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Sustainable Cooperation in Organizations

A Primer in Analytical Sociology

Rafael Wittek
Department of Sociology
University of Groningen

r.p.m.wittek@rug.nl

Fehr & Gächter, *Nature* 2002, more than 4000 citations

articles

Altruistic punishment in humans

Ernst Fehr* & Simon Gächter†

* University of Zurich, Institute for Empirical Research in Economics, Blumlisalpstrasse 10, CH-8006 Zurich, Switzerland
† University of St Gallen, FEW-HSG, Varnbüelstrasse 14, CH-9000 St Gallen, Switzerland

Human cooperation is an evolutionary puzzle. Unlike other creatures, people frequently cooperate with genetically unrelated strangers, often in large groups, with people they will never meet again, and when reputation gains are small or absent. These patterns of cooperation cannot be explained by the nepotistic motives associated with the evolutionary theory of kin selection and the selfish motives associated with signalling theory or the theory of reciprocal altruism. Here we show experimentally that the altruistic punishment of defectors is a key motive for the explanation of cooperation. Altruistic punishment means that individuals punish, although the punishment is costly for them and yields no material gain. We show that cooperation flourishes if altruistic punishment is possible, and breaks down if it is ruled out. The evidence indicates that negative emotions towards defectors are the proximate mechanism behind altruistic punishment. These results suggest that future study of the evolution of human cooperation should include a strong focus on explaining altruistic punishment.

public goods can be solved if enough humans have a tendency for altruistic punishment, that is, if they are motivated to punish free riders even though it is costly and yields no material benefits for the punishers.

We examined the question of whether humans engage in altruistic punishment and how this inclination affects the ability of achieving and sustaining cooperation. A total of 240 students participated in a 'public goods' experiment with real monetary stakes and two treatment conditions: punishment and no punishment. In both conditions, groups with four members played the following public goods game. Each member received an endowment of 20 money units (MUs) and each one could contribute between 0 and 20 MUs to a group project. Subjects could keep the money that they did not contribute to the project. For every MU invested in the project, each of the four group members, that is, also those who invested little or nothing, earned 0.4 MUs. Thus, the investor's return from investing one additional MU in the project was 0.4 MUs, whereas the group return was 1.6 MUs. Because the cost of investing 1 MU in the project was exactly 1 MU, whereas the private return was only 0.4 MUs, it was always in the material self-interest of any subject to keep all MUs privately—irrespective of how much the other three subjects contributed. Yet, if all group members kept all MUs

cooperate or punish others, because cooperation and punishment are costly and yield no pecuniary benefits. Therefore, the selfish motives associated with theories of indirect reciprocity[10–15] or costly signalling[16–18] cannot explain cooperation and punishment in this environment.

However, punishment may well benefit the future group members of a punished subject, if that subject responds to the punishment by raising investments in the following periods. In this sense, punishment is altruistic. In the presence of altruistic punishers, even purely selfish subjects have a reason to cooperate in the punishment treatment.

Altruistic punishment and cooperation

Altruistic punishment took place frequently. In the ten sessions, subjects punished other group members a total of 1,270 times; 84.3% of the subjects punished at least once, 34.3% punished more than five times during the six periods, and 9.3% punished even more than ten times. Punishment also followed a clear pattern. Most (74.2%) acts of punishment were imposed on defectors (that is, below-average contributors) and were executed by cooperators (that is, above-average contributors), and punishment of the defectors was harsh (Fig. 1). For example, if a subject invested

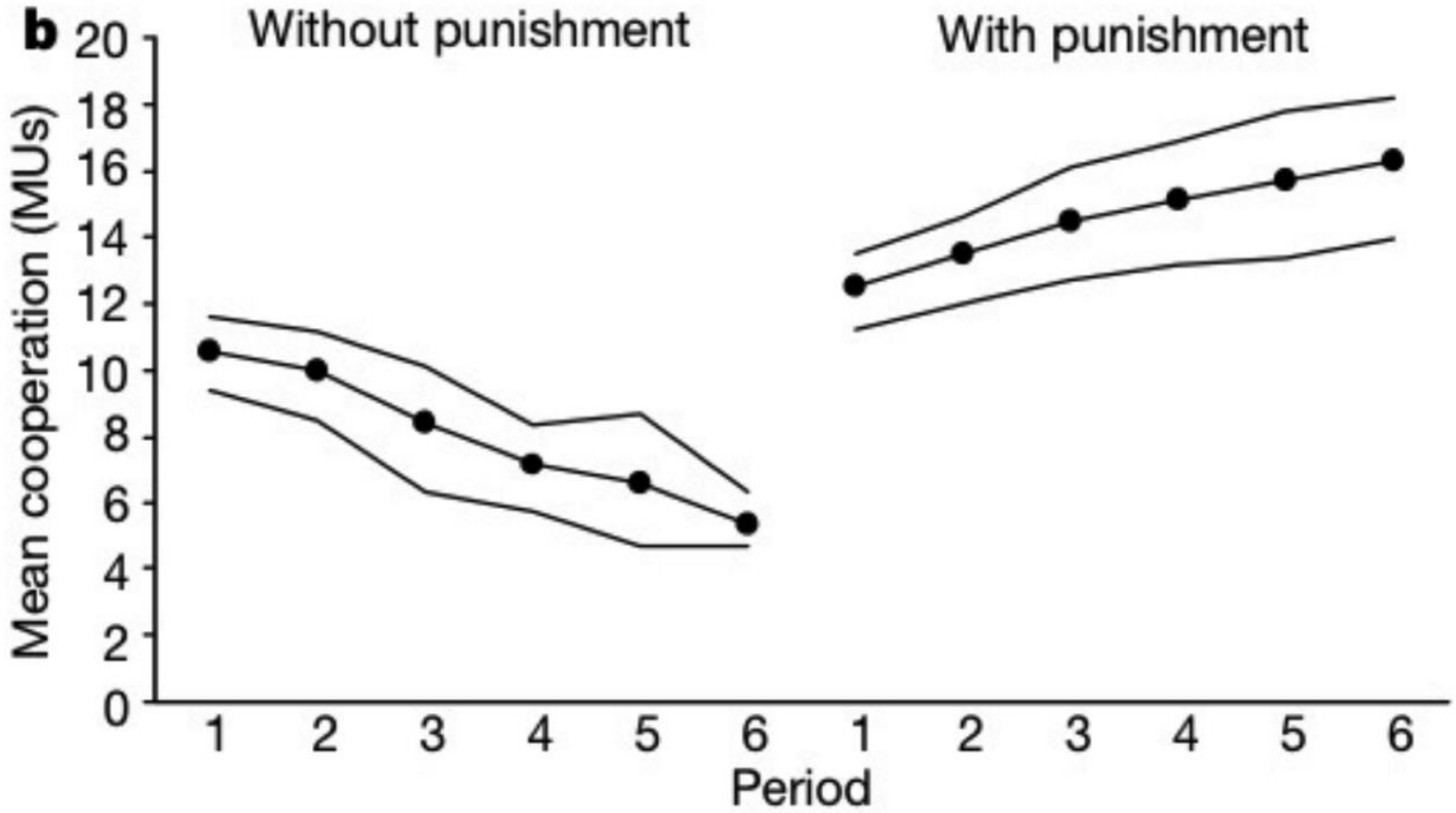


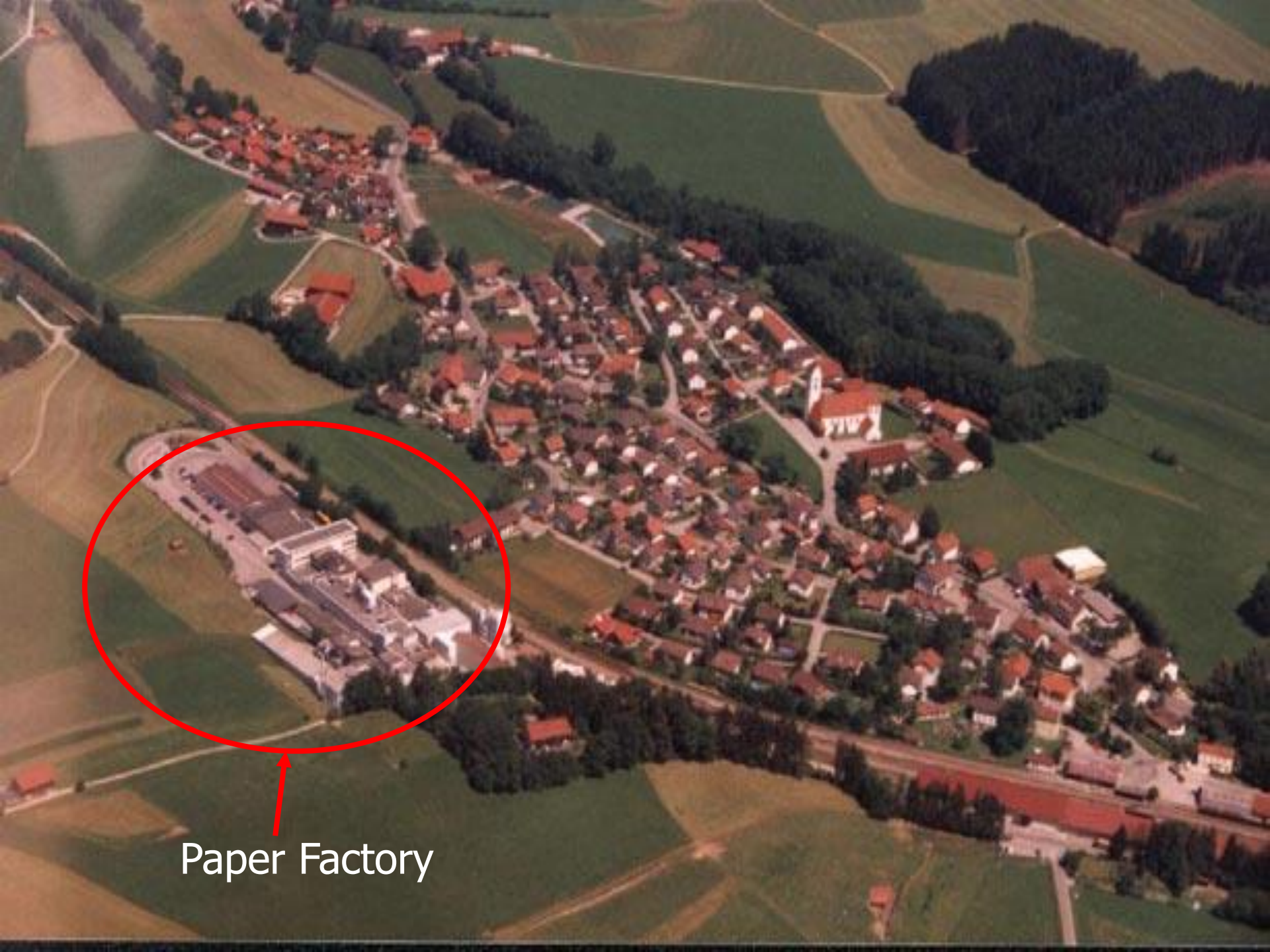
Figure 2 Time trend of mean cooperation together with the 95% confidence interval. **a**, During the first six periods, subjects have the opportunity to punish the other group members. Afterwards, the punishment opportunity is removed. **b**, During the first six periods, punishment of other group members is ruled out. Afterwards, punishment is possible.

So hasn't the puzzle of sustainable cooperation long been solved?

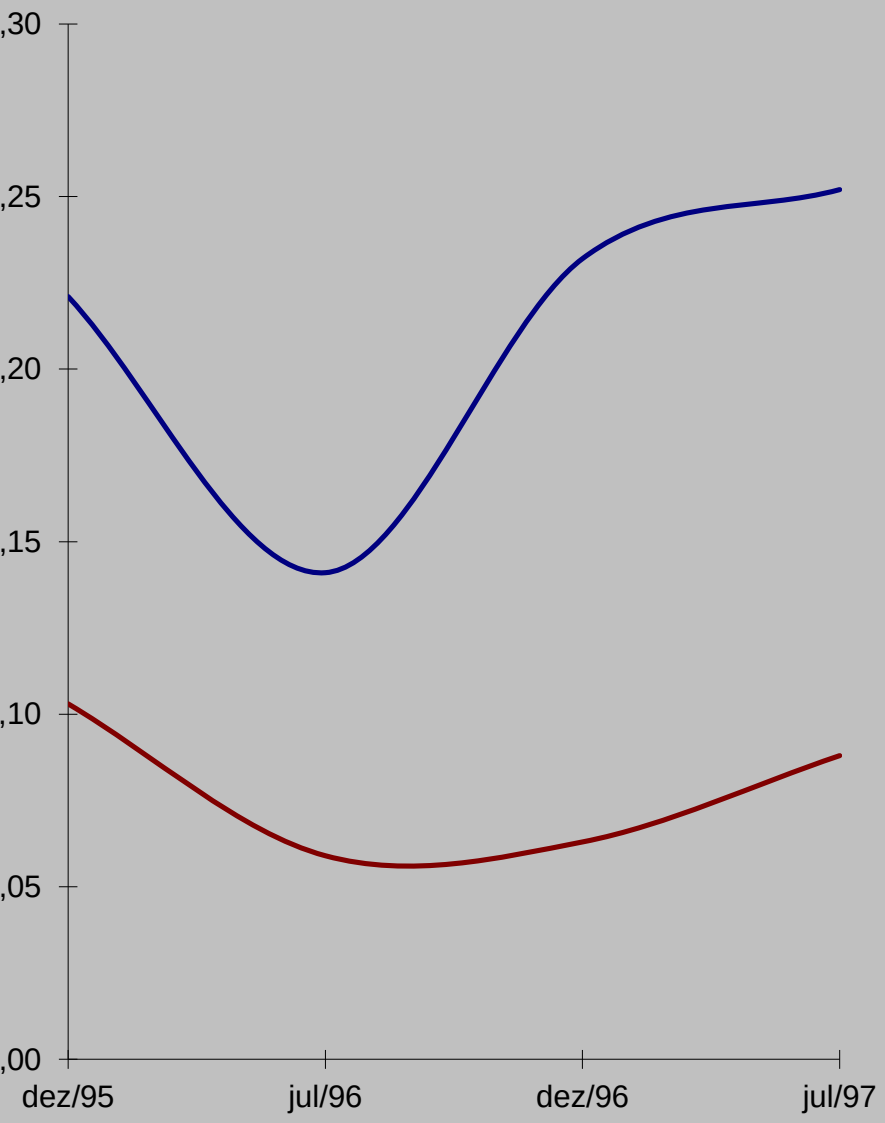
Structure of the Lecture

1. The Puzzle of Sustainable Cooperation
2. Case Studies of Sustainable Cooperation
3. Social Mechanism Theorizing
4. Conclusion

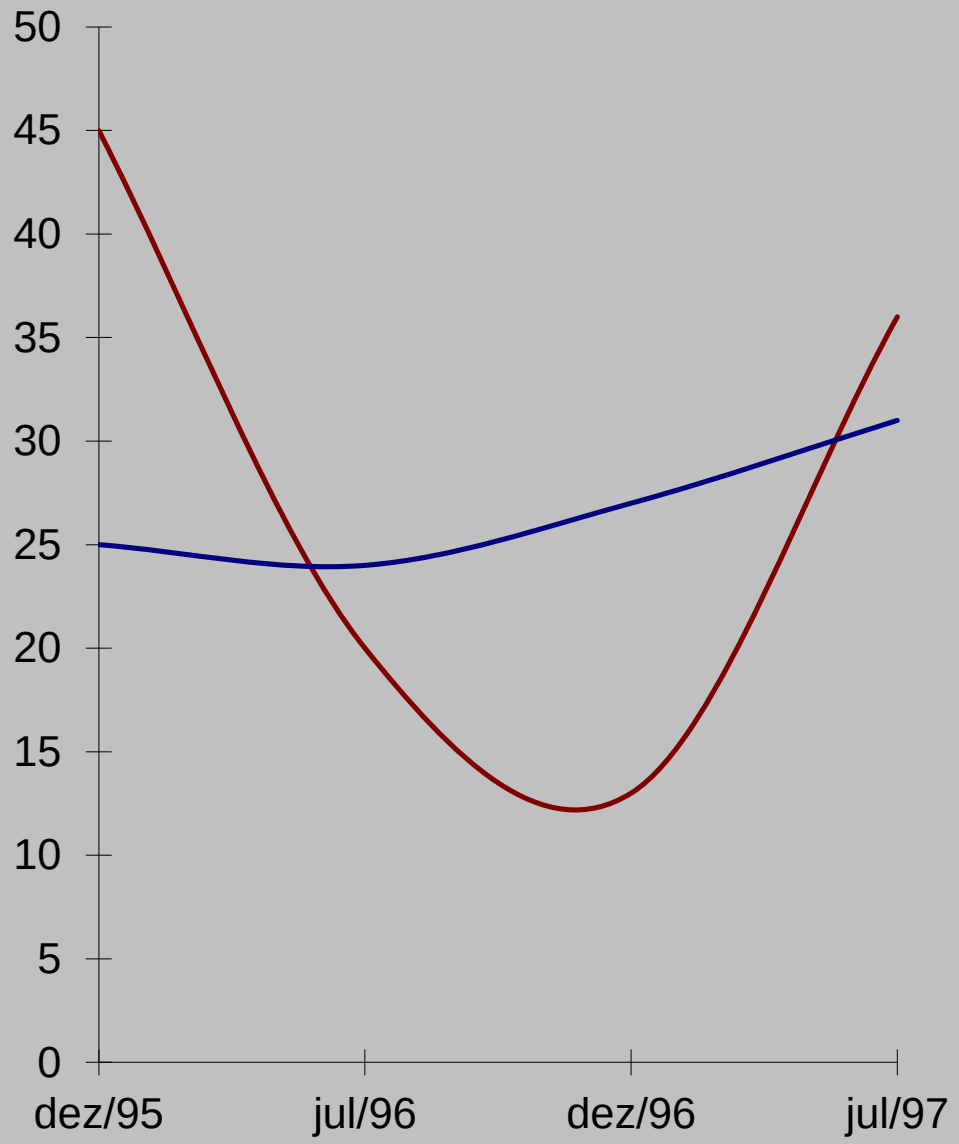
The Puzzle of Sustainable Cooperation


Paper Factory

Density



Centralization



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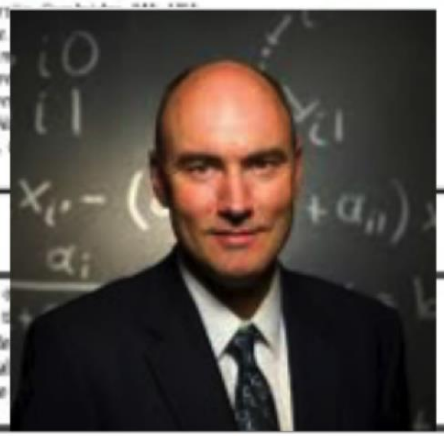
Punishment does not promote cooperation under exploration dynamics when anti-social punishment is possible

