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# Corporate governance and corporate social responsibility

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# Chapter 1. Introduction

## 1.1 Moving Towards a Stakeholder Model of Corporate Governance

Corporate governance deals with the mechanisms that oversee decision making within firms (Hambrick, Werder, & Zajac, 2008). As shown in Figure 1.1, corporate governance mechanisms exist at multiple levels, ranging from board structures, ownership structures, and corporate governance policies that are more to the micro direction (internal to the firm) to legislative, cultural, and economic institutions that are more to the macro direction (external to the firm) (Aguilera, Desender, Bednar, & Lee, 2015; Hambrick et al., 2008). Through these mechanisms, corporate governance determines what firms can do and how the risks and returns from firm activities are allocated among the parties with a stake in the firm (Aguilera & Jackson, 2010; Filatotchev & Nakajima, 2014). Therefore, the quality of corporate governance is of profound significance to various corporate actors, as well as to the economic system as a whole (Aguilera et al., 2015; Hambrick et al., 2008).

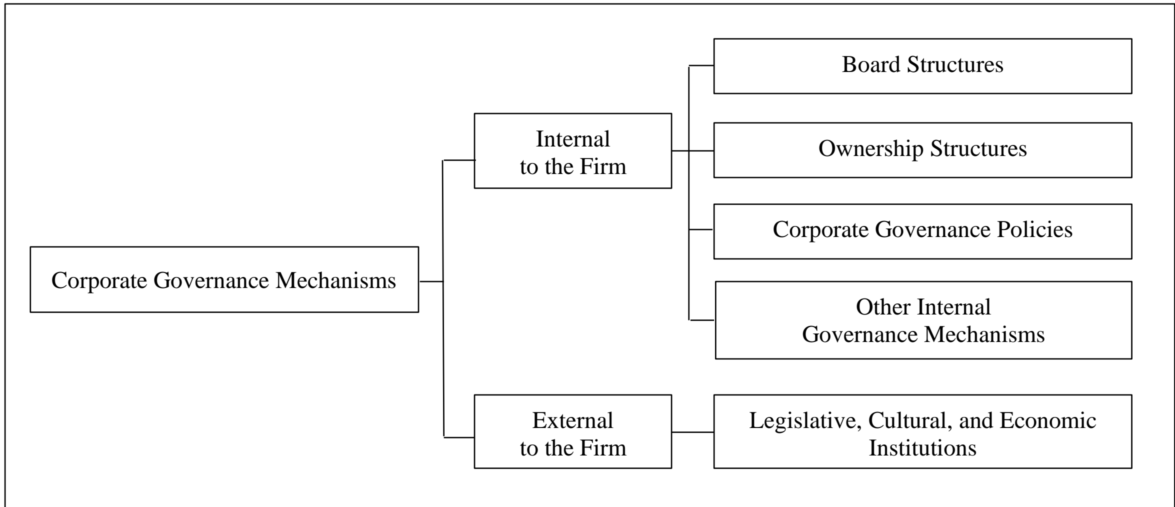


Figure 1. 1 Corporate governance mechanisms

The idea of what constitutes good governance is closely tied to how one conceptualizes corporations (Aguilera & Jackson, 2010). As the concept of corporations has

evolved in the past decades, so have the boundaries and goals of corporate governance (Aguilera et al., 2015; Hambrick et al., 2008; Walls, Berrone, & Phan, 2012). The traditional model of corporate governance takes an agency perspective (Fama & Jensen, 1983; Jensen & Meckling, 1976), viewing corporations as a nexus of contracts between shareholders and management, defining the goal of corporations merely as maximizing shareholder value, and focusing on mechanisms to mitigate the principle-agent problem caused by the separation of ownership and control (Adams, Hermalin, & Weisbach, 2010; Dalton, Hitt, Certo, & Dalton, 2007; Hambrick et al., 2008).

