In this paper, I address this gap by discussing some potential problems that the inclusion of social criteria in executive pay may provoke, and offering some alternative solutions.

## Social Criteria as Part of Executive Pay

In general, compensation includes salary, bonus, incentives, stock, stock-option gains and potential returns from option grants. The huge pay packages received by managers during the last decade over the past century, and the first decade of the current century, were bolstered mainly by larger stock grants, long-term incentive pay, supplemental retirement pay and options gains. These forms of pay almost always link executive retribution to the firm's financial performance by including criteria that focus on accounting and market-based measures. Indeed, Murphy (2000) provided evidence of the dominance of financial performance criteria in executive compensation plans.

However, some have cast doubt on the efficacy of linking pay exclusively to financial results since this practice may lead to unintended consequences (Deyá-Tortella, Gómez-Mejía, De Castro and Wiseman, 2005). Some have gone even further in explicitly blaming the overwhelming focus on financial performance in incentive systems for the recent wave of corporate scandals. Scholars such as Kochan (2002: 139) have argued that the real root of corporate malfeasance is “*the overemphasis... corporations have been forced to give in recent years to maximizing shareholder value without regard for the effects of their actions on other stakeholders*” (emphasis in the original). Also, voices against the idea of an almighty financial criterion come from those who have been traditional defenders of shareholder value maximization as the preferred objective for corporations. They now recognize that “the excessive use (and inadequate policing) of such compensation schemes helped fuel the corporate crisis of 2001 and 2002, and must be reined in” (Sundaram and Inkpen, 2004: 358).

A troubling fact is that corporate malfeasance not only affects investors and pension holders – corporate crisis in the beginning of the century had estimated losses of US pension and 401(k) plans was in the neighborhood of \$7 trillion (Siebert, 2002) – but also had important social costs. This brings to the forefront the social relevance of corporations and their role within society.

Under the stakeholder perspective, many scholars and experts have argued that, given that the firm should respond to a variety of interest groups (employees, customers, communities, governmental officials and the environment), the compensation packages of top managers

should contain criteria that would address the interests of other stakeholders rather than just shareholders.

Do firms actually follow this advice? Some do, or at least so they say do. Companies such as Procter & Gamble, 3M, Bristol-Myers Squibb, and Sunoco contend that they consider the social initiatives in their evaluation of executive compensation package. For instance, 3M proclaims in its *proxy statement*: “Executive compensation is linked to Company performance compared to specific financial and non-financial objectives. These objectives range from achieving earnings and sales growth targets to upholding the Company’s Statement of Corporate Values (which include customer satisfaction through superior quality and value, attractive investor return, ethical business conduct, respect for the environment, and employee pride in the Company).” Similarly, Sunoco’s *proxy statement* announced in 2003 that “Sunoco’s annual incentive program results in payments that are closely correlated with Sunoco’s earnings, return on capital, and health, environmental and safety performance.” But the fact is that it is hard to find more detailed information on these social criteria (such as actual measures, weights, and the like) beyond these declarations of intent.

Despite the hundreds of articles written over more than eight decades of executive compensation research, the academic community has largely neglected the study about the relations between CSP and managerial pay. This may be simply because the relations did not exist and thus were not worth being studied. Or it may be because the field traditionally has concerned itself overwhelmingly with financial performance. Only recently have scholars started to analyze this relationship. For this article, I gathered scholarly work on the topic from reputable academic journals and summarized it in Table 1.

Unfortunately, the evidence provided by these studies is far from conclusive (for more information on this topic see Berrone and Gómez-Mejía, 2008). While some studies indicate a positive link between social performance and executive pay, other studies presented evidence that shareholders either penalize their managers for social initiatives or compensate them for poor social performance. Some concluded that CEOs “pay the price” for socially correct behaviors (Coombs and Gilley, 2005), and that they “are encouraged not to have a high environmental reputation” (Stanwick and Stanwick, 2001: 180).

These studies are exemplary efforts in providing textured insights but still too preliminary to fully understand the links between social performance and executive compensation.