Oliver P. Hauser [a,b], Martin A. Nowak [a,b,c], David G. Rand [d,e,f,g,*]



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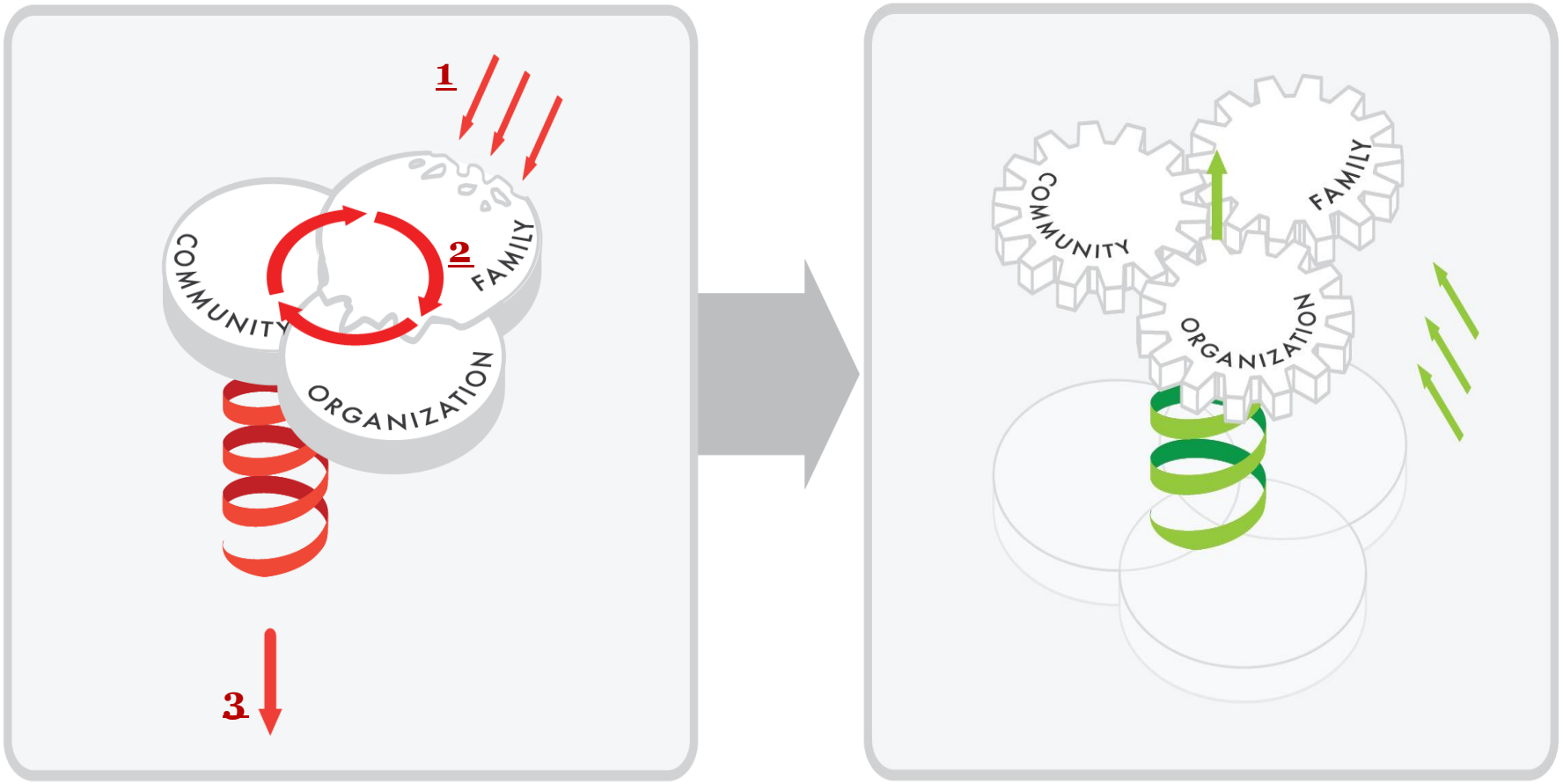
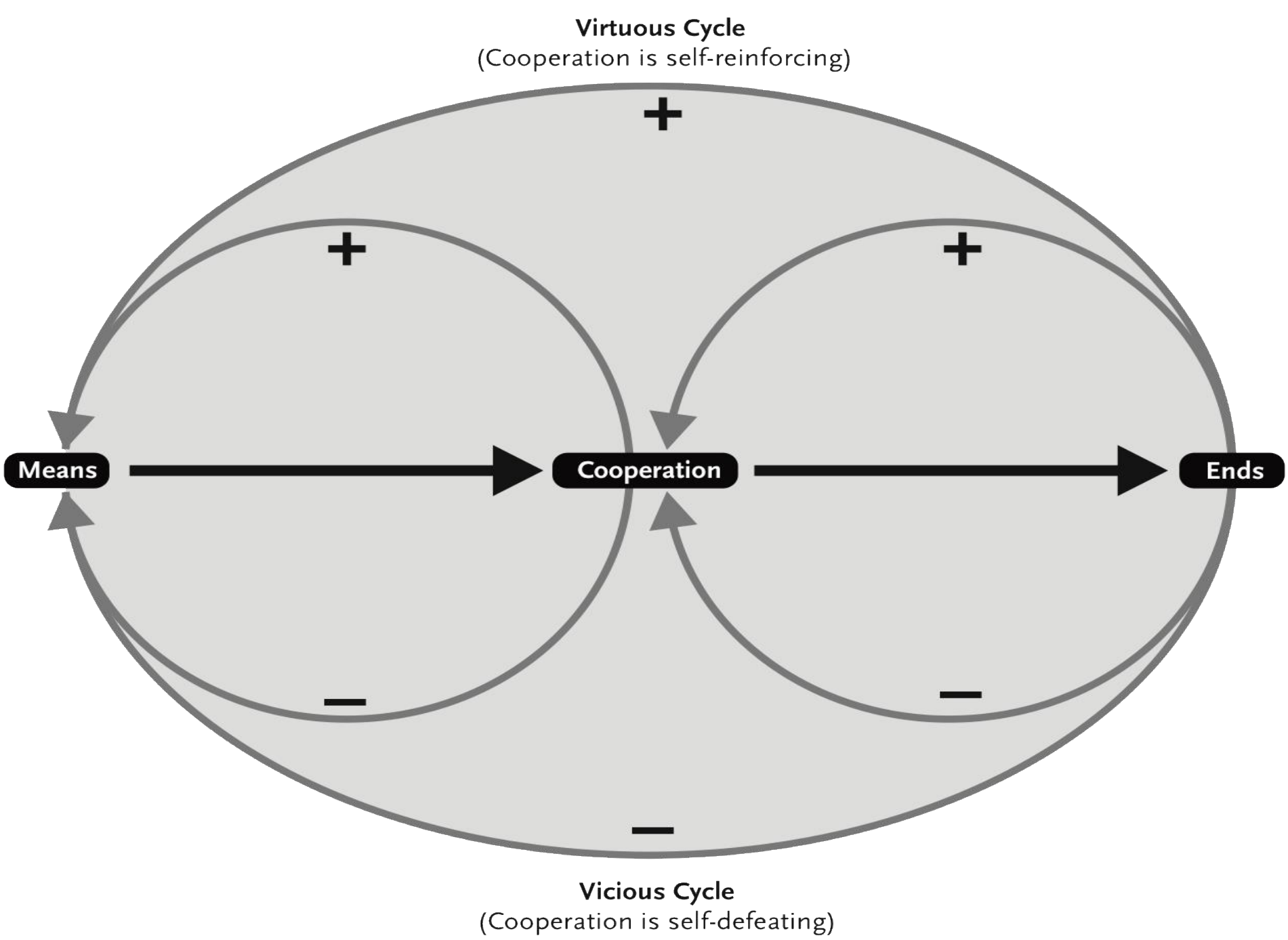
ABSTRACT

It has been argued that punishment promotes the evolution of cooperation when mutation rates are high (i.e. when agents engage in 'exploration dynamics'). Mutations maintain a steady supply of agents that punish free-riders, and thus free-riders are at a disadvantage. Recent experiments, however, have demonstrated that free-riders sometimes also pay to punish cooperators. Inspired by these empirical results, theoretical work has explored evolutionary dynamics where mutants are rare, and found that punishment does not promote the evolution of cooperation when this 'anti-social punishment' is allowed. Here we extend previous theory by studying the effect of anti-social punishment on the evolution of cooperation across higher mutation rates, and by studying voluntary as well as compulsory Public Goods Games. We find that for intermediate and high mutation rates, adding punishment does *not* promote cooperation in either compulsory or voluntary public goods games if anti-social punishment is possible. This is because mutations generate agents that punish cooperators just as frequently as agents that punish defectors, and these two effects cancel each other out. These results raise questions about the effectiveness of punishment for promoting cooperation when mutations are common, and highlight how decisions about which strategies to include in the strategy set can have profound effects on the resulting dynamics.

WHAT KEEPS COOPERATION GOING?

THREE THREATS TO SUSTAINABLE COOPERATION




Virtuous Cycle
(Cooperation is self-reinforcing)
+
+
+
Means
Cooperation
Ends
–
–
–
Vicious Cycle
(Cooperation is self-defeating)

Cooperation and Value Creation: Three Examples

Overview

1. Feedback Loops
   - CEO Compensation
2. Spill-Over Effects
   - Work-Home Balance
3. External Shocks
   - Reorganizations

Case 1: Feedback Loops

Sustainable Cooperation in the Board and the Rise of CEO Compensation

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Outrageous!?

Leo Dennis Kozlowski, Former CEO of Tyco International

- Convicted in 2005
- $81 million in unauthorized bonus
- He had Tyco pay for his $30 million New York City appartment, including
  - $6,000 shower curtains
  - $15,000 "dog umbrella stands”
  - Purchase of art for $14 million
- Tyco paid $1 Million for the 40th birthday party of Kozlowski's second wife

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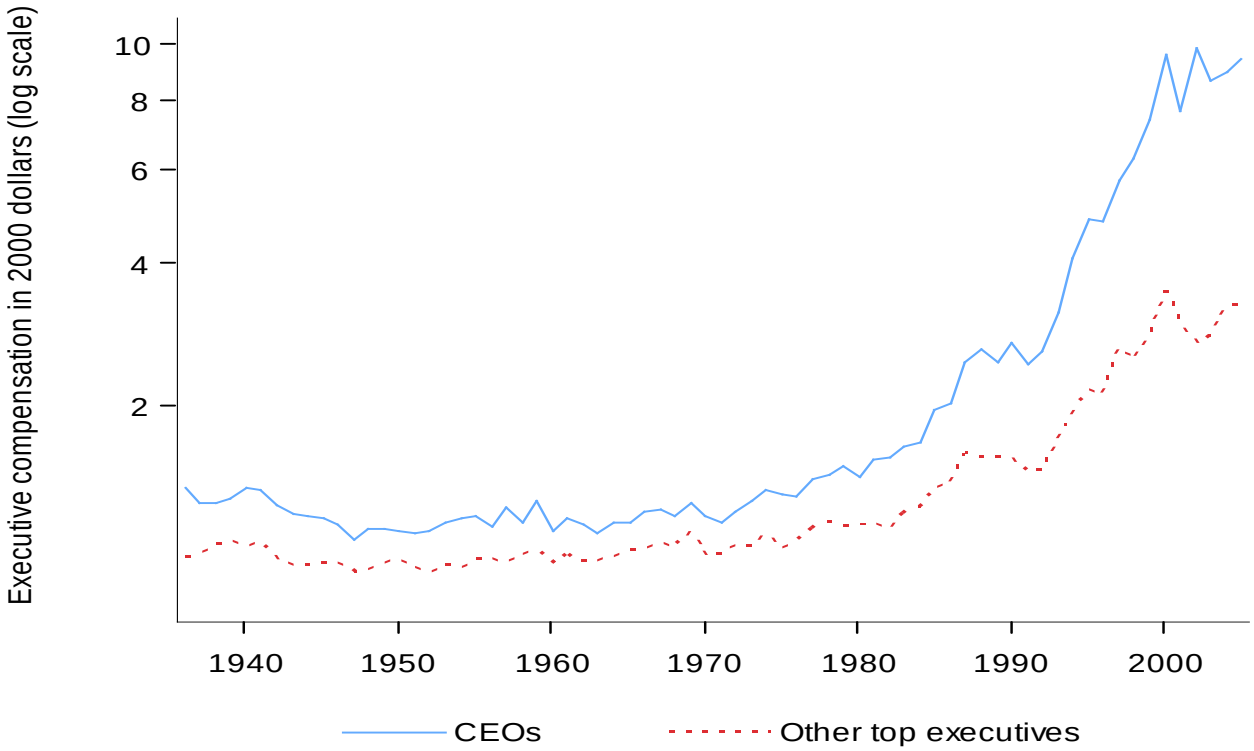
Rising CEO Compensation

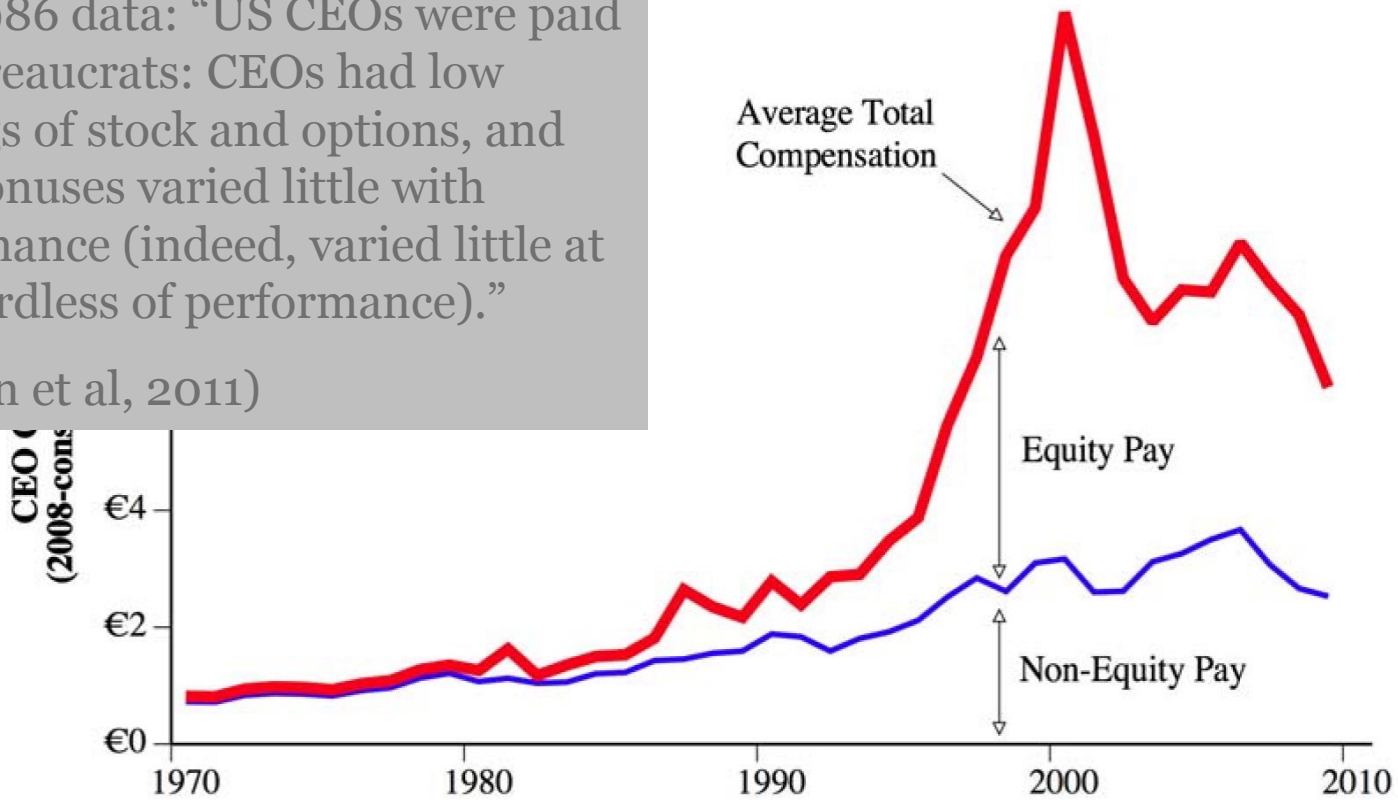


Based on a sample of the three highest-paid officers in the largest 50 firms in 1940, 1960 and 1990 (for a total of 101 firms). Source: Frydman & Jenter (2010)

Figure 2.1 Average Equity and Non-equity Compensation for CEOs in US S&P 500 Firms, 1970-2009

1974-1986 data: "US CEOs were paid like bureaucrats: CEOs had low holdings of stock and options, and their bonuses varied little with performance (indeed, varied little at all regardless of performance)."

