# Political Promotion as Part of Chief Executive Officer's Remuneration

# – An empirical study in China's State-owned Enterprises

Thesis submitted in partial fulfilment of the requirement for the degree of Doctor of Philosophy

ZHANG, Chao

May 2017

# Declaration

I confirm that this is my own work and the use of all material from other sources has been properly and fully acknowledged.

_____ Date:_____

ZHANG, Chao

# Abstract

This thesis attempts to investigate the importance of political promotion among the incentives for CEOs working in China's State-owned Enterprises (SOEs). Data and benchmark regressions in this thesis show that CEOs' monetary payments is not sensitive to firm performance in SOEs. However, there are clear evidences that CEOs have strong incentives to improve firm performance. This observation violates the predictions of traditional CEO remuneration design theory. To account for this difference, this thesis proposes that political promotion matters significantly for CEOs of SOEs. China's SOEs are supervised by the State-owned Asset Supervision and Administration Commission (SASAC), who has the power to decide political promotion of CEOs. Because political promotion is closely related to firm performance and other criteria set by SASAC (such as the growth rate of asset size), this thesis shows that, CEOs of SOEs have strong incentives to improve firm performance in order to increase the chances to be promoted. This thesis uses two case studies and a survey analysis to test the hypothesis. It concludes that CEOs of SOEs care about political promotion far more than monetary payments.

# Acknowledgements

First and foremost, I would like to express my deepest gratitude to my supervisors, Kecheng Liu, Jessica Hong Yang and Zhixiang Zhang for their guidance, support and the unwavering faith that they have in me. Their knowledge, experience, communicative efficiency, and creative abilities are qualities that I could not have hoped for my ideal supervisors to have. They are willing to provide guidance to steer me towards the right direction but not so much as to suffocate my own critical thinking. They also have been immensely helpful in making me think harder about the motivations, potential contributions, importance and positioning of my work. They have encouraged me greatly in my efforts and generously shared their in-depth understanding of the related areas.

Furthermore, I would like to thank the committee that evaluates my thesis. Their comments have greatly helped me to improve my research.

Last but not least, I want to express my sincere thanks to my family. They are very supportive of my Ph.D. study. They have taken care of many daily affairs so that I can concentrate on the study and writing of the thesis. I appreciate all the support and love you have given to me.

# Table of Contents

# Content of Tables and Figures

# Chapter 1. Introduction

## 1.1 Research Background

China is now undergoing a transition from planned economy to market economy. Since the beginning of the Reform and Opening-Up policy in the late 1970s, China has maintained an average annual growth rate of 8%, and now it has become the second largest economy in the world, with its foreign exchange reserves and volume of international trade ranking at the top of the world. SOEs have played an indispensable role in these remarkable achievements.

Different from their counterparts in Western economies SOEs enjoy dominant position in China's economy. Compared to private enterprises SOEs have absolute advantages regarding firm size, sales and market power. Industries such as steel, electricity, telecommunications and mining are monopolized by SOEs.

This phenomenon can also be observed in China's capital market. The earliest IPOs are mostly for the SOEs. A large number of private-owned enterprises went public as the capital market developed. Yet, still more than half of the listed companies in the stock market are SOEs or companies that are actually controlled by the state.

Contrast to the great contributions of SOEs to China's growth, the CEO remuneration is comparatively low. Take the bank industry for example. In 2011,for the non-State-owned banks, the annual salary of the CEO in Ping An Bank was 8,690,000 RMB, which is the highest in the industry; China Merchants Bank offered 5,350,000 RMB to its CEO, and the number in China Minsheng Bank is 5,160,000 RMB. In a striking contrast, the "Big Four", the four biggest state-owned commercial banks—the Industrial and Commercial Bank of China, the Bank of China, the China Construction Bank, and the Agricultural Bank of China—paid an average of less than 2,000,000 RMB for their CEOs annually, while these four banks were dominating the market in size and profitability. Apparently, other factors are considered in the design of the CEO remuneration in China's banking industry. In fact, this is also true in other industries.

Interestingly, the remunerations for CEOs in China's SOEs are quite low compared to the contributions they have made. According to the CSMAR database, China's largest financial research database, the average annual salary of SOE CEOs in 2009 was just 680,000 RMB. While according to Conyon and Murphy (2000), in 1997, CEOs of the top 500 British companies earned an average of £660,000 pounds annually (approximately 9,400,000 RMB), and the salary of CEOs in the top 500 American companies was an average of over £6 million pounds (approximately 85 million RMB). Admittedly, these numbers might have measurement errors, but we can conclude that CEOs of China's SOEs are far less compensated than their counterparts in developed countries.