From a research perspective, perhaps the most important issue that remains unanswered is how incentive schemes may actually have undesired effects on global social actions. A case in point is the environmental performance of firms of multinational companies. A company with low environmental impact in one specific country does not necessarily mean that the overall environmental performance of the firm is superior. Companies can relocate their dirty operations to regions with lax environmental standards (also known as pollution havens) to avoid stricter ones (Christmann, 2004). And this might be the result of poorly design incentive programs, which may incite managers to opportunistically conduct social initiatives in those countries where these initiatives are deemed important while performing poorly in those countries where social issues are neglected (Berrone and Gómez-Mejía, 2008).

**Table 1**

Studies on the Relation Between Social Performance and Executive Compensation

Authors	Journal	Dependent variable (DV)	Source (DV)	Independent variable (IV)	Source (IV)	Level of analysis	Theoretical framework	Expected association	Association found	Longitudinal study
(Stanwick and Stanwick, 2001)	<i>Business Strategy and the Environment</i>	Total compensation and salary	<i>Forbes</i> magazine	Environmental reputation	<i>Fortune</i> magazine	CEO	<i>Stakeholder mismatch</i>	Negative	As expected	No
(McGuire, Dow, and Argheyd, 2003)	<i>Journal of Business Ethics</i>	Strengths and weaknesses in corporate social responsibility	KLD Index	Salaries, annual bonus and long-term	<i>Compustat</i>	CEO	Stakeholder theory	Positive for salary, bonus and long-term for weakness and contrary for strengths	Salary and long-term have a positive impact on weaknesses. Neutral otherwise	No
(King and Lenox, 2004)	<i>Strategic Management Journal</i>	Adoption of environmental strategies	EPA - TRI	Compensation explicitly linked to the implementation of environmental activities	Survey	Environmental managers	<i>Absorptive capacity theory</i>	Not explicit (positive combined with information provision)	Positive, but marginal	Yes
(Coombs and Gilley, 2005)	<i>Strategic Management Journal</i>	Total compensation, salary, annual bonus and long-term	<i>Compustat</i>	Stakeholder management	KLD Index	CEO	Stakeholder-Agency	Positive	Neutral and/or negative	Yes
(Russo and Harrison, 2005)	<i>Academy of Management Journal</i>	Environmental performance	EPA - TRI	Salary explicitly linked to environmental performance	Survey	Plant and environmental managers	Congruence theory	Positive	Positive for the plant managers	No
(Deckop, Merriman, and Gupta, 2006)	<i>Journal of Management</i>	Corporate social performance	KLD Index	Focus on short and long-term (pay mix)	<i>Compustat</i>	CEO	Agency and CSR	Negative for short-term and positive for long-term	As expected	No
Berrone and Gómez-Mejía, in press)	<i>Academy of Management Journal</i>	Total CEO compensation	<i>Compustat</i>	Environmental performance – Pollution prevention and end-of-pipe	EPA - TRI	CEO	Institutional and agency theories	Positive	As expected	Yes

## Benefits and Drawback of Social Criteria in Pay Schemes

Many have argued that the proper combination between short and long-term incentives structured around social performance indicators can be expected to have several benefits (Berrone and Gómez-Mejía, in press; Coombs and Gilley, 2005; Russo and Harrison, 2005), especially for top managers since they are ultimately responsible for resource allocation pertaining to social initiatives and processes. Moreover, if top managers are rewarded for social performance, this would cascade down to lower levels in the firm and promote a consistent social strategy of the firm.