(Conyon et al, 2011)

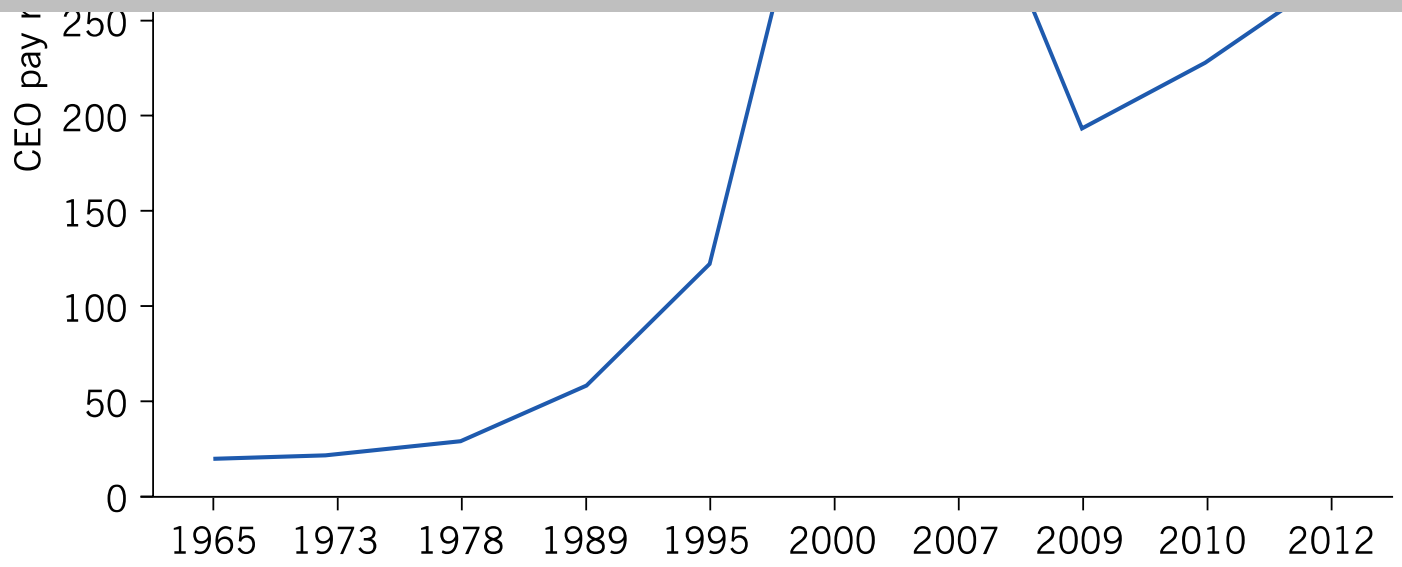


Note: Compensation data are based on all CEOs included in the US S&P 500, using data from *Forbes* and ExecuComp. CEO total pay includes cash pay, restricted stock, payouts from long-term pay programs and the value of stock options granted (using company fair-market valuations, when available, and otherwise using ExecuComp's modified Black-Scholes approach). Equity compensation prior to 1978 estimated as 11.2% (and 0%) of total pay (based on Murphy (1985), equity compensation from 1979 through 1991 estimated as amounts *realized* from exercising stock options during the year, rather than grant-date values. Non-equity incentive pay is based on actual payouts rather than targets, since target payouts were not available prior to 2006. Monetary amounts are converted to 2008-constant US dollars using the Consumer Price Index, and then converted to Euros using the 2008 year-end exchange rate.

Figure 1. Trend in ratio of average CEO pay in largest 350 US companies to pay of workers in the same industry

The escalation in CEO pay has far outpaced wage gains for production workers:

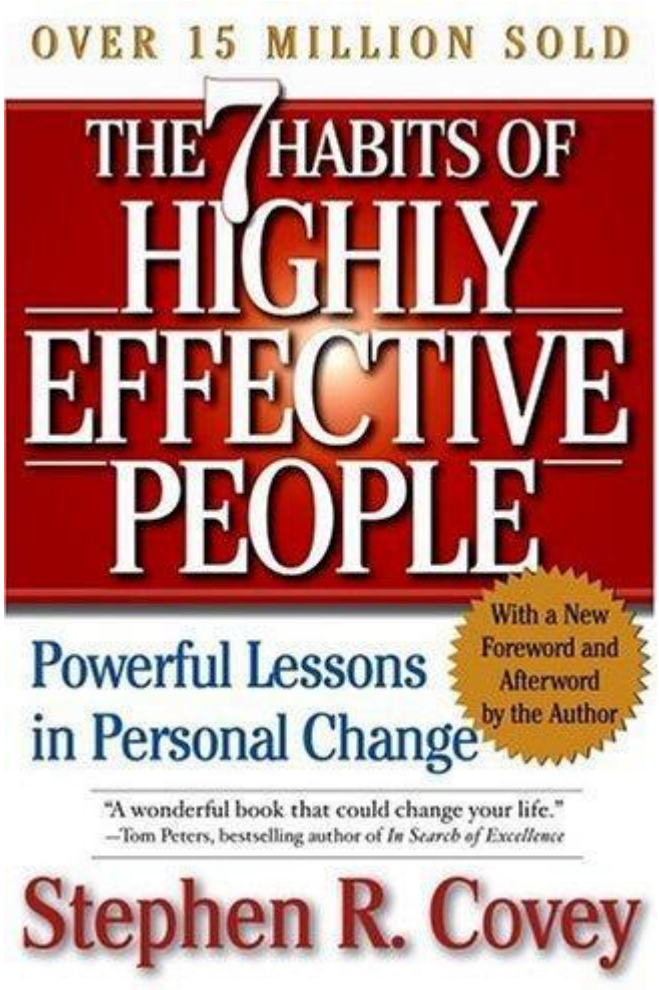
- in 1970, the average CEO made 31 times the wages of the average production worker
- by 2009 the average CEO made 263 times the wages of production

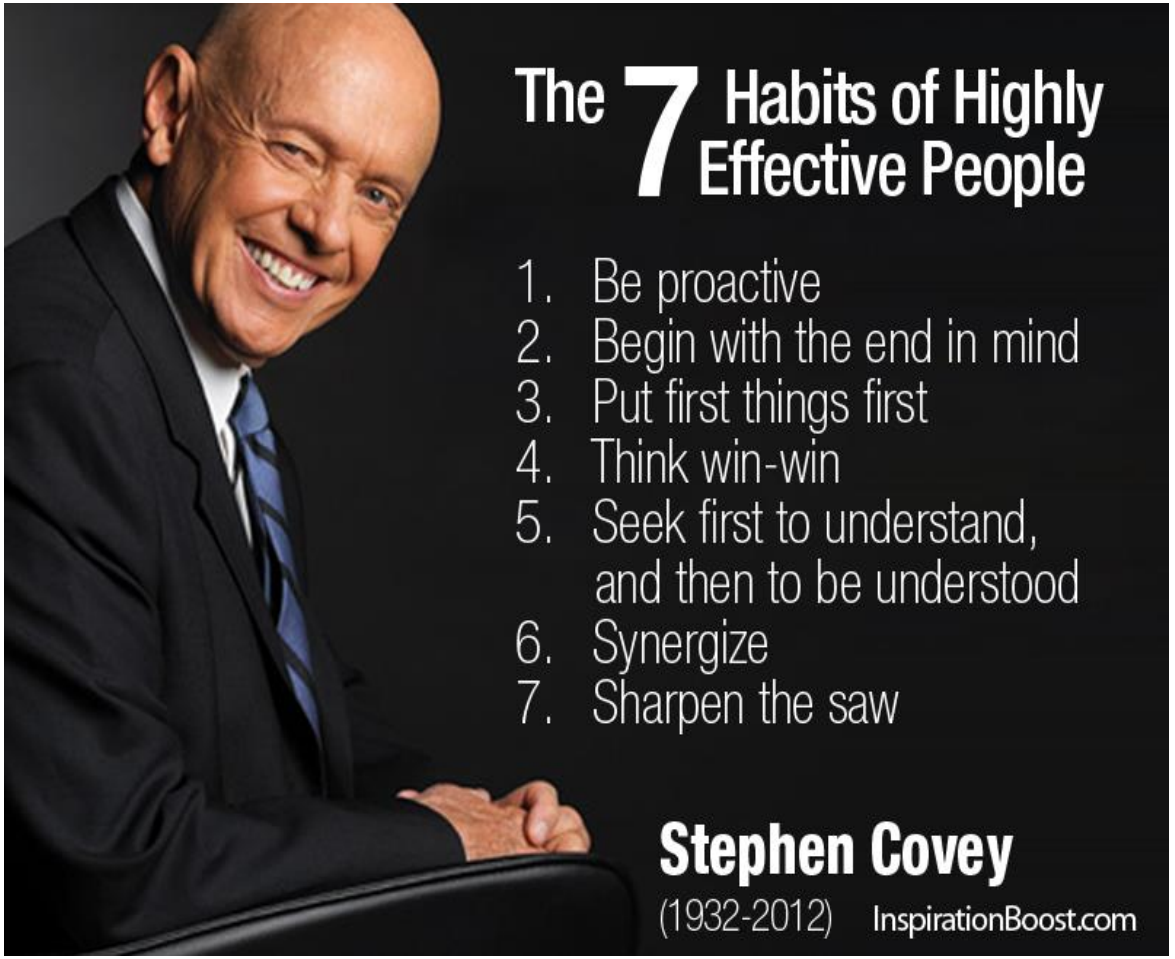


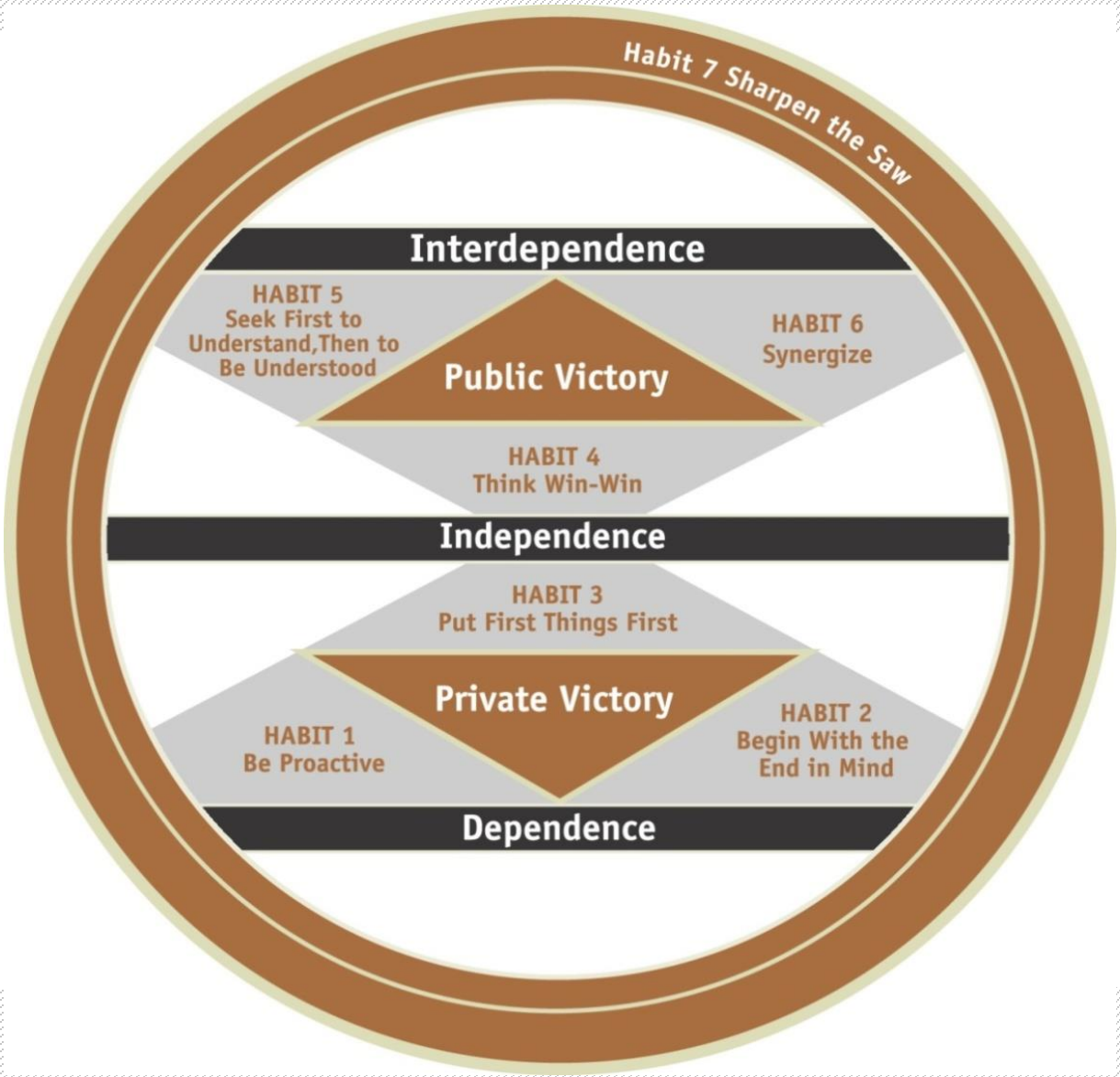
Source: Based on Mishel, L., and N. Sabadish. *CEO Pay in 2012 Was Extraordinarily High Relative to Typical Workers and Other High Earners*. Washington, DC: Economic Policy Institute, 2013. [1].

Case 2: Spill-Over Effects

Personal Growth Trainings, Work-Home Interference, and Sustainable Cooperation


OVER 15 MILLION SOLD
THE 7 HABITS OF HIGHLY EFFECTIVE PEOPLE
Powerful Lessons in Personal Change
With a New Foreword and Afterword by the Author
"A wonderful book that could change your life."
—Tom Peters, bestselling author of In Search of Excellence
Stephen R. Covey


The 7 Habits of Highly Effective People
1. Be proactive
2. Begin with the end in mind
3. Put first things first
4. Think win-win
5. Seek first to understand, and then to be understood
6. Synergize
7. Sharpen the saw
Stephen Covey
(1932-2012)
InspirationBoost.com



40% of habits focus on interpersonal relations

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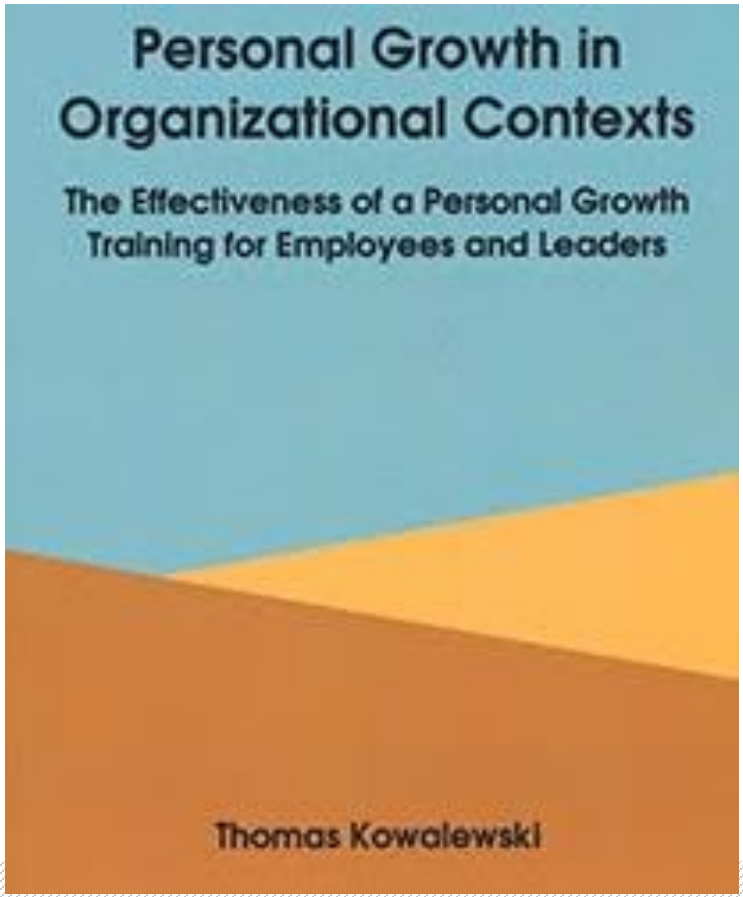
First Ever Experimental Test (2015)