There are many explanations for this phenomenon. Chen, Firth, and Rui (2006) summarized that the government's active intervention, underdeveloped corporate governance and poor

incentive mechanism designs are three most popular explanations. In the transition from a planned economy to a market economy, economic systems and related laws and policies are far from perfect, thus the government's interventions have been constantly observed. Meanwhile, to avoid income inequality, the government sets an upper limit for CEO remunerations. All these factors imply that the remunerations of CEOs in China's SOEs have unique characteristics.

Another important factor that distinguishes the CEO remuneration in China from that in developed economies is the exceptive characteristics of China's capital market. For instance, there has always been a "split of ownership and rights" ("the Split" in short) in the Chinese stock market. There are outstanding shares as well as non-tradable shares such as State-owned shares, State-Owned Corporate Share, Domestically-funded and Internationally-funded Corporate Share. The only difference between the two is whether the share is tradable. Due to "the Split", there are two stock pricing mechanisms in China: for the non-tradable shares, the price is negotiated for the transfer; and for the tradable shares, the price is determined by auction in the stock market. Compared to tradable shares, the price of non-tradable shares owned by the largest shareholders is significantly lower, and the transfer of shares is much more difficult. Thus the largest shareholders do not pay close attention to their stocks, which means the stock price provides little incentive for CEOs.

Therefore, it is interesting to exam the incentives that CEOs from China's SOE have in managing the enterprises, and there have already been fruitful literatures that address this problem (we review the relevant studies in the chapter of Literature Review). Most of these papers, nevertheless, are constrained by the idea of whether monetary payment, in certain way, can provide enough incentives. They divide the monetary payment to various items and categorize them as incentive pay or fixed pay, but seldom jump out of the traditional incentive monetary payment framework pioneered by Jensen and Murphy (1990). This paper also investigates the incentive problems of CEOs in China's SOE, but propose and test a new mechanism that provides incentives: political promotion.

### 1.2 Motivation and Objectives of the Research

The roles played by CEOs in the management have attracted intensive attention of modern corporate governance and have inspired abundant academic research. The design of CEO remuneration is commonly believed to be crucial to provide incentives for executives to perform in the way that is desired by shareholders. According to existing research, a good design of remuneration can provide efficient incentives for CEOs so that they can maximize the shareholders' wealth and the firms' values, thus alleviating the moral hazard problem.

The seminal work by Jensen and Murphy (1990) shows that if a CEO's monetary payments is compatible with his or her incentive pay, the CEO will be more motivated to improve the firm's performance. For example, firms that pay their CEOs stocks and stock options rather than fixed salary perform significantly better. The mechanism is simple. CEOs paid by stocks get larger remunerations if stock price rises, and improving firm performance helps to

increase firm value and hence its stock price. By contrast, CEOs paid by fixed salary have no incentives to increase firm performance because they will not be compensated. Their investment strategies will be short-sighted because the incumbent CEO fears that long-run investment will benefit his successor. Following Jensen and Murphy (1990), many empirical studies confirm this argument (see literature review).

However, when this theory is applied to China's State-owned Enterprises (henceforth SOEs), the findings are mixed. Because SOEs rarely pay their CEOs with stocks, and even so, these stocks are not allowed to be sold in the second market, the performance of these SOEs should be poor according to theory's prediction. Nevertheless, sharp improvements of performance have been observed in many SOE. Some explain these improvements by categorizing monetary payments in more details such as fixed salary, perquisite consumption and allowance, and argue that some kinds of these payment play the role of incentive pay (see literature review). The problem is that there is no evidence that shows monetary payments to CEOs in China's SOEs provides them enough incentives to exert high effort and to improve firm performance. By contrast, empirical studies such as Firth et al. (2006) found out that the monetary payments, particularly the part of incentive pay, has been too low to provide incentives for CEOs to improve firm performance in China.