However, since the 1990s, the scope of corporate governance has broadened to encompass multiple stakeholders who can affect or are affected by a firm's operations (Aguilera et al., 2015; Hambrick et al., 2008; Walls et al., 2012). Stakeholder theory (Freeman, 1984) has been the most preferred lens for understanding the rise of the stakeholder model of corporate governance. This theory views corporations as a set of relationships among stakeholders, including not only shareholders, but also creditors, employees, customers, suppliers, the community, the environment, and ultimately society at large (Aguilera & Jackson, 2010; Parmar et al., 2010). According to the tenets of stakeholder theory, maintaining a good relationship with stakeholders is essential for firms to secure long-term survival and success (Freeman, 1984; Laplume, Sonpar, & Litz, 2008).

As the field of corporate governance moves towards a stakeholder model, it has also increasingly recognized corporate social responsibility (CSR)—the responsibility of firms to actively serve the interests of a broader set of stakeholders beyond their shareholders—as an important part of the corporate goal (Walls et al., 2012; Wang, Tong, Takeuchi, & George, 2016). This trend is well illustrated in the "Davos Manifesto 2020" from World Economic Forum, which redefine the purpose of a corporation as to engage all its stakeholders in shared and sustained value creation. The "Davos Manifesto 2020" argues that companies should no

longer serve only the interests of their shareholders, they must also commit to satisfying the needs of customers, treating employees with dignity and respect, forstering diversity and inclusion at work, dealing with suppliers ethically, supporting the community, protecting the environment, and improving the state of the world.[1]

At the same time, various corporate governance mechanisms that aim at fostering CSR have emerged in response to calls from the public, policymakers, and researchers. For instance, internal to the firm, we have seen the diffusion of CSR contracting to enhance managerial commitment to CSR (Flammer, Hong, & Minor, 2019) and board gender diversity policies to advance gender equality at the top (Klettner, Clarke, & Boersma, 2016). External to the firm, for example, a growing number of countries have established CEO-to-worker pay ratio disclosure requirements to reduce income inequality and board gender quotas to promote more gender-balanced boards (Terjesen, Aguilera, & Lorenz, 2015).

## 1.2 Corporate Governance and CSR

CSR reflects the extent to which a firm actively engage in satisfying a broader range of stakeholder demands (Jamali, Safieddine, & Rabbath, 2008; Tang, Qian, Chen, & Shen, 2015). Corporate governance plays an important role in CSR to the extent that it shapes the structure of rights and responsibilities among stakeholders and thus, the importance of CSR in firm resource allocation (Aguilera & Jackson, 2003; Devinney, Schwalbach, & Williams, 2013; Hambrick et al., 2008; Jain & Jamali, 2016). The move from a shareholder model towards a stakeholder model of corporate governance reflects the growing demand for firms to engage in CSR and respect the rights of non-shareholder stakeholders (Aguilera, Florackis, & Kim, 2016; Bundy, Shropshire, & Buchholtz, 2013). Specifically, firms are increasingly

[1] https://www.weforum.org/agenda/2019/12/davos-manifesto-2020-the-universal-purpose-of-a-company-in-the-fourth-industrial-revolution/, Davos Manifesto 2020: The Universal Purpose of a Company in the Fourth Industrial Revolution, Accessed February 16, 2020.

expected to be actively involved not only in managing the negative externalities of their operations, but also in addressing the world's most pressing societal challenges such as climate change, poverty, data fraud/theft, income inequality, and gender disparity (Wang et al., 2016).

Advocates of CSR have long argued for the business case for CSR, namely, a positive relationship between CSR and firm performance. The theoretical foundation of the business case for CSR lies in stakeholder theory (Freeman, 1984), which emphasizes the interdependence between firms and their stakeholders (Laplume et al., 2008; Parmar et al., 2010). According to stakeholder theory, CSR creates value for firms by improving stakeholder relationships (e.g. developing trust and cooperative relationships with stakeholders) that reduce the firms' transaction costs and risks and increase the firms' competitive advantages, reputation, and legitimacy (Barnett & Salomon, 2012; Hillman & Keim, 2001; Kurucz, Colbert, & Wheeler, 2008). Not only do these benefits associated with CSR and good stakeholder relations enable firms to gain and sustain superior financial performance, they also help firms temper punitive stakeholder sanctions when negative events occur (Godfrey, Merrill, & Hansen, 2009; Lins, Servaes, & Tamayo, 2017) and recover more quickly from inferior performance (Choi & Wang, 2009).