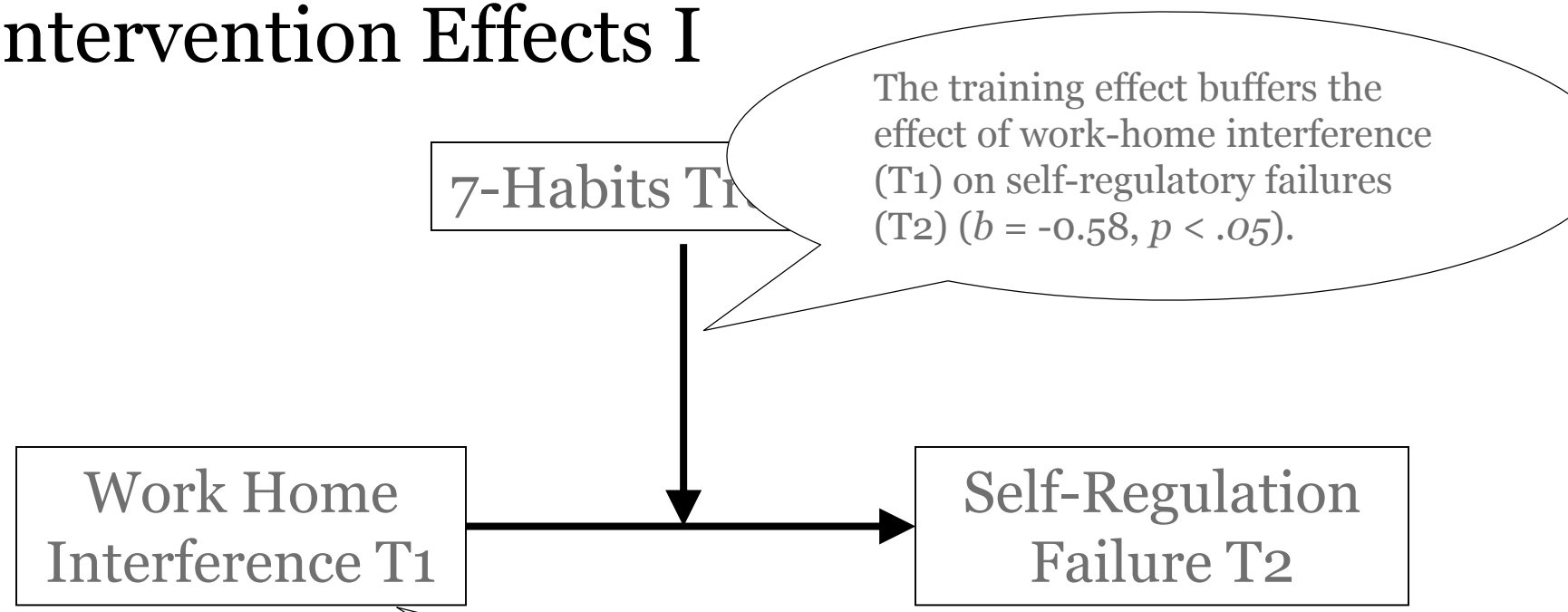


- Youth care organization
  - 650 employees, 15 sites in NL
  - 25 departments, av. team size 17.5
  - Our sample: 454
- 7 habits training
  - for employees
  - 2-day training, two weeks apart
- Randomized cluster controlled trial field experiment on team-level:
  - 15 depts. Treatment, 10 control
  - Survey: 1m before and 6m after training

Self-Regulation Failures

- 13-item Brief Self-Control Scale (Tangey, Baumeister, and Boone, 2004).
- “Sometimes I can't stop myself from doing something, even if I know it is wrong.”
- “I say inappropriate things”
- …
- 7-point scale ranging from “Strongly disagree” to “Strongly agree”.

Intervention Effects I



Work-home interference at baseline predicts self-regulatory failures six months later for the control condition**, but not for the training condition.**

Employees in **the control condition** who experienced more work-home interference at baseline experienced more self-regulatory failures six months later (*b* = 0.68, *p* < .01).

Effective Intervention!?

- So 7-Habits Training has the potential to prevent selfregulation failures due to work-home spillover effects.
- So far, so good?
- No. There were many unintended consequences that actually **undermined** cooperation or its underlying conditions!

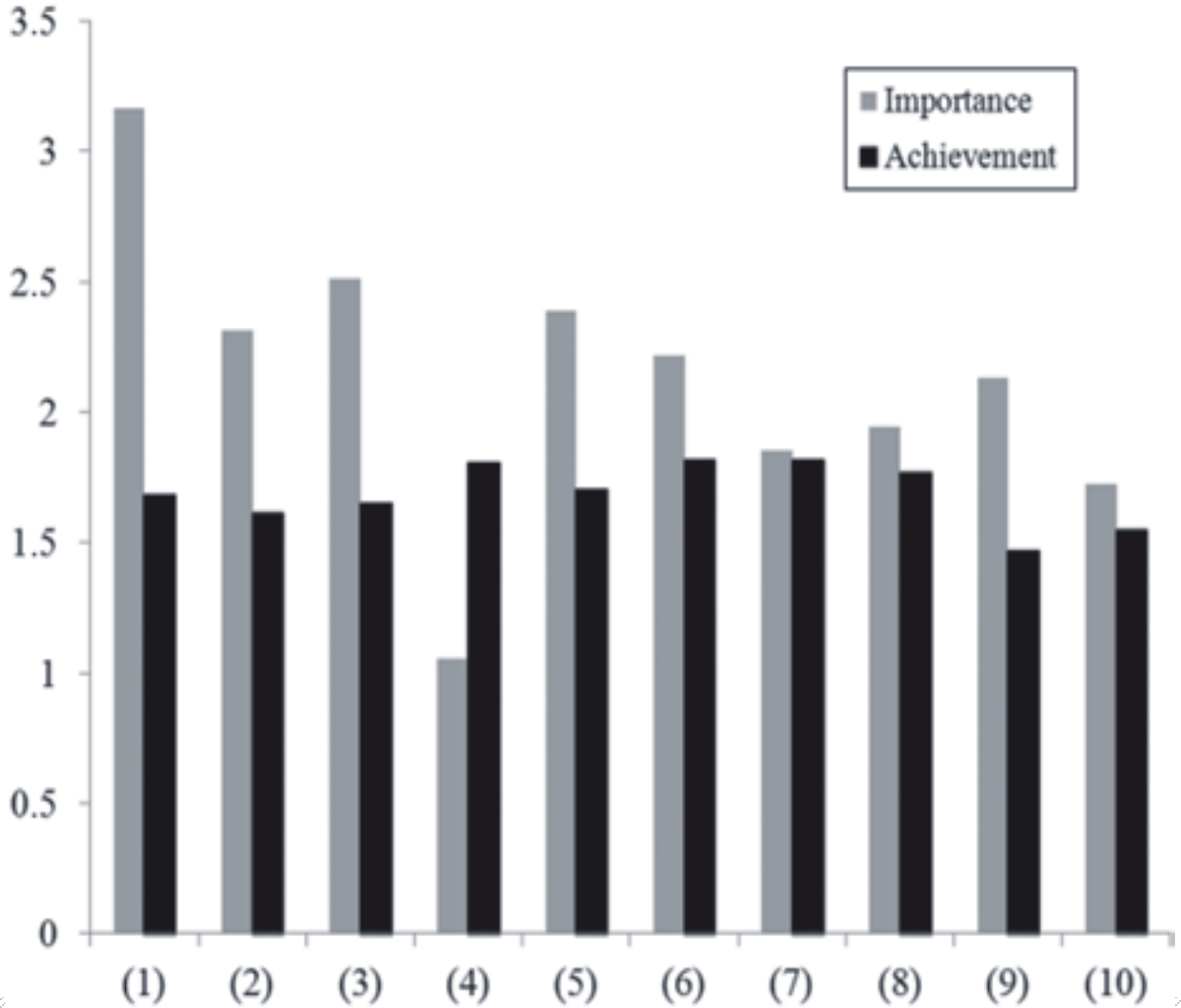
Case 3: External Shocks *Sustainable Cooperation and Reorganization Success*

HP announces major restructuring including ESSN

21 March 2012 | By Penny Jones

HP has announced a company restructure designed to make the company more effici which includes merging its Global Accounts Sales organization with the new HP Enterprise Group which looks after enterprise, servers, storage, networking and technology services (ESSN).

Fig. 2 Reorganization success (per domain). Mean values per domain: (*1*) Efficiency, (*2*) Product or service quality, (*3*) Personnel costs, (*4*) Regulation and product standards, (*5*) Communication, (*6*) Responsibility, (*7*) Transparency, (*8*) Controllability, (*9*) Corporate culture, (*10*) Information



Telephone interview with N=401 Dutch organizations, conducted in 2003

Early Announcement

- When did your top management inform [middle management, employees] about the interventions that will follow from the reorganization?"
- (1) before decisions about the reorganization were made
- (2) after the plans of the reorganization were defined
- (3) just before the reorganization started
- (4) they were not informed at all.

Table 2 Multivariate regression: effect of information timing on reorganization success

	Model 1		Model 2		Model 3	
	Estimate	S.E.	Estimate	S.E.	Estimate	S.E.
Information						
Employees not informed	−1.79**	0.57	−1.59**	0.59	−1.61**	0.60
Early information employees	−0.70*	0.32	−0.75*	0.33	−0.85*	0.43
Early information managers	0.84**	0.29	0.90**	0.30	0.99*	0.40
Reorganization						
Share affected employees			0.27**	0.10	0.27**	0.10
Negative						.35
Consequ						
Negative						.69
Negative						.62
Controls						
Size						.10
Employe						.30
Vertical conflict	−0.15	0.16	−0.18	0.17	−0.18	0.17
Involvement culture	−0.08	0.10	−0.08	0.11	−0.08	0.11
R^2	0.05		0.07		0.07	
N (listwise valid)	384		356		356	

**$p<0.01$; *$p<0.05$

Effect is negative for employees, and positive for managers. Why?

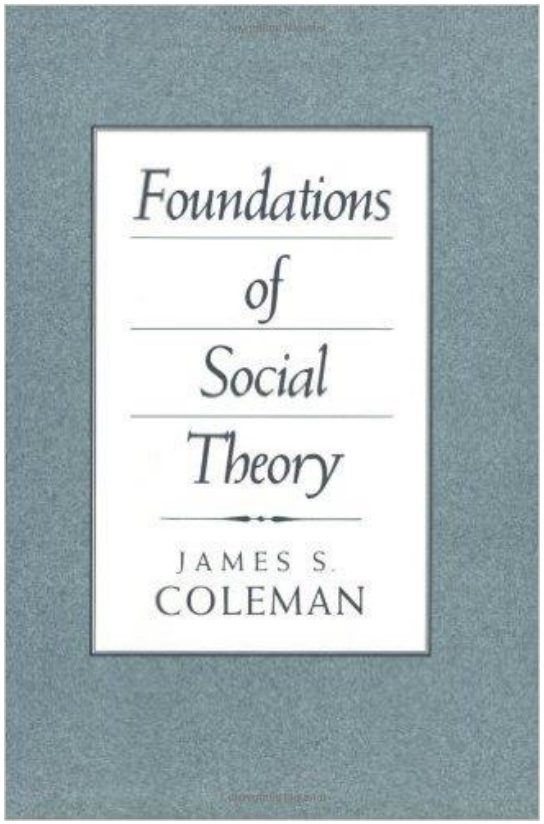
Social Mechanism Theorizing: A Primer in Analytical Sociology

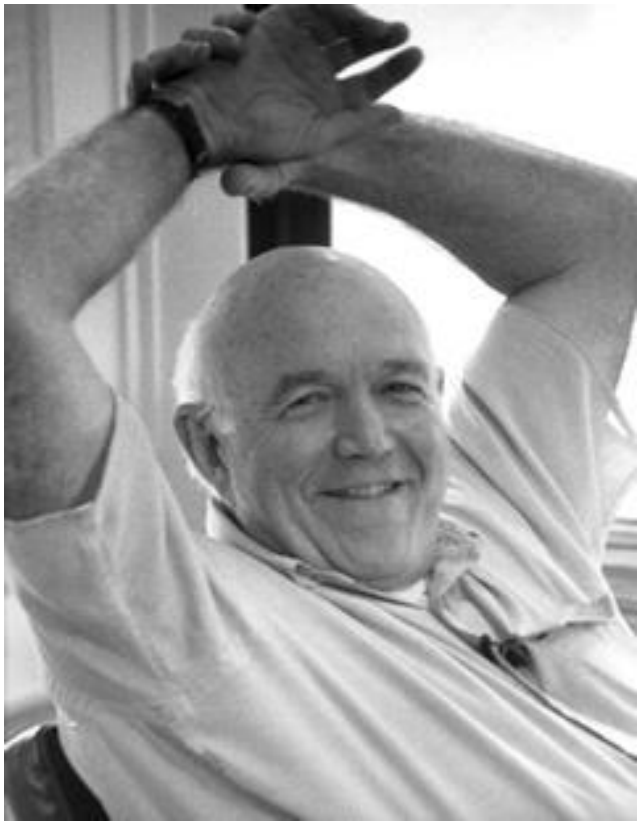
The Toolbox

1. The Coleman Boat
2. The DBO-Framework
3. The Theoretical Paradigm

The “Coleman Boat”

James Coleman





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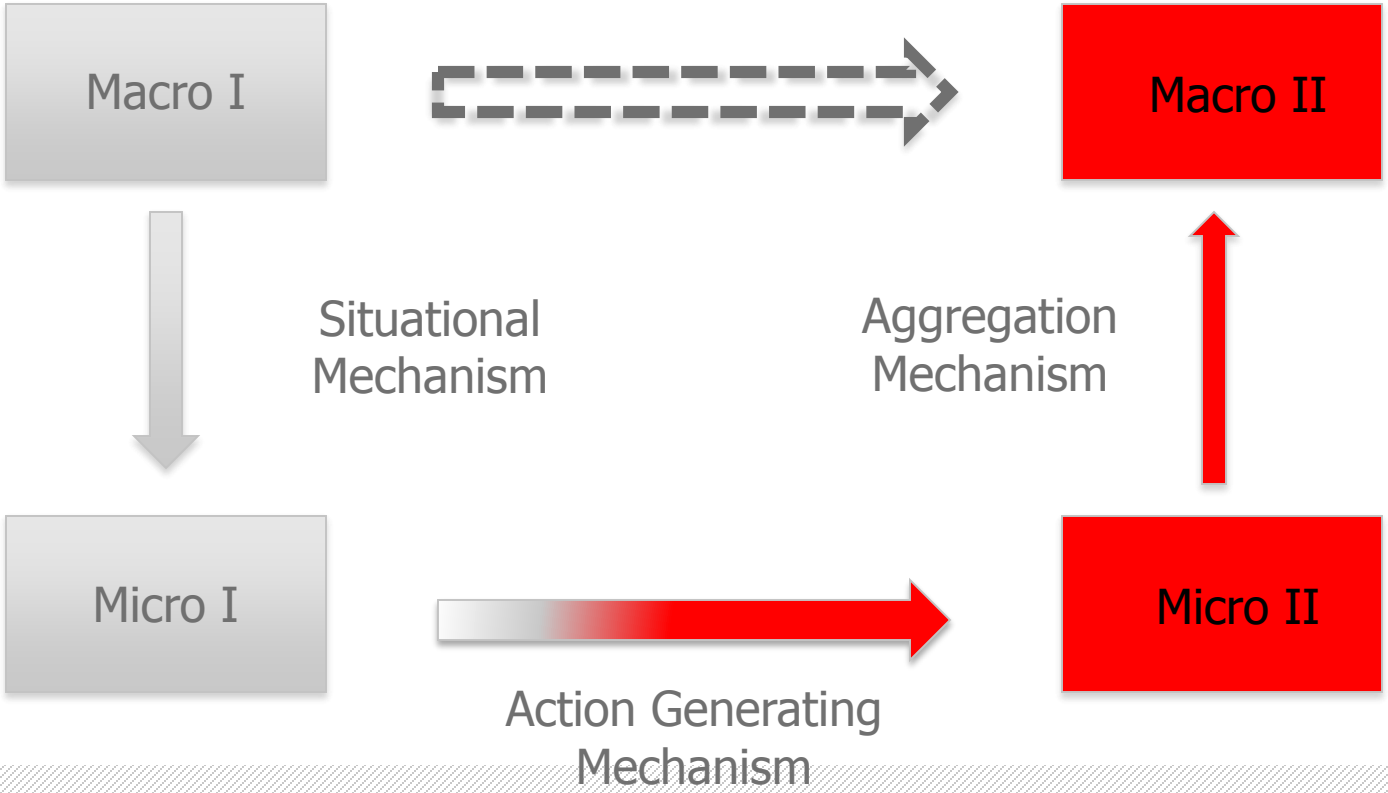
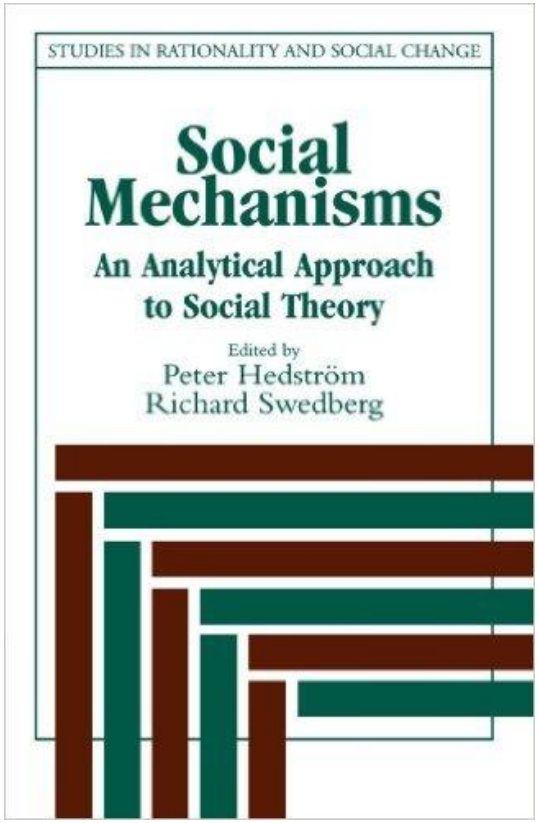
A Complete Mechanism Explanation



https://www.youtube.com/watch?v=dGazoxKGo6o&feature=youtu.be

The DBO-Framework


STUDIES IN RATIONALITY AND SOCIAL CHANGE
Social Mechanisms
An Analytical Approach to Social Theory
Edited by
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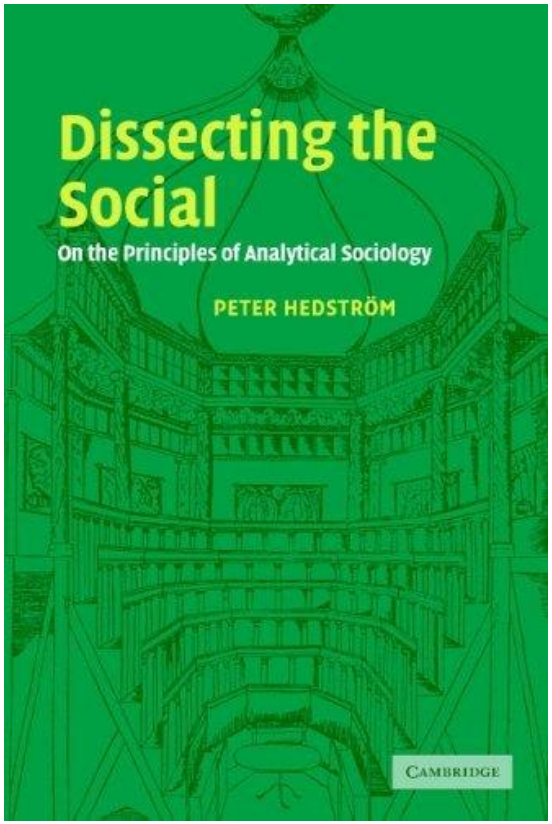
Richard Swedberg