In light of these results, this thesis investigates the potential mechanism of corporate governance in China's SOEs that consolidates the observed paradox: sharp improvement of firm performance and low incentive pay to the managers. This paradox, nevertheless, can be addressed and explained if other mechanisms that play the role of providing incentives for CEO can be found. Indeed, the first economic principle, which is argued by Mankiw (2003 and so on), and taught for first year undergraduate students in basically all the universities worldwide, is that people respond to incentives. If no evidence showing that monetary payment provides enough incentives for CEO to improve firm performance in China's SOE can be found, there must be other type of incentives. Therefore, this thesis's objective is to identify the alternative mechanism and test its importance in motivating CEO effort. Considering the special institutional design of China's SOEs, where noticeably, China's SOEs usually appoint their CEOs by their superior administrative agencies rather than hiring through market, Cao et al. (2009, 2011) argue that, because SOEs have strong political connections and their CEOs have political titles, political promotion might be very important to justify CEO behaviors in corporate governance. Political connections, therefore, is the key difference between China's SOEs and their counterparts in other countries. Therefore, this study conjectures that political promotion might be the alternative mechanism in motivating CEO effort..

Political promotion means, literally, that CEOs of China's SOEs have better chance to be promoted with higher political rank if the performance of their managed enterprises is better, with the measurement of firm performance following the criteria of China's State-owned Assets Supervision and Administration Commission (SASAC). Here, it is necessary to introduce the institutional design of China's SOEs. All SEOs in China have political rank. Generally speaking, the larger the asset size, the higher is its rank. Accordingly, the CEO of

these SEOs also have political rank, and their rank follows strictly with the rank of SEOs. Monetary payment that a CEO in SOEs can get is determined by the political rank as well. If an SOE shows significant improvement of its firm performance, its CEO has larger chance to be promoted, either to operate another SOE with higher political rank, or to work directly in the government as a governor that has equal or higher political rank. We give more detailed introduction in section 1.2 and 6.3. about the background of an SOE's political connections, and we provides one examples of political promotion here.

Mr. Jiang was the president of China Development Bank (CDB) during 2008 and 2010. For these three years, his monetary payments (annual salary) was fixed at 1 million Yuan, but the return on equity of CDB improved sharply, from 5.97 in 2008 to 9.49 in 2010. In 2011, Mr. Jiang was promoted as the director of the board of Agricultural Bank of China (ABC). ABC's asset size was almost twice as large as CDB. After another three years working in ABC, Mr. Jiang was promoted again as the vice secretary of Jilin Provincial Committee of CPC. Interestingly, before Mr. Jiang finally became a pure governor, his monetary payments is ABC was 860 thousand Yuan, lower than his payment previously in CDB. Therefore, this example shows that Mr. Jiang's effort to improve CDB's performance during 2008 and 2010 was not motivated by monetary payments. Instead, political promotion might be important. In fact, we provide more examples of political promotions in section 7, where we extend these examples as case studies to show the importance of political promotion in China's SOEs.

To sum up, the objective of this study is two folds. **The first objective** is to test Jensen and Murphy (1990) theory using sample of China's SOEs. The estimation strategy in this paper differs from previous studies in the sense that this paper not only categorizes monetary payments in various forms but also takes into account the institutional change of CEO pay during SOE reforms. There are two times of setting the "salary limits" for CEOs of SOEs, respectively in 2009 and 2014. The impact of the salary limit is studied. In addition, data set that is used in this study is updated. If monetary payments, no matter what form they are, do not provide incentives to CEO to improve firm performance, the **second objective** of this study emerges naturally, which is to answer what, if any, provides CEOs of SOEs incentives to exert effort and to improve firm performance. This paper proposes that getting political promotion is the key incentive, due to special institutional design of SOE in China. Using both case studies and survey data, this paper shows that CEOs of SOEs care more about political promotion rather than monetary payments. In anticipation of being promoted, CEO exert high effort to improve his/her firm performance and asset size.

### 1.3 Research Design and the Structure of the Thesis

This research includes four stages: the first stage lays out the research question and hypothesis; the second stage and the third stage are the methodologies applied to test the hypothesis that answer the research questions; the last stage discusses and concludes.

**Stage 1:** Research questions and hypothesis

When reviewing the literature about CEO remunerations and firm performance, a common belief is reached so that CEOs are better motivated to improve firm performance if their remunerations are tied with the firm performance. This is often called the incentive pay. Particularly, Jensen and Murphy (1990) show that if monetary payments to CEOs include shares or options of the firms they work for, the firms' performance improves significantly. The theory is supported by empirical findings in the US and other developed economies.