One of the main benefits of rewarding social performance at the top is that it would stimulate managers to deploy efforts and resources towards social initiatives, which are expected to increase the firm's value. But there are at least three issues that cast doubt on the accuracy of this statement. First, it is not clear whether social initiatives have a salutary impact on the firm's economic performance. While some studies have shown a positive association between social performance and financial results, many scholars have professed a negative association. The latter claim is that if investors cared enough about the pollution performance information required under the enactment to punish poor performers, firms would have a market-based incentive to embark on social initiatives, and thus no social ills would exist. In a recent review of research papers regarding the association between social initiatives and firm performance, Margolis and Walsh (2003) found that less than half of the reviewed studies exhibited a positive relationship, and that the majority showed a neutral or negative link. This review, together with other research, suggests that the link between environmental performance and financial results is ambiguous at best. That is, while socially irresponsible businesses can be punished by society (consumers, employees, local communities, NGOs) in terms of their image, reputation, and legitimacy for not fulfilling their public responsibilities, it is unclear how a good social performance can cause their market share to increase.

The second aspect that casts doubt on the benefit of rewarding managers for undertaking social initiatives (which presumably considers the need of a broader array of constituencies) is that *all* stakeholders are assumed to favor responsible actions and thus are treated in an indiscriminate way. But the truth is that while some constituencies may have a general preference for social initiatives, one cannot assume that social-friendly policies don't conflict with the interests of other stakeholders or that they are oblivious to trade-offs. For instance, workers and their families have been documented not to favor environmental policies on the part of governments or firms if implementing them would put their jobs at risk. Therefore, rewarding certain actions believed to be beneficial for a certain group can cause discontent among other stakeholders.

A third aspect to consider is that social initiatives are mainly driven by intrinsic motivations. Indeed, many people and firms invest their time and money in improving the environment and supporting charities without economic returns. It could be that some people are altruistic, that is, they seek to improve the welfare of others without receiving any personal benefit. Another intrinsic motivation is "impure altruism," that is to say, people (or firms) may get a "warm glow" (Andreoni, 1989) and improved self image from carrying out social works. A related intrinsic motivation is concern for fairness. Regardless of its motives for altruism, self image or fairness, it can be safely assumed that in many cases underlying motivations for social initiatives are intrinsic. According to enthusiasts of the link between social initiatives and executive pay, to provide an economic (and explicit) incentive can reinforce the natural

tendency of managers to undertake social responsible actions. But theoretical and empirical evidence from psychology and economics suggests that such extrinsic incentives can crowd out the intrinsic motivations which motivate voluntary contributions. The underlying idea of this stream of research is that motivations are not additive, and monetary rewards may reduce the sense of control a person has over her actions, reducing her willingness to allocate resources (time, money and the like) towards social endeavors. As a consequence, including social criteria in compensation packages could lead toward the opposite of the intended goal. In other words, recognizing and supporting social efforts monetarily can undermine the “built-in” incentives and thus have the potential for negative effects and unintended consequences. To solve this problem, many companies have adopted non-monetary rewards for social actions. For instance, firms like Husky, the Canadian supplier of injection molding systems, reward managers and employees with extra vacation days if they take an active role in NGOs, social endeavors and the like. Others, like the company Evo Gear, use alternative perks to encourage social actions. They offer a \$200 bicycle as an incentive for full-time employees who bike at least three days a week (two in the winter), which helps to reduce the environmental footprint of their staff (and also keeps employees in good shape). Also, internal awards are often used to enhance social performance. Aware of this trend, new companies have emerged, such as Charity Choice, which offers Charity Giving Gift Certificates to incentivize executives and employees and helping to foster charitable giving as part of the corporate culture.

Another often mentioned benefit of linking pay to social performance is that it would shield managers from uncertain results of social strategies. As argued above, results from social endeavor are ambiguous and, as a consequence, if managers are not compensated for the increased risk associated with social investments, they will presumably allocate capital into less uncertain alternatives. Several aspects deserve to be mentioned regarding this issue. First, linking pay and social performance could lead managers to consider social criteria opportunistically (Cennamo, Berrone, and Gómez-Mejía, 2008). Since social performance may be easier to obtain than financial results, managers may be tempted to favor the latter in order to maximize their income. Moreover, given that including social criteria alleviates the drawbacks from potential losses of social actions, managers have little incentive to make the most out of them, and overlook the potential financial outcomes that may derive from them.