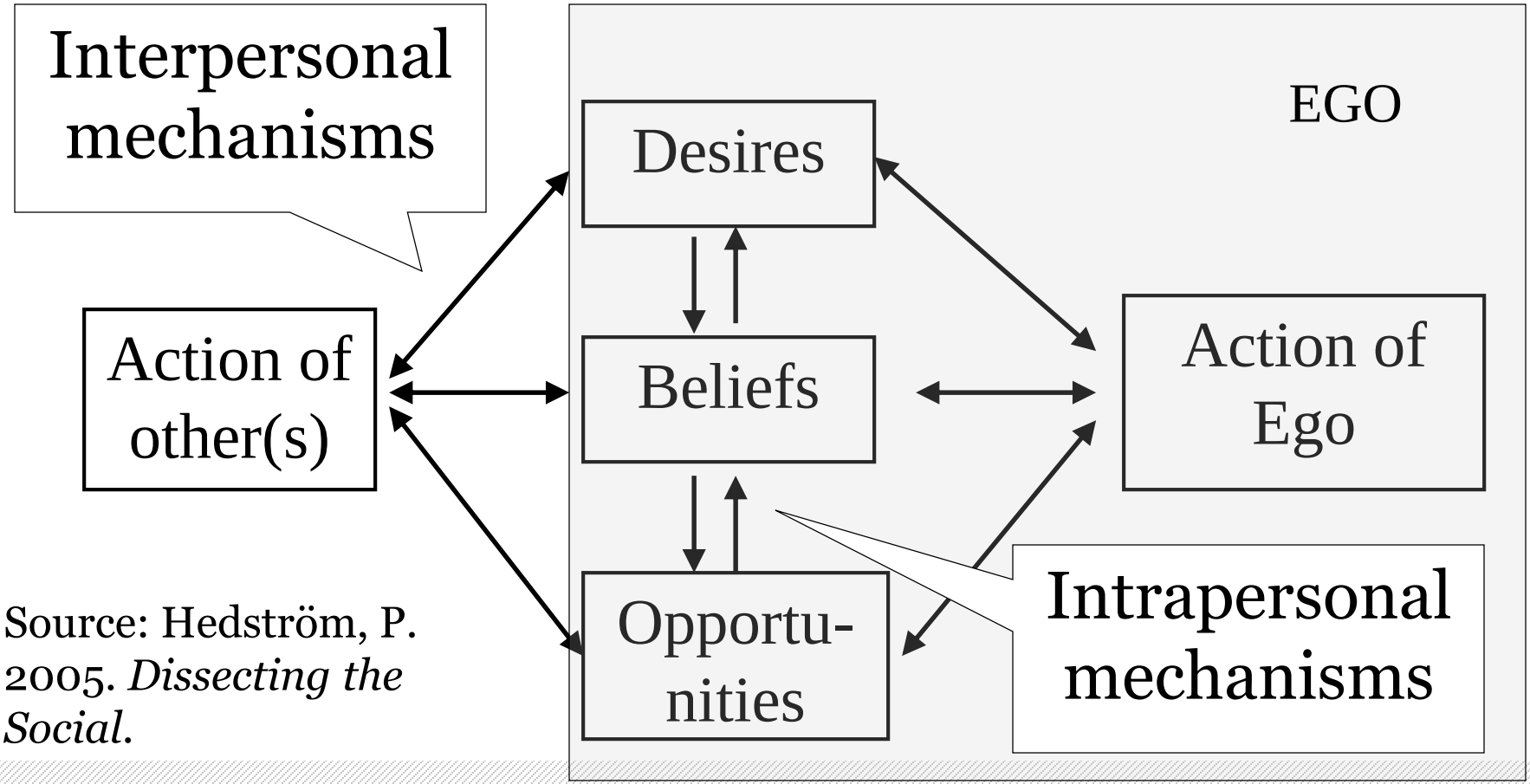

Dissecting the Social
On the Principles of Analytical Sociology
PETER HEDSTRÖM
CAMBRIDGE

Actor Assumptions

- Desires
  - a wish or want
- Beliefs
  - a proposition about the world held to be true
- Opportunities
  - 'menu' of action alternatives available to the actor

Peter Hedstrom

Intra- and Interpersonal Mechanisms



Source: Hedström, P. 2005. *Dissecting the Social.*

Examples for Intra- and Interpersonal Mechanisms

Standard Examples for Mechanisms

- Intra-personal: "wishful thinking“
  - desires affect beliefs
- Inter-Personal: “vacancy chains”
  - action of one actor influences the opportunities of another

Example: cooperation and well-being

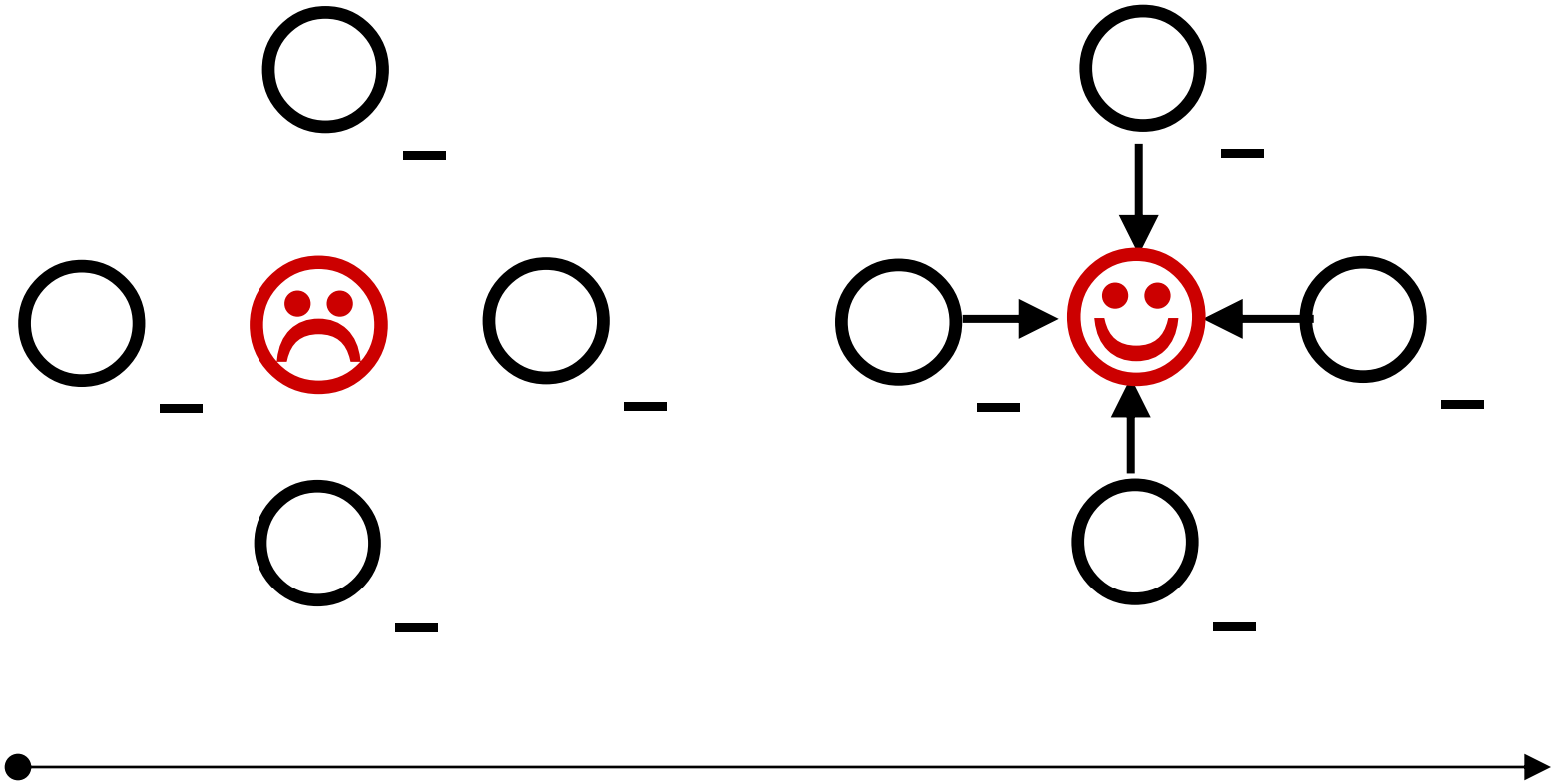
Do cooperative relations breed psychological well-being? (Influence Effect)

OR

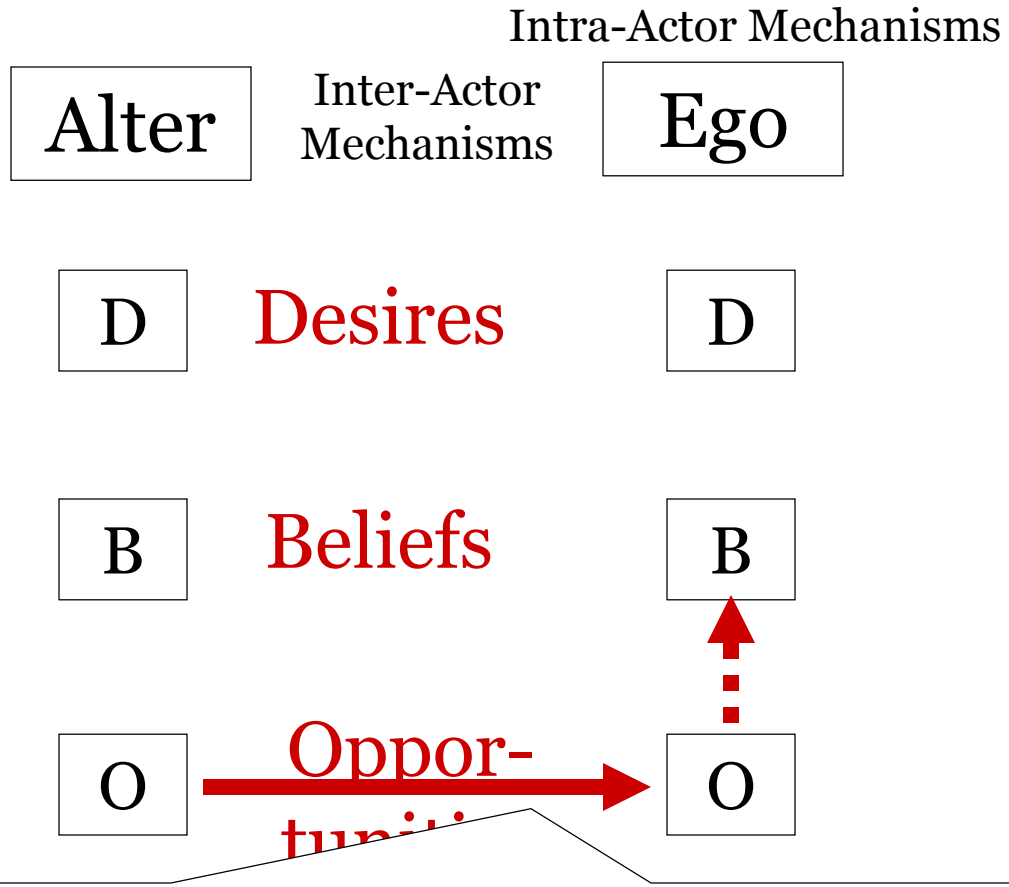
Does psychological well-being lead to more cooperative relations? (Selection Effect)

Need to disentangle influence and selection mechanisms

Interpersonal Influence: Popularity



Popularity

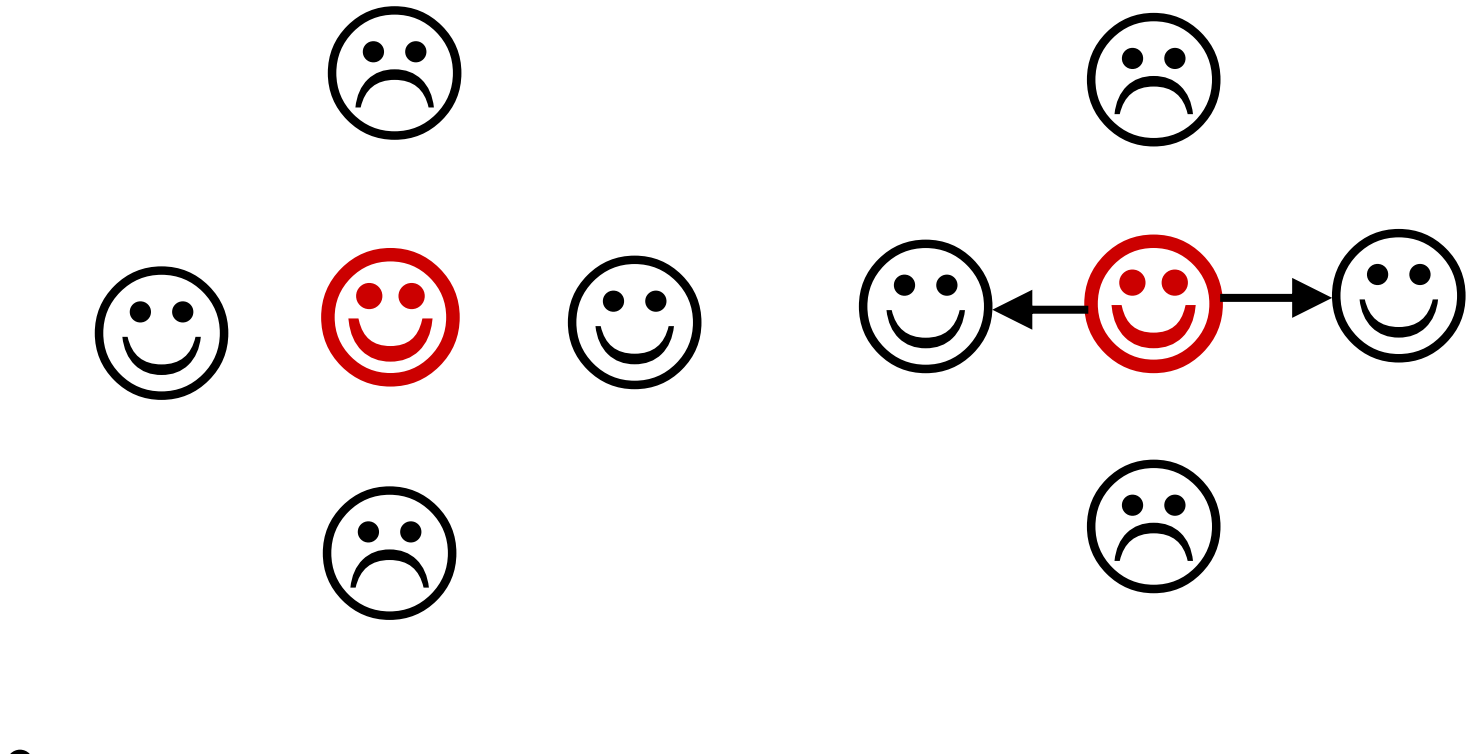


Social Support Theories

- "Buffer" theories (Wellman, Kadushin)
  - Networks buffer stress effects on mental well-being
  - Networks provide resources and sociability
- Social production function theory (Lindenberg)
  - Universal and instrumenal goals
  - Physical well-being (comfort, stimulation)
  - Social well-being (affection, status, behavioral confirmation)