However, when this theory is applied to China's SOEs, the findings are not in line with the theory. China's SOEs pay almost no incentive pay to CEOs in terms of monetary payments. Even if they do, the amount is too little to justify the effort of these CEOs to improve firm performance. Why? What differences are there between China's SOEs and enterprises in developed countries such as the US?

Noticeably, China's SOEs usually appoint their CEOs by their superior administrative agencies rather than hiring through market. Cao et al. (2009, 2011) argue that, because SOEs have strong political connections and their CEOs have political titles, political promotion might be very important to justify CEO behaviors in corporate governance. Political connections, therefore, is the key difference between China's SOEs and their counterparts in other countries.

This thesis thus explores the importance of political promotion in providing CEOs with incentives to improve firm performance. It proposes a hypothesis that political promotion motivates these CEOs to increase asset size and returns on assets. This hypothesis is proposed based on two reasons. First, the traditional CEO remuneration theory cannot explain the observations of China's SOEs. This raises the question of what are the motivations of CEOs working in SOEs. Considering that SOEs have political connections and the fact that political promotions are commonly valued by their CEOs, political promotion is highly possible to be the answer to this question. Second, two case studies are used as examples to testify to the role of political promotion in providing motivations for CEOs of SOEs. The results in case studies confirm our conjecture that political promotion does matter.

**Stage 2:** Benchmark empirical findings and case studies

The stage 2 illustrates in details how our hypothesis comes about. As mentioned before, the conjecture that political promotion matters comes from the observations that classical CEO remuneration theory, e.g., the one proposed by Jensen and Murphy (1990) ,does not hold for cases of China's SOEs. The key difference between China's SOEs and other enterprises (in and outside of China) is that China's SOEs have strong political connections, or political ranks. Therefore, to explain why classic theory cannot be applied to China's SOEs, one needs to identify the impact of political promotion on SOE CEOs in China.

Formally, this thesis firstly re-address Jensen and Murphy (1990)'s theory and test it with all China's SOEs listed in the A-share market. The test takes into account perquisite consumption, allowance, salary limit (discussed in details in section 4), and other forms of monetary

payments that might play the role of "incentive pay". This work is to confirm that Jensen and Murphy (1990)'s theory is not tenable for Chinese SOEs. Particularly, the correlation between "incentive pay" in monetary terms and firm performance is insignificant.

To show that this result is not driven by the country fixed effect, we carry out a similar exercise for all the private enterprises listed in domestic A-Share market. The findings are in line with the classic theory. This shows that the findings regarding SOEs cannot be attributed to the country fixed effect. In addition, what can be observed from the data, particularly when comparing SOEs with private enterprises, is that CEOs of SOEs have strong incentives to improve firm performance and expand the asset size. This is particularly true when CEOs are going to be politically promoted in the next 1 or 2 years. Note that these CEOs are appointed by the supervisors, and they have political ranks and titles. Therefore, the normal career path for these CEOs is political promotion rather than running a successful enterprise. We discuss the nature of China's SOEs in details in section 5, and we illustrate that political promotion is one of the most important career concerns of CEOs of SOEs. However, political promotion is decided by administrative department who is in charge of these SOEs (normally the State-owned Assets Supervision and Administration Commission). This decision is made based on the evaluation of firm performance. To be sure, for supervisors, profitability is usually not the first variable to measure the performance. Instead, asset size, return on assets, and return on equity are the primary measures.

The empirical findings show that corporate governance in China's SOEs is different, with the difference lying in political promotion, a non-monetary term. This thesis uses two case studies to formally address this conjecture and provide a preliminary understanding of the background. In both cases we carefully choose the timing of the event during which the two strict salary limits were enforced by China's government. These two cases have strong persuasive power to illustrate the argument.

The hypothesis is that, CEOs in China's SOEs care more about political promotion instead of monetary payments. This hypothesis is akin to the career concern theory. The case studies show that CEOs that lead to better firm performance are more likely to be politically promoted. On the other hand, the monetary payment of these CEOs does not grow as fast as the firm profit. These two phenomenon together show that these CEOs value political promotion more than monetary payment, because the latter is inefficient to provide CEOs with incentives. Otherwise, these CEOs will choose to leave their job to pursue higher payments, which is certainly not the case.