Although, as discussed above, a positive relationship between CSR and firm performance can be expected through improved stakeholder relations, improving these relations is a slow and time-consuming process (Brammer & Millington, 2008; Freeman, 1984; Godfrey et al., 2009; Gupta & Misangyi, 2018; Kacperczyk, 2009; Kang, 2016; Ogden & Watson, 1999; Servaes & Tamayo, 2013). Therefore, it is widely acknowledged that the financial benefits from investing in CSR are more likely to materialize in the long term (Berrone & Gomez-Mejia, 2009; Deckop, Merriman, & Gupta, 2006; Dyck, Lins, Roth, & Wagner, 2019; Kang, 2016; Oh, Chang, & Cheng, 2016). In the short term, however, firms

often have to endure financial sacrifices when they commit resources to CSR, because advancing CSR is costly in terms of both finance and managerial attention (Barnett & Salomon, 2012; Dorobantu & Odziemkowska, 2017; Gupta & Misangyi, 2018; Kock, Santaló, & Diestre, 2012; Surroca, Tribó, & Zahra, 2013).

Given the long-term nature of CSR, which brings uncertainty, and the short-term performance implications of CSR, it is reasonable to expect that many firms may avoid CSR and allocate resources to more conservative investments (Berrone & Gomez-Mejia, 2009; Campbell, 2018). The ignorance of CSR has resulted in systematic corporate misconduct in the past, such as the Enron and WorldCom accounting scandals, the Exxon Valdez and BP oil spills, and the 2007-2008 global financial crisis, which has caused significant damages to both the economy and society.

Moreover, due to their profound influence on society, corporations play a vital role in addressing the most pressing challenges facing the world such as climate change, income inequality, and gender disparity (George, Howard-Grenville, Joshi, & Tihanyi, 2016; Joshi, Neely, Emrich, Griffiths, & George, 2015; Tsui, Enderle, & Jiang, 2018). Failing to tackle these challenges may be costly: climate change threatens human health and sustainability,[2] income inequality erodes a country's social fabric,[3] and gender disparity impedes the full development and appropriate deployment of half the world's total talent pool.[4] Corporations can prevent climate change by mobilizing substantial resources to improve energy efficiency and advance renewable energy.[5] They can reduce income inequality by narrowing the pay gap between top executives and rank-and-file employees (Tsui et al., 2018) and investing in

[2] https://climate.nasa.gov/effects/, NASA: The Effects of Climate Change, Accessed September 18, 2019. https://ec.europa.eu/clima/change/consequences_en, European Commission: Climate Change Consequences, Accessed September 18, 2019.
[3] https://wir2018.wid.world/files/download/wir2018-full-report-english.pdf, World Inequality Lab: World Inequality Report, Accessed September 18, 2019.
[4] https://www.weforum.org/reports/the-global-gender-gap-report-2018, World Economic Forum: Global Gender Gap Report, Accessed September 18, 2019.
[5] https://www.businessroundtable.org/policy-perspectives/energy-environment, Business Roundtable: Energy and Environment, Accessed September 18, 2019.

employee professional development.[6] As employers, corporations are also influential in mitigating gender disparity by promoting diversity and inclusion in the work place.[7]

Recognizing the power of corporations to impose damages on society and to address societal challenges, both academics and policymakers have been keen on understanding ***the effectiveness of different corporate governance mechanisms in enhancing firm commitment to CSR*** (Devinney et al., 2013; Jain & Jamali, 2016; Ryan, Buchholtz, & Kolb, 2010; Walls et al., 2012). This also forms the main research question of my dissertation.