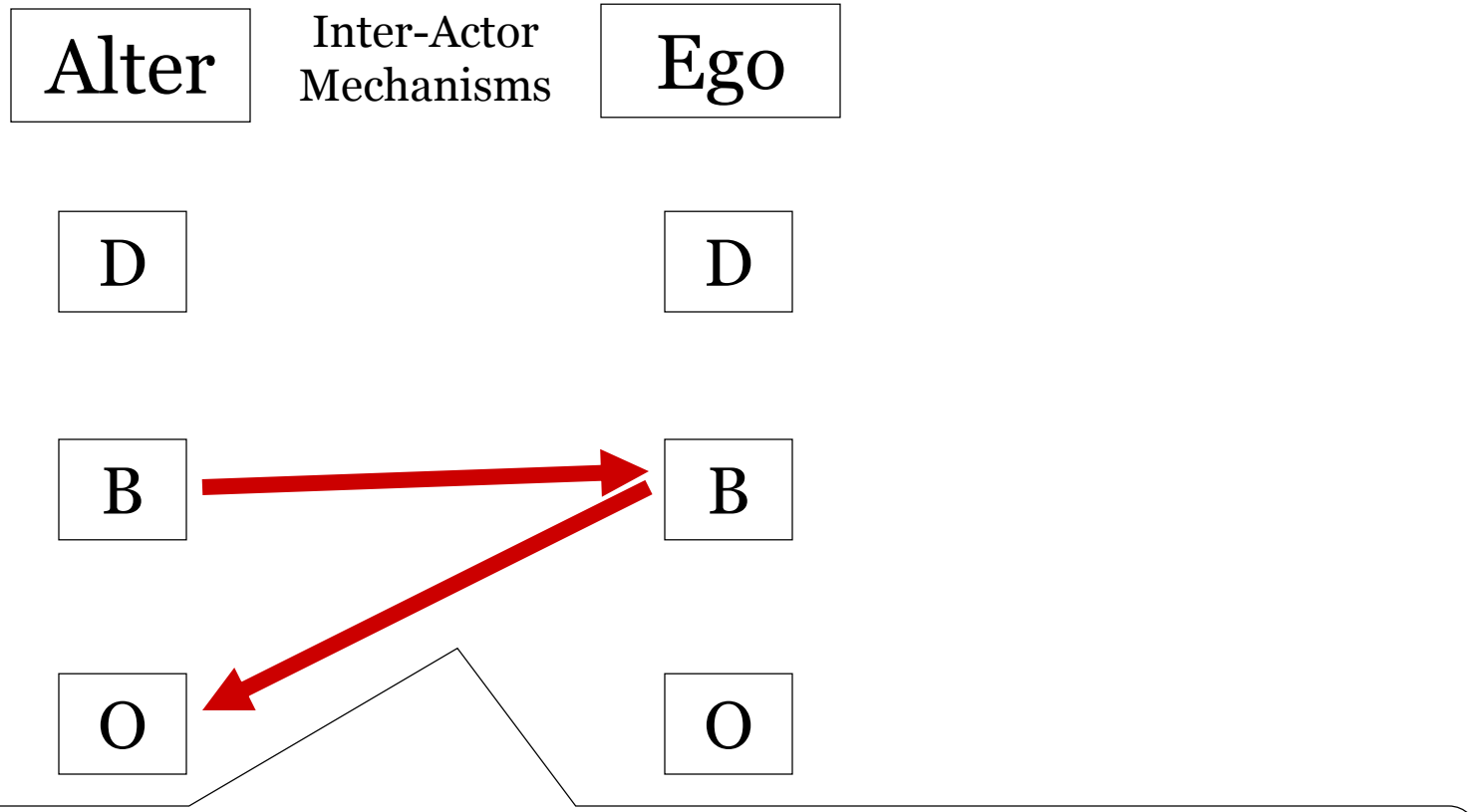
Opportunity based social capital explanation: ´Popularity´

Interpersonal Selection: Homophily



Time

Homophily



Interpersonal Selection: Uncertainty reduction (´Homophily´)

The Theoretical Paradigm

Competing Theoretical Paradigms

	Paradigms		
Dimensions	Rationalist	Culturalist	Structuralist
Interests Desires	individual preferences and beliefs	social identities	structural position
Identities Beliefs	autonomous preferences and beliefs	constitutive of individuals	derivative of structural position
Institutions Opportunities	equilibria of strategic interactions	embedded norms	deep power relations

Adapted from Lichbach, M. (2009): Is Rational Choice all of Social Science? p 132

Social Mechanisms at Work

A Step-By-Step Guide (1)

1. Specify the explanatory problem at the Macro Level
   - Define the dependent variable Macro II
   - Define the independent variable Macro I
2. Explicate your theoretical paradigm(s)
   - Rationalist? Culturalist? Structuralist?
   - Specify baseline actor assumptions (e.g. thin vs. thick model of rationality)

Note: In principle, you can "start" with your explanation at any of the nodes or mechanisms in the framework. For this exercise, we assume you have some thoughts about the research problem at the macro level.

A Step-By-Step Guide (2)

3. Reconstruct the situational mechanism(s)
   - Determine the kind of actors involved.
   - Building on step 2 (paradigm choice), explicate how (changes or variations in) the situation/context affect desires, beliefs, and opportunities of each type of actor.
   - Explicate how the Macro I – Micro I effect differs for different types of actors.

A Step-By-Step Guide (3)

4. Elaborate the action-generating mechanism.
   - Explicate which individual level action needs to be explained (Micro II)
   - Explicate how Macro I affects DBO at Micro I
   - Disentangle intra-actor mechanisms.
   - Identify and disentangle inter-actor mechanisms.
5. Specify the aggregation mechanism
   - Explicate how Micro II aggregates into Macro II.

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Applying the Framework: The Three Examples Again

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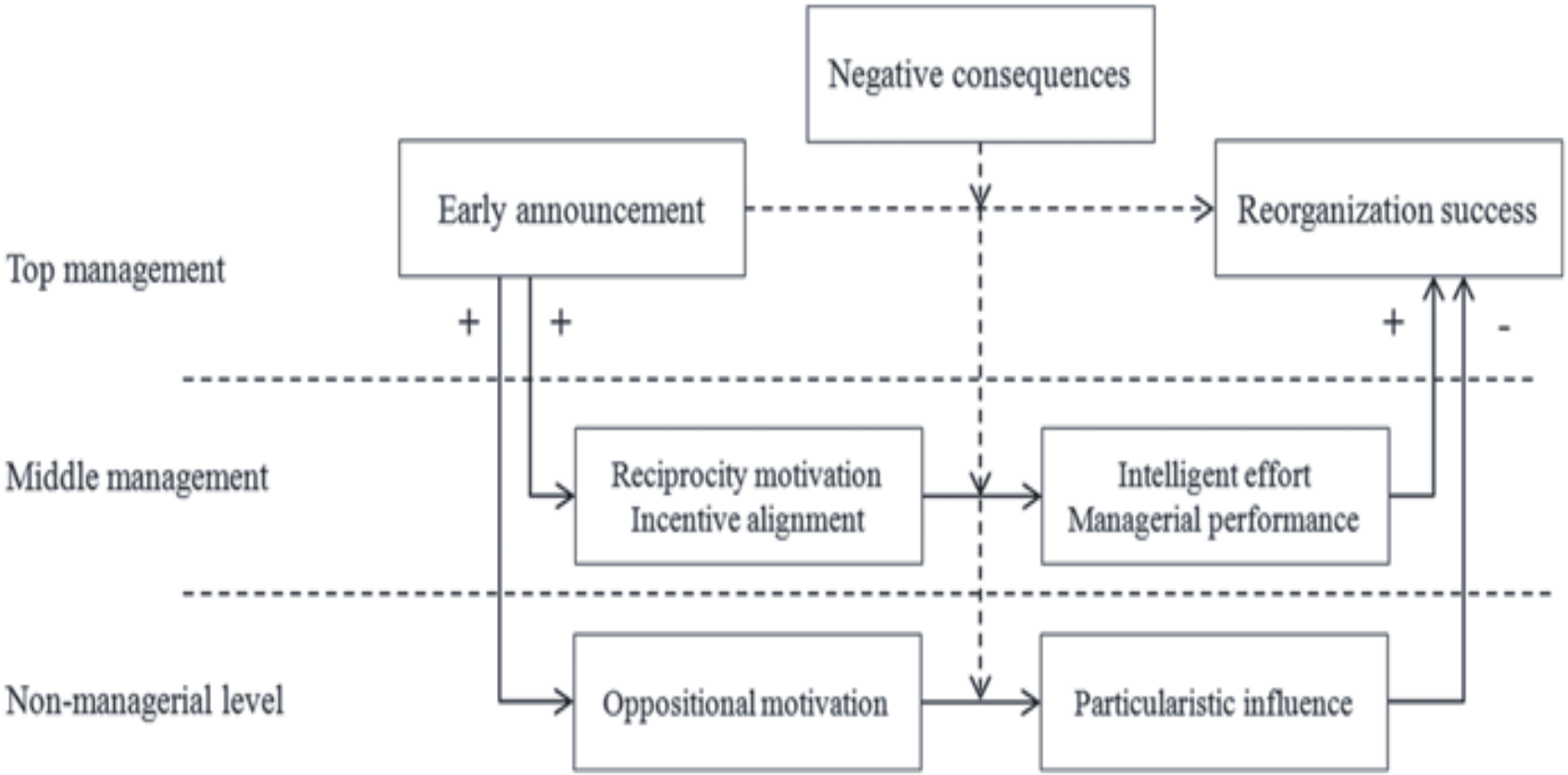
Example 1: External Shock
Reorganization Success



Single macro predictor, single macro outcome.
Single micro predictor, single micro outcome.
Multiple types of actors, multiple mechanisms.

Situational Mechanism

Managers: Commitment Mechanism

›Effect on **opportunity structures**

- information advantage
- Allows to anticipate on the change and its consequences,
- improves their chances to take measures that lead to successful implementation.

›Effect on **preferences**

- Top management signals trust in middle managers, thereby triggering reciprocity motivations (“gift exchange mechanism”).
- Since middle managers are important change agents, the design and successful implementation of organizational change policies is usually part of their performance evaluation and therefore also affects their career prospects.

Employees: Influence Mechanism

› Effect on **opportunity structures**

- Provides information advantage, which extends the time available to build coalitions

› Effect on **preferences**

- provides an incentive to improve their power position vis-à-vis management by forming oppositional coalitions.
- This incentive will increase the higher the potentially negative effects of the reorganization on the employees.

Action Generating Mechanism

Management: Commitment

› Information advantage, increased reciprocity motivation and performance incentives as they follow from early information will increase change related intelligent effort and performance of middle managers.

Employees: Influence

›Information advantage and incentives to form oppositional coalitions will increase employees' efforts to influence change agents and to exert pressure to adjust reorganization objectives to their own advantage.

Aggregation Mechanism

Management: Commitment

The higher the number of middle managers whose change related efforts and performance increases, the higher the likelihood that the reorganization is successful.

Employees: Influence

The higher the number of employees who engage in particularistic influence attempts, the lower the likelihood that the reorganization is successful.

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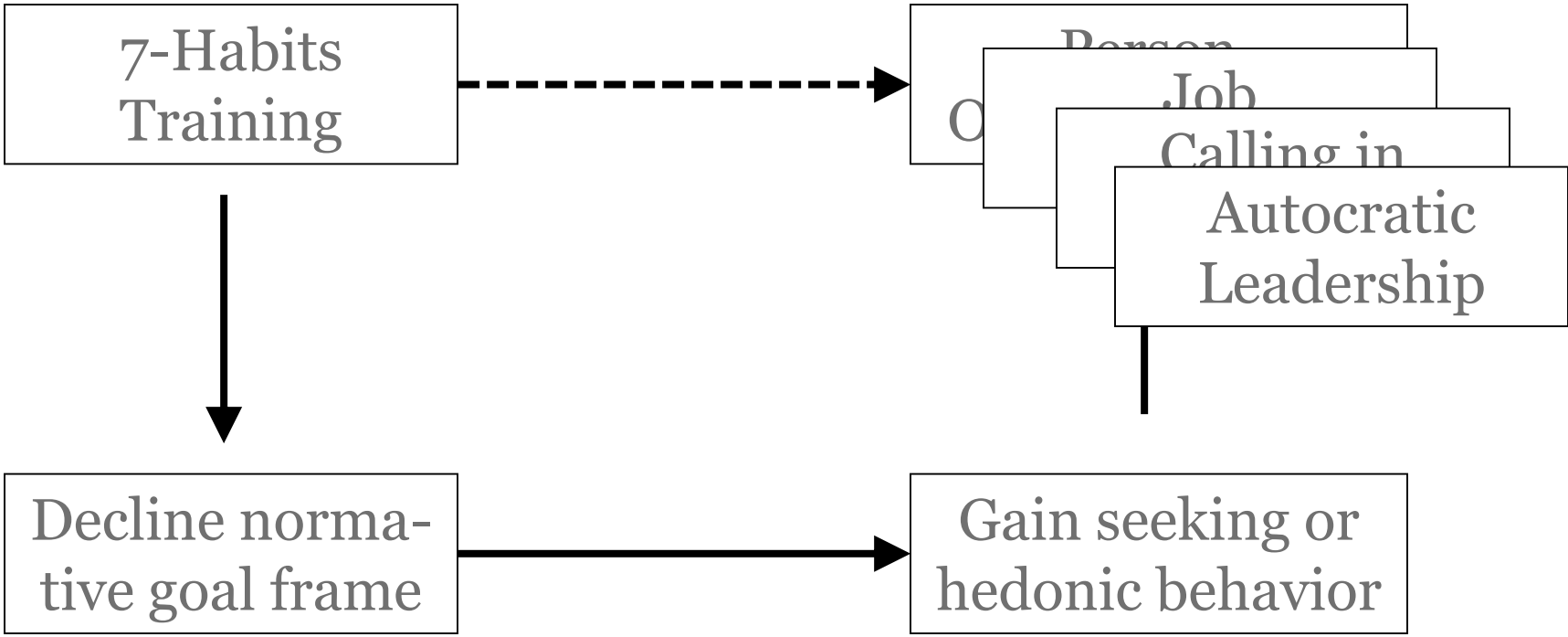
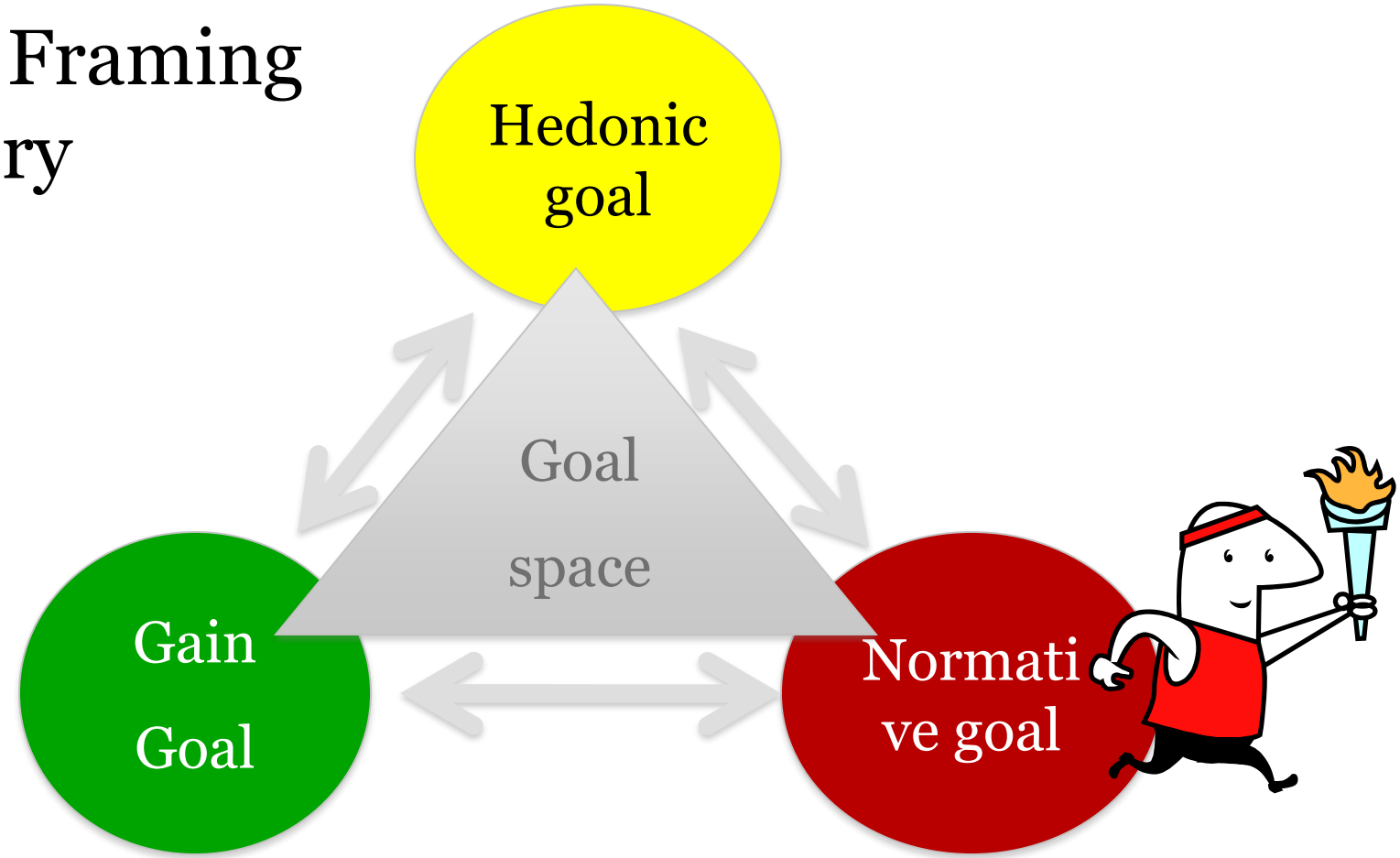
Example 2: Spill-Over Personal Growth

Personal Growth Training and Cooperation



Single macro predictor, multiple macro outcomes.
Single micro predictor, multiple micro outcome.
Single type of actor, same mechanism.