Another related aspect refers to how to measure social performance. While financial measures are well developed, social performance measures are still an open field to be explored. Even with a precise measure of social performance, these measures may also be open to manipulation. As a consequence, control policies and information systems are needed (Berrone and Gómez-Mejía, in press), which in turn would increase the costs of rewarding social performance effectively.

Also, it has been argued that an advantage of social criteria in executives pay packages would make managers explicitly accountable for the social behavior of the firm. While this may be true, it is important to consider the context in which the firm operates. It is often said that stakeholders like consumers want companies to promote the public good by providing healthier and safer products, retirement and health care benefits for its employees, and much else besides. However, stakeholders’ expectations vary by industry and geography. For instance, environmental concern is an ongoing risk for many companies, especially those in the energy and chemical industries. Too often, however, companies in polluting industries ignore environmental demands and invest in other social initiatives with the mistaken belief that any social action will suffice to signal appropriate corporate behavior to the market. However, the market is unlikely to be fooled by diverting signals, and true benefits of social and ethical



initiatives come only when stakeholders are satisfied beyond doubt (Berrone, Surroca, and Tribo, 2007).

Recognizing the importance of context, the Spanish bank “Caja Navarra” launched a civic banking program named “You Choose: You Decide”. It is a pioneer initiative on the international financial scene where the governing bodies of the bank do not decide the destination of social investments anymore (a third of their profits after taxes). This decision now lies in the hands of their customers. Therefore, through this initiative, all of bank’s customers are the owners of the institution’s social investment, which amounted to €42 million in 2007.

## Conclusion

In this paper, I analyzed the benefits and shortcomings of rewarding social performance at the apex of the company. I highlighted how outrageous pay packages and the unusual perks paid to some executives have led to impel the idea of rewarding for social behavior. Certainly, current competitive business environment calls for a more sophisticated function of the company in society. More and more specialists are recognizing that the classic economic view of the firm in society suggested by the Nobel Laureate Milton Friedman is incomplete at best. He claimed that “there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits” (Friedman, 1970). But firms are much more than that. They are complex entities that engage multiple actors with conflicting interests and goals that need to be balanced. Every business should think about the role social issues can and should play in strategy so that they can build trust among consumers and other stakeholders, and offer products and services that address their concerns.

In this context, it seems rather obvious that companies should reward their top managers for good social performance. However, as presented in this paper, there are many issues that need to be considered to have a successful outcome. Aspects such the financial uncertainty surrounding social issues, conflicting interests of stakeholders, the use of social criteria opportunistically, the lack of proper measures, the need for monitoring systems, and the relevance of context are just a few potential shortcomings that pay designers may face when including social criteria in compensation packages. Table 1 depicts a toolkit for compensation designers who want to include social performance criteria in compensation packages.

### Table 1

#### Toolkit for Linking Social Performance and Pay

- Be aware of the link between social and economic performances
- Define how social initiatives will be measured
- Have proper information systems and monitoring mechanisms in place
- Understand how social initiatives affect the different stakeholders of the firm and account for potential trade-offs
- Balance between intrinsic motivation and extrinsic incentives
- Comprehend the context in which the firm operates and identify those aspects that are highly value within it.

All of these issues should be taken into consideration, since a poorly designed executive compensation packages can reward decisions that are not in the long-term interests of the company, its stakeholder and society as a whole.

Moreover, boards of directors and pay policy designers should proceed with caution in the presence of intrinsic motivations. A careful design and implementation is needed to maintain and support intrinsic motivations while also providing robust extrinsic incentives.

A note of caution: The preceding paragraphs by no means attempt to underestimate the intrinsic value of social initiatives. Rather, I try to recognize the complexity that rewarding social performance at the top entails. Only by recognizing the costs and risks associated with this practice will firms will be able to successfully obtain the purported goals of it. Finally, it is also important that corporate responses to social claims should not be exclusively valued in terms of their instrumental benefits since financial performance is not the final judge of questions that implicate moral values and ethical concerns.

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