## 1.3 Research Gaps

The question which corporate governance mechanisms can positively contribute to CSR has become a burgeoning field of study in the past two decades (Oh, Chang, & Kim, 2018). With internal corporate governance mechanisms as the focus, this stream of research has linked CSR to traditional good governance practices such as board independence, board gender diversity, CSR committees, long-term incentives, institutional ownership, and shareholder activism (for reviews, see Jain & Jamali, 2016; Walls et al., 2012). Regarding external corporate governance mechanisms, a number of studies have examined how legal, cultural, and economic institutions influence a firm's CSR commitment (for reviews, see Aguinis & Glavas, 2012; Jain & Jamali, 2016). Notably, the role of corporate governance in encouraging firms to address societal grand challenges such as climate change, income inequality, and gender disparity has received growing attention in the literature (Berrone & Gomez-Mejia, 2009; Connelly, Haynes, Tihanyi, Gamache, & Devers, 2016; Iannotta, Gatti, & Huse, 2016; Kogut, Colomer, & Belinky, 2014; Tsui et al., 2018; Walls et al., 2012).

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[6] https://www.businessroundtable.org/policy-perspectives/building-americas-tomorrow-ready-workforce/workforce-development, Business Roundtable: Workforce Development, Accessed September 18, 2019.

[7] https://www.businessroundtable.org/policy-perspectives/diversity, Business Roundtable: Advancing Diversity and Inclusion, Accessed September 18, 2019.

Notwithstanding the progress that has been made in understanding the effects of different corporate governance mechanisms on CSR, several opportunities exist to further explore this relationship. First, the effects of internal and external corporate governance mechanisms on CSR are examined separately. Studies on internal corporate governance mechanisms frequently take the agency or resource dependence perspectives, focusing on mechanisms that may better monitor management or enhance firm awareness of non-shareholder stakeholders' interests (e.g. Berrone & Gomez-Mejia, 2009; Deckop et al., 2006; Graves & Waddock, 1994; Hillman, Keim, & Luce, 2001; Johnson & Greening, 1999; Kock et al., 2012; Neubaum & Zahra, 2006; Walls et al., 2012). Yet, these studies have provided mixed empirical evidence (Oh et al., 2018; Walls et al., 2012), which may be partially attributed to the ignorance of a firm's external governance environment (Aguilera et al., 2015). Studies on external corporate governance mechanisms generally draw upon institutional theory to examine the direct effect of these mechanisms on CSR (e.g. Campbell, 2007; Hartmann & Uhlenbruck, 2015; Ioannou & Serafeim, 2012; Keig, Brouthers, & Marshall, 2015). Nevertheless, our knowledge of how external corporate governance mechanisms affect CSR indirectly through shaping the effectiveness of internal corporate governance mechanisms is limited (Aguilera et al., 2015).

Second, few studies have considered whether the relationship between a specific corporate governance mechanism and CSR varies in different temporal contexts. The corporate governance system is composed of human actors whose preferences and behavior are deeply influenced by the larger environment they are embedded in. Hence, as the market conditions and social norms evolve over time, corporate governance actors may adjust their behavior accordingly, which may change their impact on CSR. For example, quasi-indexers, a

group of institutional investors who are characterized as passive monitors of firm activities, have become more active in promoting CSR among firms in which they hold shares.[8]

Third, most studies have investigated how certain corporate governance mechanisms affect a firm's involvement in CSR (for reviews, see Jain & Jamali, 2016; Walls et al., 2012), whereas less attention has been directed to how a firm makes use of socially responsible governance structures. This begs the questions whether some socially responsible governance mechanisms are adopted merely for symbolic reasons and what kind of firms are more likely to commit symbolic adoption of socially responsible governance structures. These questions are essential for understanding the relationship between corporate governance and CSR.