Goal Framing Theory



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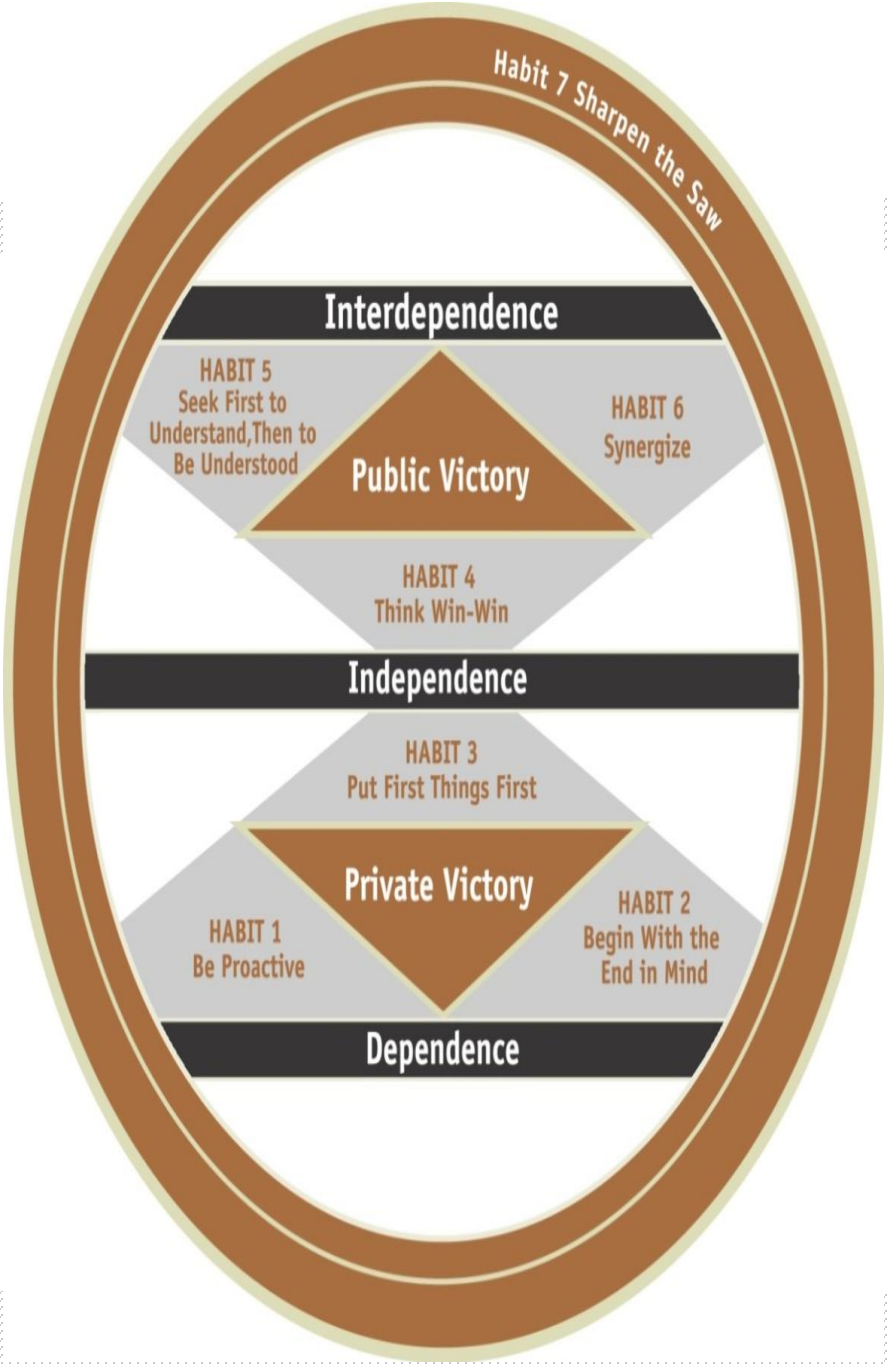
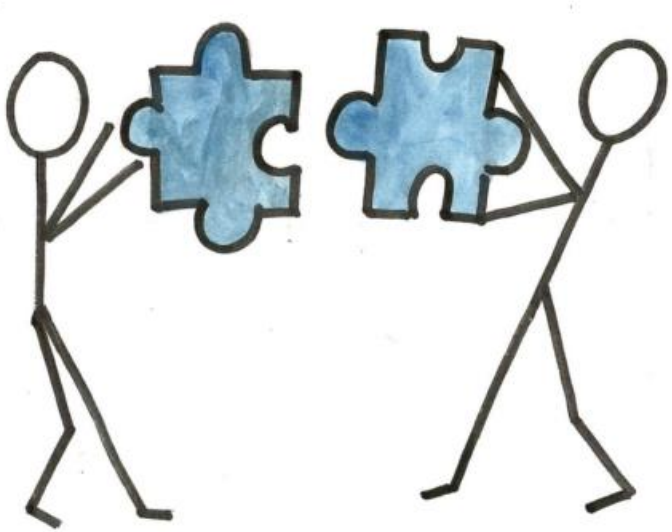
Prediction

- About 40% focuses on interpersonal behaviors, but it is framed as instrumental for personal goals
  - Example: Habit 5: Listen to others to make them listen to you in turn.
- Given this emphasis on personal goals, the first block (PRIVATE VICTORY) acts like a **prime** for the second (PUBLIC VICTORY),
- This makes the second block stand in the service of the first, thus creating a down-shift of the normative goal.



Person-Organization fit declined

- Six months after the training, employees who attended the 7 habits training experienced **lower person-organization fit** (value congruence) compared to employees in the waiting-list control condition.
- This effect disappeared under high levels of perceived organizational support as observed at baseline or high tenure.



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Job satisfaction declined

Employees who participated in the 7 Habits training were less satisfied with their

- job content
- career opportunities
- job in general

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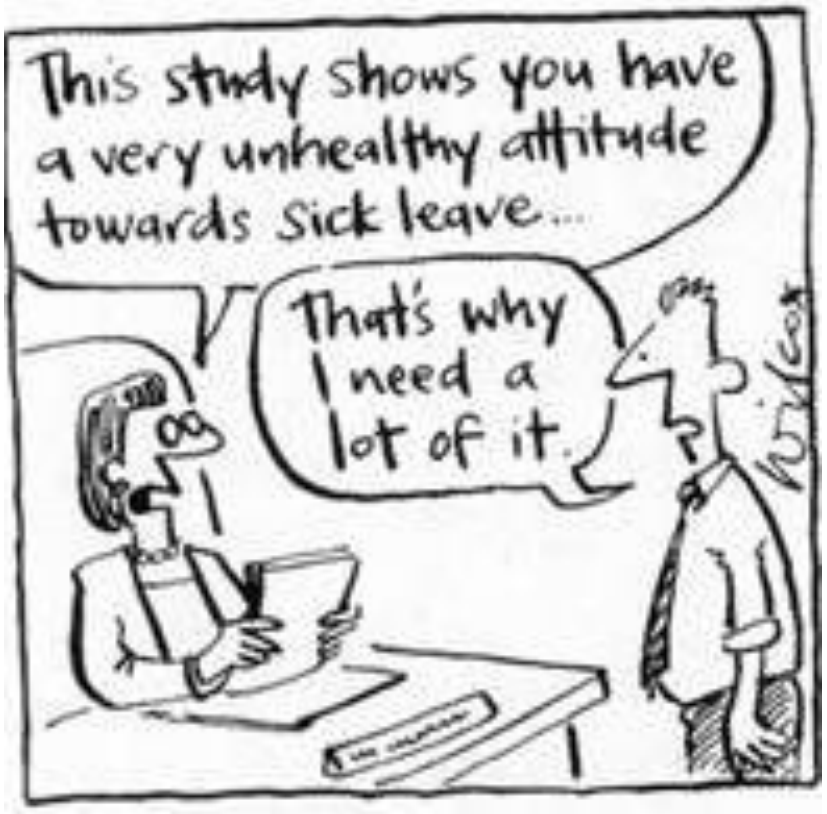
Sick leave increased

The 7 Habits training neutralized organizational efforts to reduce absenteeism. Likelihood to call in sick:

- decreased for employees in the **control condition**
  - median attendance spell 182 days
- **remained unchanged** in the **training condition**
  - median attendance spell 121 days
  - 1.51 times higher likelihood to call in sick compared to control condition



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Managers became more autocratic

- Managers who attended the 7 Habits training increased in their follower-rated autocratic and transactional leadership behaviors.
- Managers who also attended the coaching (train-the-trainer) variant after attending the general training variant of the 7 Habits training increased in their follower-rated transformational leadership behaviors.

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No improvement in performance

- Participation in the 2-day personal growth training **increased** the engagement in **self-rated innovative work behavior**, both on the individual and team-level.
- However, we found **no increases** in self-rated measures of team or individual **work performance.**

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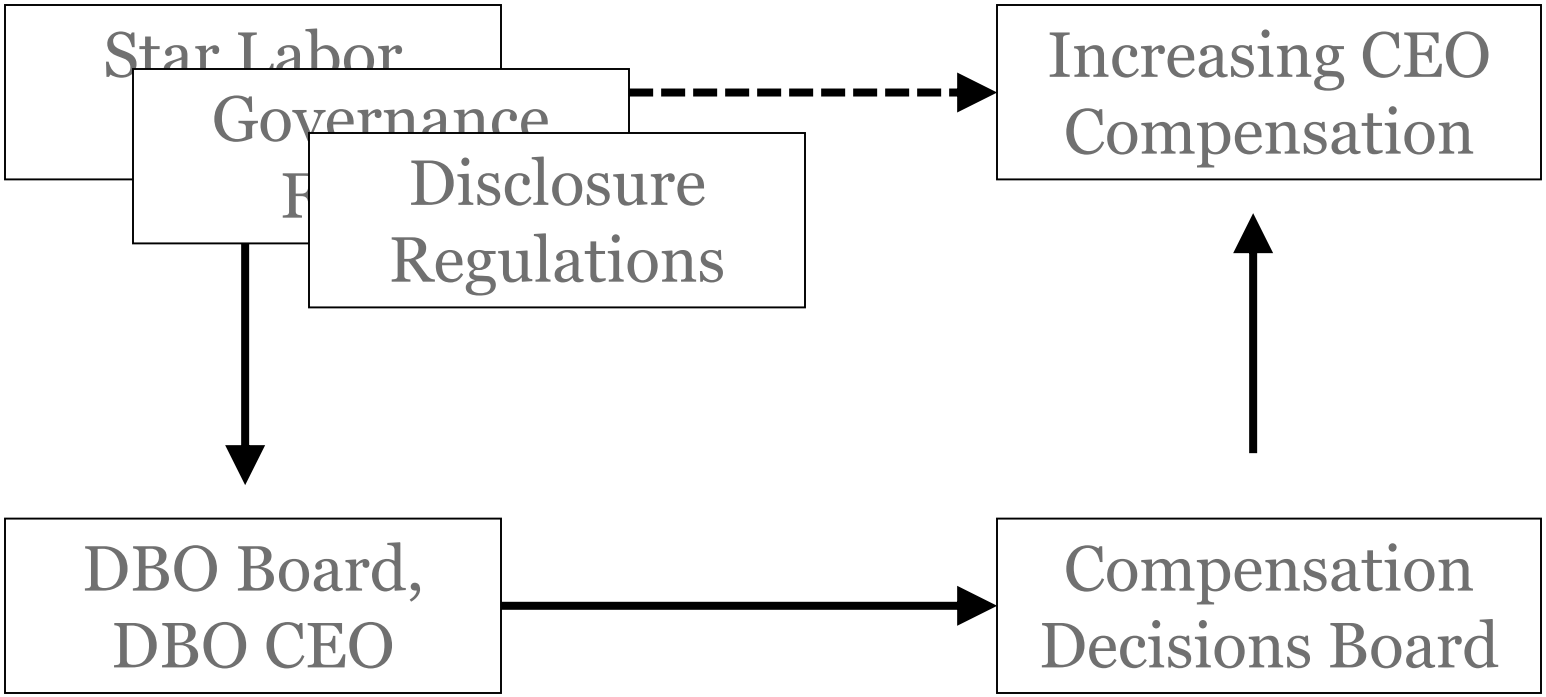
Case 3: Feedback Loops
CEO Compensation and Sustainable Cooperation

Disclosure Regulations and Compensation



Multiple macro predictors, single macro outcome.
Multiple micro predictors, single micro outcome.
Multiple types of actors and multiple mechanisms.

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Macro I

Star Labor Markets

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Mechanism 1: Efficient Contracts

- Key argument: it is not a failure, but the play of market forces!
- Market for executive talent is competitive
  - Pay results from the bidding of firms for scarce talent
  - Pay is efficiently structured to address incentive problems
- Increase in CEO pay reflects…
  - growing importance of general skills to run modern firm
  - trend toward more externally hired CEOs (up from 15% in the 1970s to more than 26% in the 1990s)
- Relationship between size and executive pay
  - CEOs of larger firms are more highly paid.
  - Growth in CEO pay reflects growth in firm size

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Efficient Contracts: Counterevidence

- Firm size explains only 50% of the increase in compensation (Nagel, 2008)

“Macro I”

Governance Failures

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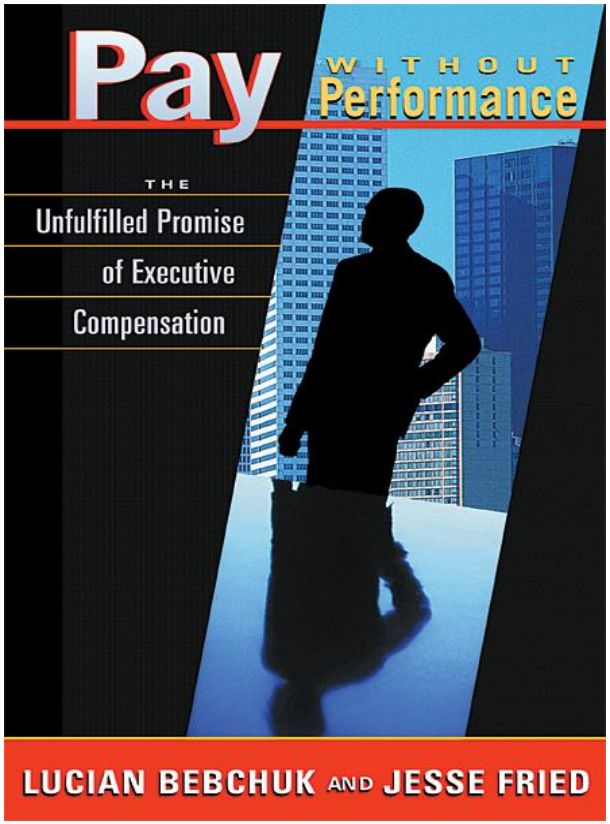
Mechanism 2: Managerial Power



- CEO may have substantial influence over
  - the composition of the board of directors,
  - the compensation committee determining CEO pay,
  - the selection of the compensation consultant advising the compensation committee.
- CEO pay is not the product of arm's-length negotiation because the CEO does not bargain against the owner of the firm

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Managerial Power: Evidence

- CEO pay is higher in firms
  - with a weak board of directors,
  - no dominant outside shareholder,
  - a manager possessing a larger ownership stake
  - more outside board members appointed by the CEO
  - more board members serving on three or more boards
  - board members with a smaller ownership stake in the firm
  - CEOs who also serve as chairman of the board.
- Powerful CEOs are able to increase not only their own pay but also the pay of their subordinates.

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Managerial Power: Counterevidence

- Difficulties in explaining the rise in CEO pay in recent decades, because corporate governance strengthened
  - corporate boards contain more external directors
  - takeovers grew more prevalent
  - Increasing shareholder activism

“Macro I”

Disclosure Regulations

Executives' Use Of Perquisites Draws Scrutiny

By MICHAEL C. JENSEN

Scores of American corporations, large and small, are disclosing for the first time this year details of executive hideaways, personal use of corporate jets, and free financial and medical services provided to high-ranking company officials and their families.

Perquisites, or perks as they are called, have been routinely offered for decades by companies to reward and motivate executives. But abuses have mushroomed in recent years, according to some critics. Government regulators have intensified their scrutiny of perks, and fraud charges are being brought against flagrant violators of the perk system.

"The excesses just got to the point where it became a scandal," Stanley Sporkin, chief of enforcement at the Securities and Exchange Commission, said in an interview.