**Stage 3:** Survey data analysis and test of our hypothesis

To test the hypothesis, this thesis uses survey analysis. We use survey because there is no available data about political promotion. The thesis carefully designs a survey questionnaire, and distributes it to 100 CEOs working in SOEs or private enterprises. We retrieved 54 responses, in which only 40 are complete and consistent. We use these 40 survey results to illustrate and test our hypothesis.

The questionnaire is written in Chinese, as we are doing research on Chinese firms, and most CEOs working either in private enterprises or SOEs do not have sufficient English language skills. In the thesis, however, the English translation of the questionnaire will be presented, along which we illustrate the reasons for designing each question and the expected goals and results. Then this thesis summarizes the survey data and shows the patterns of the statistics. By comparing SOEs with private enterprises, the survey is able to provide several key evidences that support the argument that CEOs in China's SOEs care more about political promotion rather than monetary payments.

Finally, the thesis makes further comparison of the results found here with those from previous related studies. It concludes the paper as well as proposes the potential directions for future research.

**Stage 4:** the connections of the above-mentioned stages

Once more, we discuss our research questions and hypothesis, and the methodology to test the hypothesis in the final stage. The logic of the reasoning is straightforward. Classic theory in addressing the relationship between CEO incentive pay and firm performance explains well the situations of enterprises in the US and other countries, as well as private enterprises in China. But it fails to match the situation for China's SOEs. By carefully reviewing the nature of China's SOEs in section 5, we find that China's SOEs has a unique characteristic: they are influenced by politics and their CEOs have political ranks. Political promotion is commonly observed for these CEOs, and there is literature that proposes the potential role of political promotion in providing incentives for these CEOs to exert high effort (e.g., Cao et al., 2009, 2011).

By formally testing the classic Jensen and Murphy (1990)'s theory for China's SOEs, we confirm that this theory fails to describe the motivations of CEO efforts to improve firm performance. The study of institutional design of China's SOEs (in section 5) enables us to hypothesis the potential gap between the theory and reality: political connections and political promotions matter. To justify this hypothesis, we use two case studies where the stories of political promotion of CEO perfectly support our views. Realizing that a larger sample is needed to test the hypothesis, we use survey data analysis.

In all, we find that political promotion is the key and usually the only concern of CEOs working in SOEs.

### 1.4 Why are the findings of political promotion important?

The classic paper by Mullainathan and Bertrand (2003) shows that, under certain conditions, CEOs pursue a quiet life rather than monetary payments. This paper shows that, when we study corporate governance, particularly regarding the managerial control, it is unwise to presume that CEOs are after monetary payments. Or, at the very least, monetary payments

might not be the only interest that CEOs are pursuing. For the sample CEOs in Mullainathan and Bertrand (2003)'s paper, the quiet life is these CEOs' interest. For the sample in this thesis, i.e., China's SOEs, political promotion is the interest.

In fact, related studies already show that CEOs have various incentives in their work. Empire building was considered as the norm, increasing monetary payments was viewed as given, but this thesis finds out that getting a higher political rank is the most important interest of CEOs in China's SOEs. This result is, on the one hand, due to the particular institutional design of China's SOEs; on the other hand, due to their political status. The culture of government-owned enterprises is also important. Historically, working in the government is more attractive than doing business in China, and China's SOEs have been a vital instrument for provision of social services and an instrument of state policy (Bian 2005; Steinfeld 1998). Ambivalence about control is new to the Chinese political culture. For a long time, political control of China's SOEs has been prized even at the expense of efficiency. It is well acknowledged that, working as a CEO in China's SOEs is not to earn decent money, but to wait for the opportunities to be promoted in the political hierarchy. The so-called administrative level of SOE reflects the idea of "official standard" in management. In the era of the planned economy, state-owned enterprise in fact had no administrative level for most of employees. However, the CEO, or the chief director, is appointed by the central government, therefore they political titles. For instance, when central government owned enterprises were established, their chief directors or CEOs were assigned with political title of "Fu Bu", and other levels of political titles were extended down. This setting has become the tunnel of "normal" personnel changes.

In fact, pursuing political promotion rather than monetary payments is not a problem. Realizing this fact implies that political promotion is the more important instrument to justify CEOs' incentives to behave. The design of CEO remuneration should take political promotion into account. The problem is, current corporate governance in China's SOEs does not tie the remuneration to CEOs, no matter in monetary terms or in political promotion terms, with the profitability of the firms. Instead, the remunerations are tied with asset expansion and other political related targets, such as social responsibility. Under this biased incentives, we observe non-economic decisions of CEOs in managing the firms.