## 1.4 An Overview of the Dissertation

This dissertation contains three empirical studies that are designed to advance our knowledge about the effectiveness of different corporate governance mechanisms in enhancing CSR, with a focus on addressing the above three research gaps. Specifically, Chapter 2 addresses the third research gap by exploring what kind of firms are more likely to have NGO directors on boards for symbolic reasons, Chapter 3 deals with the second research gap by examining whether institutional investors' influence over a firm's executive-to-worker pay dispersion has changed since the 2007-2008 financial crisis, and Chapter 4 tackles the first research gap by taking a holistic perspective to investigate how the effect of firm-level board gender diversity policies on women representation on boards is moderated by country-level legal, cultural, and economic institutions. As one may notice and as will be explained later, the three empirical chapters approach CSR differently to facilitate theory building and testing. Each chapter is written as an independent paper and therefore can be read separately from the rest

[8] https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter, Larry Fink's 2019 letter to CEOs, Accessed September 18, 2019. https://www.ft.com/content/a28203d8-067d-11e8-9650-9c0ad2d7c5b5, Financial Times: In the Vanguard: Fund giants urge CEOs to be 'Force for Good', Accessed September 18, 2019.

of the dissertation. At the end of the dissertation is a general conclusion—Chapter 5—which discusses the dissertation's main findings, contributions, and avenues for future research. In the following sections, I introduce each chapter briefly.

### *1.4.1 A Summary of Chapter 2: Corporate Social Responsibility and NGO Directors on Boards*

Chapter 2 examines the symbolic presence of NGO directors on corporate boards. We[9] define NGOs as private, not-for-profit organizations that "aim to serve particular societal interests by focusing advocacy and/or operational efforts on social, political and economic goals, including equity, education, health, environmental protection, and human rights" (Teegen, Doh, & Vachani, 2004: 4). Examples of NGOs include the National Association for the Advancement of Colored People, the AmeriCares Foundation, the Bill & Melinda Gates Foundation, and the World Wildlife Fund. NGO directors are directors who have work experience as executives of NGOs. We focus on NGO directors because they possess CSR-related expertise and connections that other directors may not have and thus their presence on boards provides significant symbolic value for firms by signaling the firms' social awareness and credibility (Krause, Wu, Bruton, & Carter, 2019; Yaziji, 2004).

This study consists of two related parts. First, we explore what predicts the presence of NGO directors on boards. Specifically, we expect firms with poor CSR performance in the past to be more likely to have NGO directors on their boards because these firms face a higher risk of losing legitimacy, which makes them benefit more from the presence of NGO directors. Then we examine the effect of the presence of NGO directors on CSR performance. We argue that NGO directors may not enhance CSR performance as firms may appoint such directors merely for their symbolic value.

[9] Since the underlying papers of Chapter 2-4 are joint work, I use "we" instead of "I" to acknowledge the contribution of the co-authors.

Results from an analysis of 157 S&P firms between 2012-2014 show that NGO directors are more prevalent among firms with worse CSR records as compared to peers. We also find that the presence of NGO directors on boards is not associated with subsequent improvements in CSR performance. Our findings suggest that the presence of NGO directors on boards may play a merely symbolic role.

#### *1.4.2 A Summary of Chapter 3: Institutional Investor Influence on Executive-to-Worker Pay Dispersion after the Financial Crisis*

Whereas Chapter 2 looks at a firm's overall CSR profile, Chapter 3 considers a specific CSR issue, namely executive-to-worker pay dispersion. As worries about income inequality keep growing, public outrage over the large pay gap between top executives and rank and file employees has crested after the 2007-2008 financial crisis (Dillon, 2009; Kaplan, 2013). Corporations play an essential role in reducing income inequality because how they compensate their employees represents one of the main sources of income inequality (Tsui et al., 2018).

