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Short-Termism and Executive Compensation

Our society faces several grand challenges, such as climate change, poverty, inequality, and global health. As public governance is unlikely to be sufficient to address these challenges, a large responsibility rests on the shoulders of the private sector. Accordingly, it is important to understand how and to what extent companies (and investors) can grow and sustain their organizations over time while strengthening—rather than undermining—the very system in which they operate, as they can play a critical role in addressing these societal grand challenges.

THE GOVERNANCE CHALLENGE: A LACK OF LONG-TERM ORIENTATION AND PRIVATE INCENTIVES

In a series of studies, I explore the question of whether and how companies' social and environmental engagement—in short, their corporate social responsibility (CSR)—contributes to their competitiveness. As a whole, the evidence indicates that CSR can benefit companies along several dimensions that are core to their competitiveness and enhance their financial performance. These dimensions include i) the pursuit of innovation (Flammer and Kacperczyk 2016), ii) the retention of knowledge (Flammer and Kacperczyk 2019), iii) employee engagement (Flammer and Luo 2016), iv) differentiation from competitors on the product market (Flammer 2015a), v) differentiation from competitors on the market for government procurement contracts (Flammer 2018), and vi) resilience in times of economic crisis (Flammer and Ioannou 2020). As a result, it is perhaps not surprising that CSR is found to positively affect shareholders' perceptions and shareholder returns (Flammer 2013; 2015b).

Taken together, these studies indicate that companies' social and environmental practices can enhance a firm's competitiveness and financial performance. As such, this suggests that a firm's CSR should be core to its corporate governance and an integral part of its strategy. In other words—and referring to the 'ESG' (environmental, social, and corporate governance) acronym often used among practitioners—this suggests that the 'E' and 'S' are not separate but rather an integral part of 'G' and hence should be more central to firms' strategy than it is often considered to be. By integrating 'E' and 'S' into their decision making, companies can enhance not only their profitability and ability to create long-term value, but also exert a positive impact on the natural environment and society at large.

Given the potential benefits of 'E' and 'S', it may seem puzzling that companies do not engage more extensively in CSR. My research identifies two potential reasons: i) short-termism, and ii) the lack of private incentives. In two related studies, I examine how two governance mechanisms—namely the provision of long-term executive compensation and CSR-based executive compensation—can alleviate these challenges and induce a longer-term orientation that is conducive to more sustainable business practices. These studies are summarized in the following.

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EXECUTIVE COMPENSATION TIED TO LONG-TERM FINANCIAL PERFORMANCE

In the article "Does a Long-term Orientation Create Value? Evidence from a Regression Discontinuity" (Flammer and Bansal 2017), Pratima Bansal and I investigate how the provision of long-term executive compensation—which aims to increase managers' time horizons—impacts firm value and corporate strategy.

Specifically, we identify a new form of agency conflict, which we refer to as a time-based agency conflict—that is, managers' and shareholders' time preferences are potentially misaligned and, as a result, managers may adopt short-sighted strategies that need not be in the shareholders' best interests. This agency conflict arises if managers are overly concerned about 'looking good in the short run.' In particular, career concerns, executive compensation based on short-term performance, and the pressure to meet or exceed analysts' earnings forecasts may lead managers to favor (inferior) short-term projects at the expense of (superior) long-term projects, thereby hurting the value of the firm. In an effort to mitigate managerial myopia and align managers' interests with long-term value creation, boards of directors may provide long-term incentives. To examine whether providing such incentives is effective in fostering more sustainable business practices and improving firm value, we study the provision of long-term executive compensation (that is, compensation in the form of restricted stocks, restricted stock options, and long-term incentive plans).

In conducting the analysis, an important empirical challenge is that long-term compensation is not randomly assigned to companies, which makes it difficult to assess the causal impact of long-term compensation on performance (for example, it could be that companies that expect to be more profitable in the future are more likely to provide long-term compensation to their executives; this would induce a positive correlation between long-term compensation and profitability, yet this correlation would not imply that long-term compensation causes higher profitability). To overcome this challenge, we examine shareholder proposals advocating the use of long-term executive compensation that pass or fail by a small margin of votes at shareholder meetings. Intuitively, there should be no systematic difference between companies that marginally pass long-term compensation proposals with, say, 50.1 percent of the votes and companies that reject comparable proposals with 49.9 percent of the votes. The passage of such 'close call' proposals is akin to a random assignment of long-term incentives to companies and therefore provides a quasi-experimental setting that lends itself to assess the causal effect of long-term incentives on firm performance. We then use a regression discontinuity design (RDD) to compare outcomes just above and below the majority threshold.