Company officials defend their perquisite programs as generally modest in relation to overall executive compensation. The sort of comprehensive disclosure program desired by regulators, some say, would be both expensive and unproductive.

"It's a tempest in a teapot and an elec-

Cointinued on Page D4, Column 5

"Personal-Use Perks For Top Executives Are Termed Income: SEC Says Valuable Privileges Will Have to be Reported As Compensation by Firms"

Wall Street Journal (August 22, 1977)

"SEC Acts to Have More Corporate Aides Disclose Pay, Nonsalary Compensation"

Wall Street Journal (July 27, 1978)

Regulatory Efforts

- Perquisites (1970s)
  - SEC Release No. 5856 (18 August 1977)
- Golden Parachutes (1980s)
  - Deficit Reduction Act 1984
- Stock Options (1990s)
  - Financial Accounting Standards Board Rule 123 (1995)
- Accounting Irregularities (2000s)
  - Sarbanes-Oxley Act (July 2002)
- Wall Street Reform and Consumer Protection
  - Dodd-Frank Act (July 21, 2010)

Example: Perquisites (“Perks”)

- the personal use of company aircraft
- personal and home security services
- tax and financial planning services
- insurance premiums
- company cars
- personal drivers
- tax reimbursements
- club memberships

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Example: Disclosure Rules agains Perks

Stanley Sporkin, SEC Enforcement Chief justifying new disclosure requirements

SEC Release No. 5856, 18 August 1977

- Requires disclosure of perquisites given to top executives
- "Excesses just got to the point where it became a scandal." (Sorkin)
- Guilt by Ostentation
  - "at least, this is what the prosecution in such cases hopes"
- The SEC routinely expanded disclosure requirements, with major overhauls in 1978, 1993, 2006, and 2011

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Ineffective Regulation (I)

- The measures regulating pay have largely been **ineffective**, or even counterproductive, in restraining CEO pay
- The US adopted legal measures during the 1990s and 2000s to increase board independence, and board independence has increased since the mid-1980s. But these **regulatory measures did not reduce CEO pay**.

Michael Bognanno

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Ineffective Regulation (II)

FONDAZIONE RODOLFO DE BENEDETTI

The Executive Compensation Controversy: A Transatlantic Analysis*

Martin J. Conyon, The Wharton School
Nuno Fernandes, IMD International
Miguel A. Ferreira, Universidade Nova de Lisboa
Pedro Matos, University of Southern California
Kevin J. Murphy, University of Southern California

13 February 2011

- The fact that the use of options exploded following these new disclosure rules provides additional evidence on the **ineffectiveness of disclosure** in reducing perceived excesses in compensation.
- …there is **no evidence** that increased mandated disclosure had in fact led to decreased use of perquisites".
- This "clawback" provision of Sarbanes Oxley (…) was notable mostly for its **ineffectiveness**

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Micro I + II

Situational and Action Generating Mechanisms

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Actors and Context

- CEO
- Board
- Relation Board-CEO
- (Labor Market) Context
- Compensation Package

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Mechanism 3: Relational Signals

Cues about signaler's intention to initiate and maintain a mutually rewarding relationship with the receiver of the signal

Hidden quality: the degree to which the signaler is (still) committed to build or maintain a mutually beneficial relationship with the receiver of the signal

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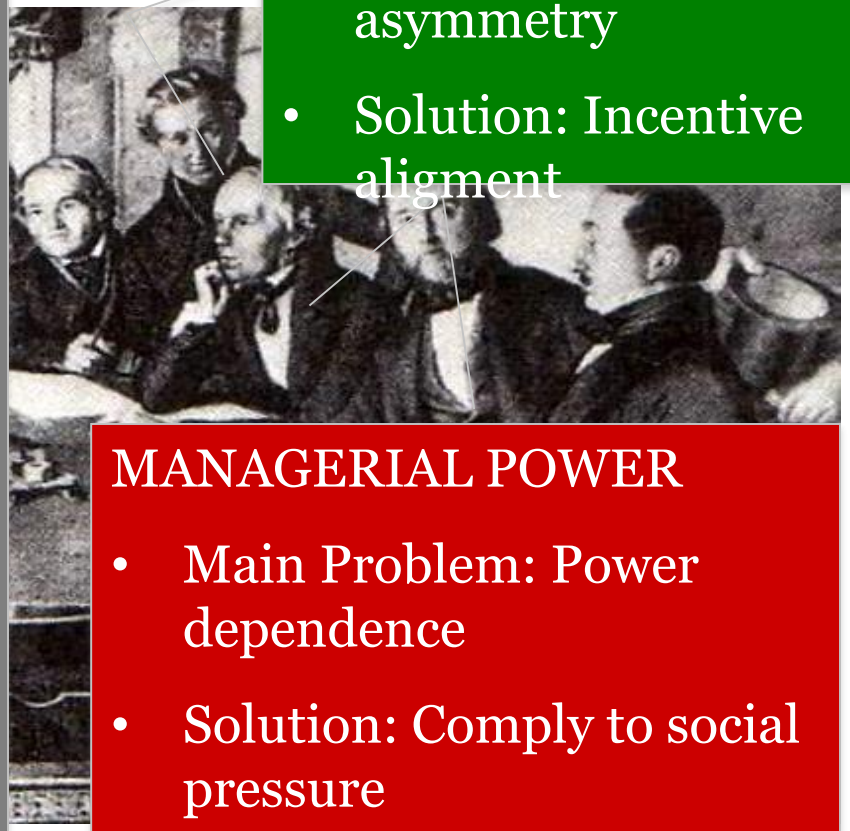
The Board

RELATIONAL SIGNALING

- **Main Challenge:** attracting talented (new) CEOs, retaining good ones), and building as well as maintaining a good, long-term personal work relationship
- Main Problem: How to signal unobservable intentions:
  - Commitment
  - Trust in expertise/competence
  - Willingness to support (e.g. against criticism)
- Solution: Costly gifts

EFFICIENT CONTRACTS

- Main Problem: Information asymmetry
- Solution: Incentive aligment



MANAGERIAL POWER

- Main Problem: Power dependence
- Solution: Comply to social pressure

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The CEO

RELATIONAL SIGNALING

- Status seeking
- Sensitive to social reciprocity obligations
- Seeks for credible cues signaling commitment of Board

EFFICIENT CONTRACTS AND MANAGERIAL POWER

- Selfish rent seeking
- not sensitive to social reciprocity obligations
- Seeks highest offer

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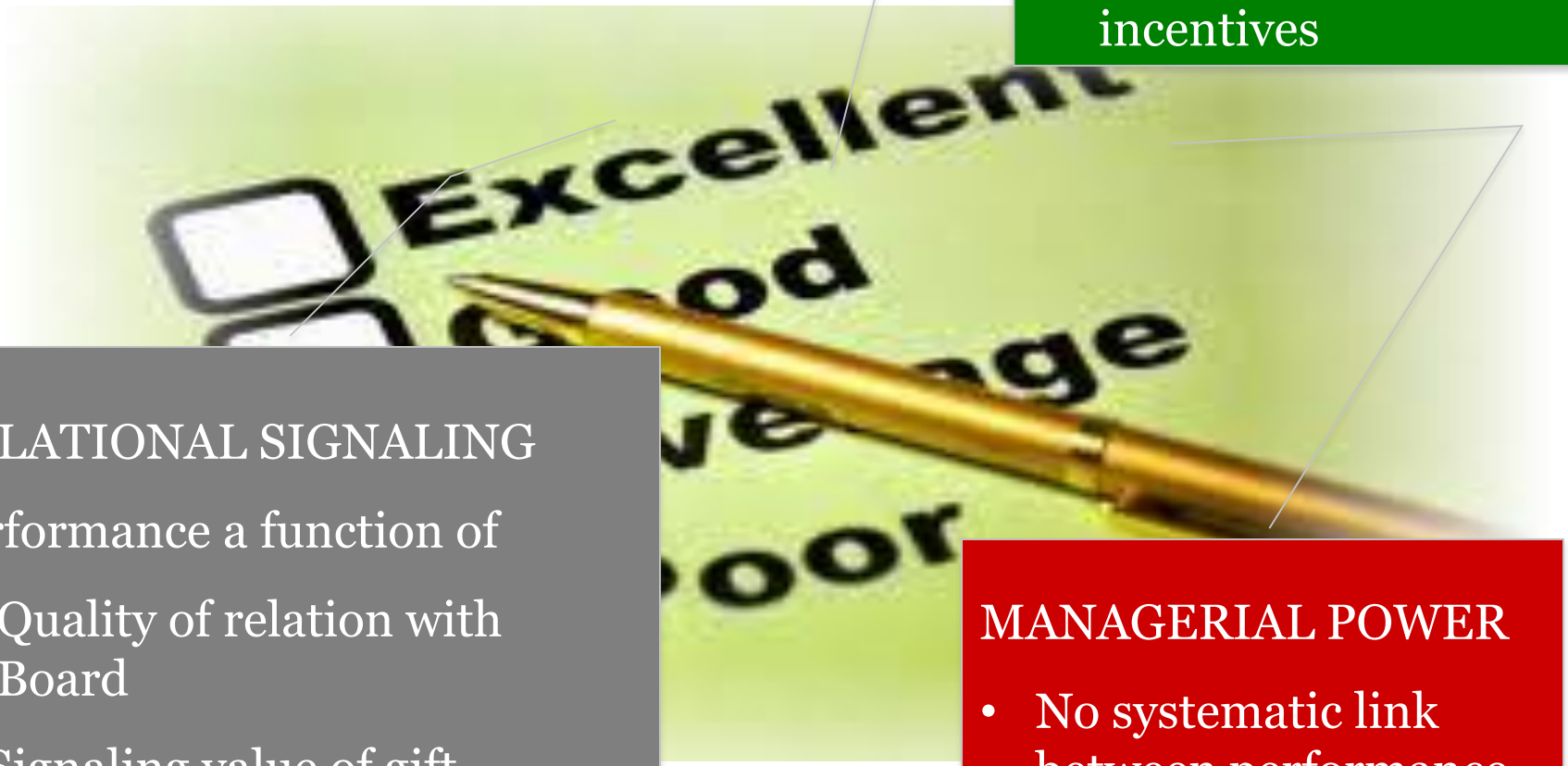
The CEO

EFFICIENT CONTRACTS

- Performance is a function of size of incentives



RELATIONAL SIGNALING

Performance a function of

- Quality of relation with Board
- Signaling value of gift

MANAGERIAL POWER

- No systematic link between performance and incentives

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The Board-CEO Relation

EFFICIENT CONTRACTS

- Arm's length market transaction
- Monitoring necessary for contract enforcement

RELATIONAL SIGNALING

- Trust relation
- Monitoring = perceived as negative signal

MANAGERIAL POWER

- Dependence relation
- Monitoring not effective

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The Labor Market and Institutional Context

EFFICIENT CONTRACTS

Scarce skills, affect "price" of CEOs

RELATIONAL SIGNALING

Part of signaling environment, affects costs and status value of signals

MANAGERIAL POWER

Governance failure affecting power balance between CEO and Board

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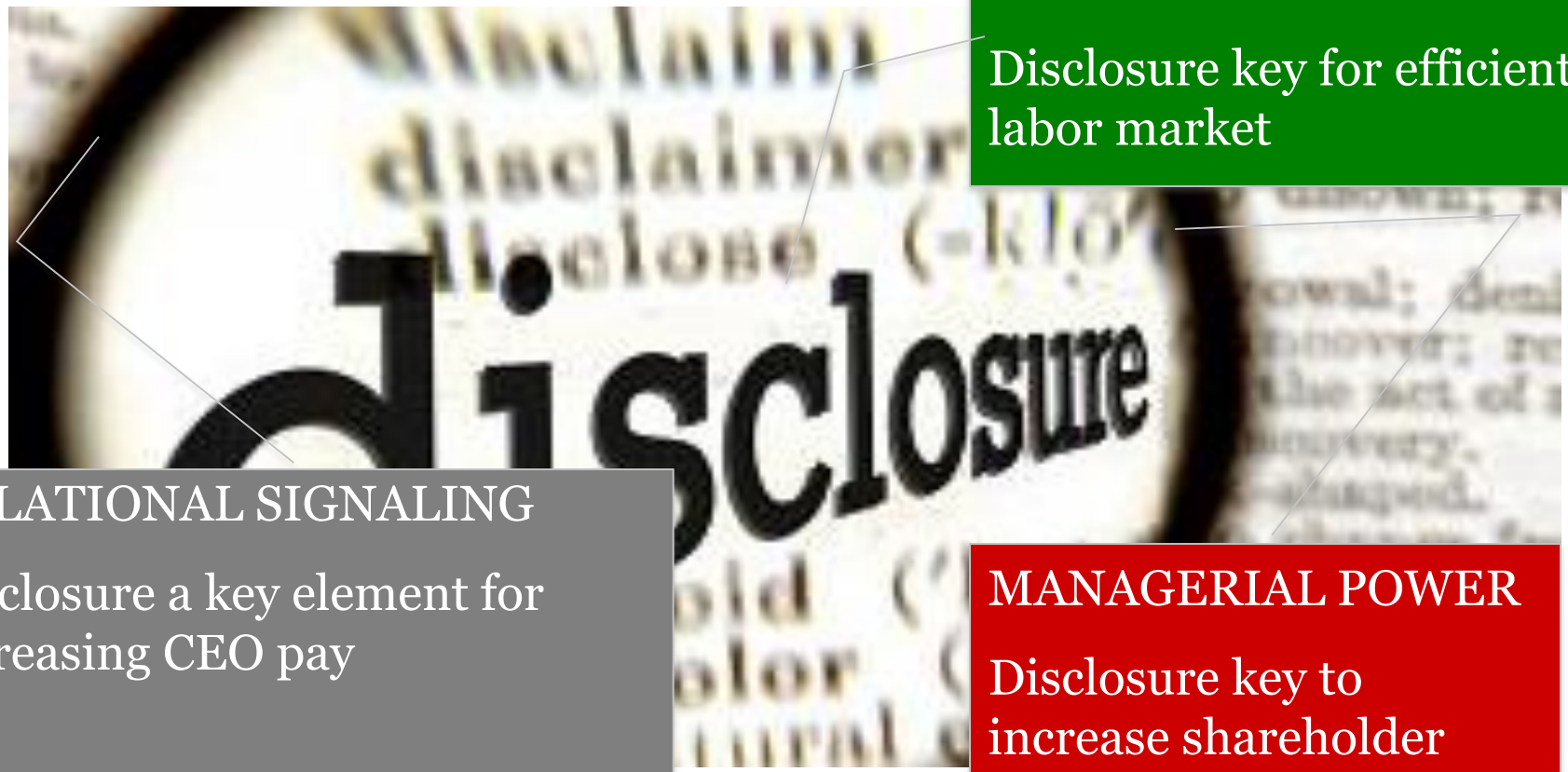
The Labor Market and Institutional Context



EFFICIENT CONTRACTS

Disclosure key for efficient labor market

RELATIONAL SIGNALING

Disclosure a key element for increasing CEO pay

MANAGERIAL POWER

Disclosure key to increase shareholder power

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Example: Disclosure Rules Again

- December 15, 2006, SEC
  - firms have to reveal the benchmark firms they use when determining the pay of a CEO
- RST prediction
  - Boards will anticipate on the relational signaling implications of the choice of a reference group
  - A higher status reference group is a relational signal
  - Results in upward bias, skewed benchmarking
- Efficient Contracts
  - Value of CEO can be covered by variable elements of pay
  - Skewed benchmarking not necessary
- Managerial Power
  - Skewed benchmarking would equal public recognition of Board being subject to CEO pressure

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Micro II + Macro II

Aggregation Mechanism

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Evidence

Compensation Benchmarking, Leapfrogs, and the Surge in Executive Pay[1]

Thomas A. DiPrete and Gregory M. Eirich
Columbia University

Matthew Pittinsky
Arizona State University

Scholars frequently argue whether the sharp rise in chief executive officer (CEO) pay in recent years is "efficient" or is a consequence of "rent extraction" because of the failure of corporate governance in individual firms. This article argues that governance failure must be conceptualized at the market rather than the firm level because excessive pay increases for even relatively few CEOs a year spread to other firms through the cognitively and rhetorically constructed compensation networks of "peer groups," which are used in the benchmarking process to negotiate the compensation of CEOs. Counterfactual simulation based on Standard and Poor's Execu-Comp data demonstrates that the effects of CEO "leapfrogging" potentially explain a considerable fraction of the overall upward movement of executive compensation since the early 1990s.

INTRODUCTION

Income inequality has been rising in the United States since the late 1970s, with most of the increase since the early 1990s being at the top of the income distribution. Some attribute the increase primarily to technical

› Simulation study suggests leapfrogging of some firms can explain upward trend since 1990s

Comparative Assessment

- RST does not need the following assumptions
  - changing tasks of CEOs over time
  - increasing scarcity of managerial talent
  - corporate governance failure
  - power asymmetry between board and CEO
  - "greedy" CEOs
- RST can explain **both**,
  - the relative stability of CEO pay until the 1980s
  - the constant increase of CEO pay since the 1980s

Conclusion

Cooperation Science 2.0

- From what gets cooperation going to what keeps cooperation going.
- Cooperation is sustainable if it succeeds to produce internal benefits and social value, even under changing circumstances (external shocks, spill-over effects, and self-reinforcing cycles).
- Social Mechanism Reasoning is essential to explain under which conditions it is most likely, and to design appropriate institutional arrangements.

Further Reading

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