We link executive-to-worker pay dispersion to institutional ownership, which provides a perfect context for investigating how the effect of corporate governance mechanisms changes in different time periods for two reasons. First, the issue salience of executive-to-worker pay dispersion has intensified dramatically since 2007 in the US as a result of the 2007-2008 global financial crisis, which increases public fury over income inequality, and the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires listed firms to disclose the ratio of their CEO to median worker pay. Second, the market share of different types of institutional investors (i.e. transient investors, dedicated investors, and quasi-indexers) has changed significantly in the past years, with quasi-indexers growing to be the largest institutional investors in the US. In August 2019, assets under management by

index funds have exceeded those managed by active funds, granting quasi-indexers considerable power to determine firm actions.[10] These two trends may have changed how different types of institutional investors perceive the risks associated with large executive-to-worker pay dispersion and thus their impact on corporate pay practice.

Therefore, the purpose of Chapter 3 is to examine whether the influence of different types of institutional investors on executive-to-worker pay dispersion has changed since the 2007-2008 financial crisis. We do so by replicating and extending Connelly, Haynes, Tihanyi, Gamache, and Devers (2016). Using a sample of S&P 1500 firms in the period of 1996-2006, the original study reports that transient institutional investors positively affect executive-to-worker pay dispersion, while dedicated institutional investors negatively affect executive-to-worker pay dispersion. Our replication considers whether these relationships remain consistent over time and whether quasi-indexers, which make up the largest group of institutional investors yet are ignored by the original study, play a role in shaping executive-to-worker pay dispersion.

Whereas we are able to reproduce Connelly et al.'s (2016) findings for the period they focus on, our results show that the impact of transient institutional investors on executive-to-worker pay dispersion turns negative during 2007-2017. We also find that quasi-indexers function as a key force in reducing executive-to-worker pay dispersion during 2007-2017, though their impact is insignificant before this period. Our findings highlight the importance of temporal context as a boundary condition in understanding institutional investor influence over executive-to-worker pay dispersion. Moreover, we demonstrate that quasi-indexers' influence over corporate governance outcomes should not be overlooked.

[10] https://www.wsj.com/articles/index-funds-are-the-new-kings-of-wall-street-11568799004, The Wall Street Journal: Index Funds Are the New Kings of Wall Street, Accessed September 22, 2019.

### *1.4.3 A Summary of Chapter 4: Board Gender Diversity Policies and Women on Boards around the World*

In Chapter 4, we study another burgeoning CSR issue in the field of corporate governance—board gender diversity (Kirsch, 2018; Mun & Jung, 2018). Board gender diversity has captured worldwide attention among academics, the media, and policymakers since the mid-2000s for both utility and justice reasons (Seierstad, 2016; Terjesen, Sealy, & Singh, 2009). At the same time, governments and corporations have taken many actions to increase the representation of women on boards (Sojo, Wood, Wood, & Wheeler, 2016). For example, by the end of 2018, eleven countries have passed board gender quotas for listed firms[11] and over forty countries have incorporated best practice provisions for board gender diversity into their corporate governance codes or disclosure regulations. At the firm level, board gender diversity policy (BGDP), a formal policy developed by individual firms with the goal of promoting board gender diversity, has diffused around the globe.

The development of corporate governance mechanisms related to board gender diversity at both the firm- and country-levels provides an ideal setting to examine how external corporate governance mechanisms interact—support, constrain, or substitute —with their internal counterparts to shape a firm's CSR outcomes. In Chapter 4, we investigate how the effectiveness of firm-level BGDPs in enhancing women on boards is contingent on the country-level governance environment in which the firm operates. Regarding the country-level governance environment, we consider not only board gender quotas and gendered corporate governance code provisions, but also other gender-related factors such as cultural gender role bias and the supply of female directors.

Based on a sample of 23,476 firm-year observations from 33 countries over the period 2003–2014, we find a positive and statistically significant association between BGDP and the

[11] Countries with board gender quotas for listed firms: Belgium, France, Germany, Iceland, India, Italy, Israel, Malaysia, The Netherlands, Norway, and Spain.

proportion of women on boards. We further show that the extent to which BGDP is effective in increasing women on boards depends on the firm's governance environment. Specifically, we find that board gender diversity provisions in corporate governance codes act as substitutes for BGDP. Gender role bias and a tight supply of female directors weaken the relationship between BGDP and the representation of women on boards.