Using this RDD specification, we find that the passage of long-term compensation proposals leads to a positive stock market reaction. More precisely, on the day of the vote, a proposal that is marginally passed yields an abnormal return of 1.14 percent compared to a proposal that is marginally rejected. This evidence indicates that adopting a longer-term orientation is value-enhancing. We further examine the effect of passing long-term compensation proposals on operating performance (return on assets, net profit margin, and sales growth). Regardless of the measure, we consistently find that operating performance increases in the long run. Interestingly, operating performance decreases slightly in the short run (i.e., in the year following the vote), indicating that an increased long-term orientation may take some time to materialize into higher profits. Finally, we find that companies adopting long-term compensation proposals are more likely to increase their investments in long-term strategies such as CSR and innovation. This suggests that an increase in long-term orientation benefits companies by fostering innovation and stakeholder relationships, allowing them to acquire intangible assets such as legitimacy, reputation, and trust.

EXECUTIVE COMPENSATION TIED TO SOCIAL AND ENVIRONMENTAL (CSR) PERFORMANCE

In an article entitled "Corporate Governance and the Rise of Integrating Corporate Social Responsibility Criteria in Executive Compensation: Effectiveness and Implications for Firm Outcomes" (Flammer, Hong, and Minor 2019), I further examine how executive compensation can help redirect managerial attention to long-term value creation. In this article, my co-authors, Bryan Hong and Dylan Minor, and I study the integration of CSR criteria in executive compensation—that is, the linking of executive compensation to social and environmental performance (e.g., CO_2 emission targets, employee satisfaction targets, and compliance with ethical standards in developing countries). Practitioners commonly refer to this incentive provision as 'CSR contracting' or 'pay for social and environmental performance' (as opposed to the traditional 'pay for (financial) performance'). The use of CSR contracting is a relatively recent practice in corporate governance and has received little attention in the academic literature.

To examine this new phenomenon, we construct a novel database that compiles information on CSR contracting from the compensation information that companies report in their proxy statements filed with the Securities and Exchange Commission (SEC). We start by documenting a series of stylized facts pertaining to CSR contracting. In particular, we observe that the integration of CSR criteria in executive compensation has become more prevalent over time (while 12 percent of the S&P 500 companies had adopted CSR contracting by 2004, this ratio increased to 37 percent by 2013), and is more common in emission-intensive industries.

We then explore how CSR contracting affects firms' outcomes. As in the case of executive compensation tied to long-term financial performance, we might expect that executive compensation tied to CSR criteria helps mitigate managerial myopia and improve corporate governance. This is indeed what we find. Specifically, we find that the adoption of CSR contracting leads to i) an increase in long-term orientation; ii) an increase in firm value; iii) an increase in social and environmental performance, especially with respect to less salient stakeholders such as the natural environment and communities; iv) a reduction in emissions; and v) an increase in green innovation. Moreover, we find that the results are stronger i) when companies specify the amount of CSR-based compensation involved (that is, when they are specific instead of vague), and ii) when the share of CSR-based compensation is larger. This suggests that CSR contracting is a more effective governance tool when it is substantive.

Overall, these findings indicate that CSR contracting enhances the governance of a company by incentivizing managers to adopt a longer time horizon and shift their attention towards stakeholders that are less salient in the short run, but financially material to the firm in the long run.

'E' AND 'S' AS INTEGRAL PARTS OF 'G'

To conclude, the insights of these studies suggest that the 'E' and 'S' in 'ESG' are not separate elements but an integral part of 'G'. Moreover, they suggest that corporate short-termism and the lack of private incentives hamper both engagement in more sustainable business practices and business success.

Two potential remedies are the provision of long-term executive compensation and CSR-based executive compensation—both of these governance mechanisms induce managers to adopt a longer-term orientation that is conducive to long-term value creation for the company and also benefits the natural environment and society at large. As such, these tools represent useful levers that boards of directors can pull to help address societal grand challenges in a way that also contributes to long-term value creation.

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