This paper contributes to the literature on board gender diversity by extending our understanding of the effectiveness of firm-level BGDP in increasing women on boards around the world. Moreover, we contribute to corporate governance research by exploring the interplay between internal and external corporate governance mechanisms. Our findings also provide important insights for policymakers by suggesting that there is no one-size-fits-all approach to creating a more gender-balanced board.

In sum, the three empirical chapters in this book take different perspectives to explore the intersection between corporate governance and CSR. As illustrated in Figure 1.2, Chapter 2 explores the symbolic role of board structures (i.e. NGO directors on boards) in CSR. Chapter 3 examines the effect of ownership structure (i.e. institutional investors) on a firm's CSR practices regarding executive-to-worker pay dispersion, focusing on whether this relationship varies in different temporal contexts. Chapter 4 investigates the effectiveness of a firm's policy regarding its board gender diversity in increasing women representation on boards, emphasizing the moderating role of the external governance environment.

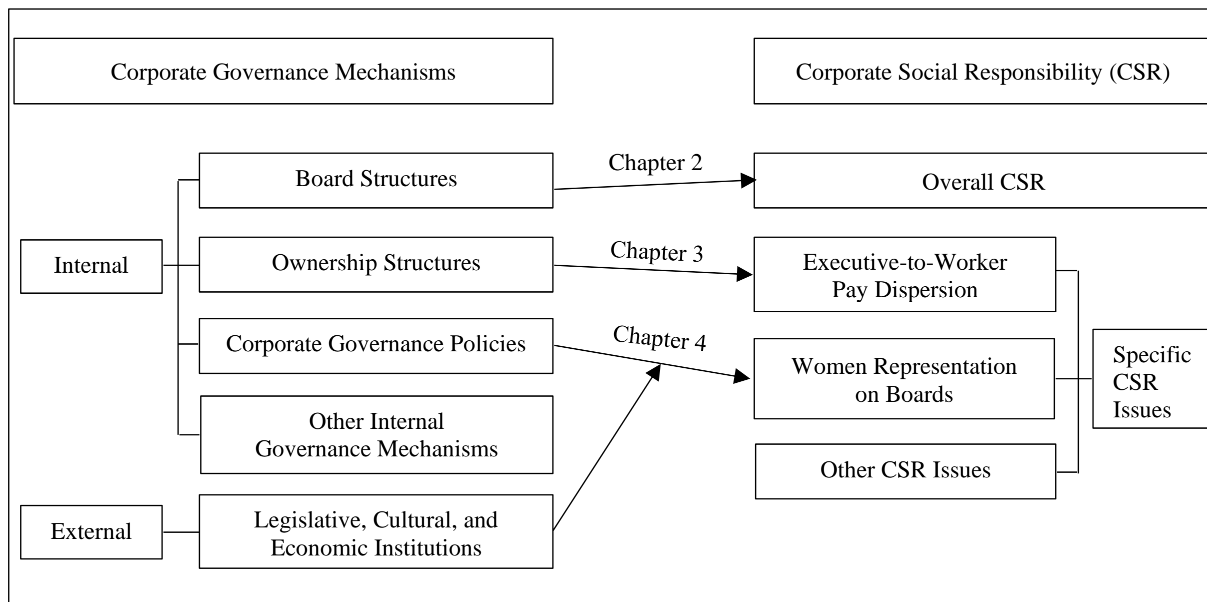


Figure 1. 2 Corporate governance and corporate social responsibility

### *1.4.4 A Summary of Chapter 5: Conclusion*

Chapter 5 provides a general conclusion of the three empirical chapters. In addition to a review of the main findings, Chapter 5 stresses the theoretical implications of these findings to the literature on the relationship between corporate governance and CSR, offers practical suggestions for policymakers, investors, and managers to foster socially responsible firm practice or improve stakeholder relations, reflects on the limitations of our studies, and discusses directions for future research. Chapter 5 ends with a few concluding remarks.