Currently, Chinese policymakers are aware of the situation that economic progress depends upon the revitalization of SOEs, and the SOE reform has started for more than two decades. However, the reform process is slow. During economic booms, the government's incentives to reform SOE are low. In certain accounts, the SOE sector has been viewed as anachronistic (Chen and Faure, 1995; Ding et al., 2000). They have been depicted variously as "industrial dinosaurs", "muscle-bound goons" or the "relics of a failed economic experiment" (Woetzel, 2008). After many years' reform, SOEs are still characterized as possessing a lack of managerial incentives, little concern for profit, low employee motivation and mobility, a tendency to maximize asset size and as being ready for dismembering (Meyer et al., 2002).

Therefore, the policy implications of this thesis are straightforward. To revitalize SOEs in China, corporate governance should concern more about profitability. To achieve the goal of increasing profitability, the design of CEO remuneration should bind the firm profitability with political promotion. This calls for the reform of SOE in two ways. First, firm performance should be measured by profitability rather than the growth of asset size. Second, incentive comes from political promotion rather than monetary payments. The reform should go in an explicit way rather than an implicit way. Political promotion is the prize for improving SOE's profitability.

# Chapter 2. Literature Review

## 2.1. Theoretical Framework for this thesis

Investigating the characteristics of CEO remunerations design in China's corporations, particularly SOEs, has academic significance. It is also very interesting to understand whether existing theoretical predictions regarding CEO remunerations of modern corporate governance are true in China. Moreover, the question of whether the remuneration in China confirms to modern theories or has its own characteristics with the deepening of the marketization process is worth unraveling as well. The research on this topic can be a reference for other emerging markets as well.

Traditional theory of corporate governance solves the discretionary problem of CEOs in management (Berle and Means, 1932). The central tenet is the assumption of conflicting interests between CEOs and firms' owners. Thus modern finance theory applies "Principal-Agency" framework to analyze this problem, with goals of designing optimal remuneration for CEOs that provides them incentives to behave in a wanted manner. (e.g. Jensen and Meckling, 1976; Jensen, 1986).

This approach has been further developed, taking various additional agency problem into account. For example, Bebchuk et al. (2002) argues that the owners of firms are not perfect principal in the economic sense, and they suffer from other problems. CEOs seek opportunities of taking advantages from shareholders as well as other creditors (Bertrand and Mullainathan, 2001). Most of these new theoretical developments, however, did not answer the basic question: what are the CEOs' interests? Without knowing the CEOs' real interests, the design of incentives for them is inefficient.

The early studies basically focus on monetary payments—cash, bonus, performance pay, stock and options, and other types of monetary incentives. These researches believe that, by tying firm performance to monetary payments, CEOs will automatically maximize what owners want (Baker et al., 1988). The following empirical studies, however, found mixed results. Some found that the incentive provided by the monetary payments is large and clear (Arrow and Solow, 1993; Knetsch & Sinden, 1984); while some found that the incentive is small and insignificant (Conyon & Murphy, 2000; Michael C Jensen & Murphy, 1990;

Murphy & Zabojnik, 2004). It is important to know why the results differ across samples. Obviously, to study the CEOs' real interests is one of the most important keys.

If monetary payments are sometimes not CEOs' prior concern, the firms' performance is surely not sensitive to their actual payment. Baumol (1959) and Willianson (1964) propose a theory of empire building where CEOs found that building a commercial aircraft carrier brings utility. If true, it is possible to explain why inadequately paid CEOs still work hard and actively participate in asset expansion and other activities aimed to improve the firm's performance. By contrast, Bertrand and Mullainathan (2003) study the US sample and found that CEOs' ultimate interest is a quiet life.

In the case of China's State-Owned Enterprises, many empirical studies regarding the sensitiveness of CEO remunerations to corporate performance also violate the predictions of the traditional agency theory. The sensitiveness is either insignificant or too small to provide CEOs adequate incentives (Firth et al. 2006; Wei, 2000). It could be that the compensation design for these CEOs is inappropriate (Zhang, 2002; Conyon and He, 2011), but it could also be that CEOs in China's SOEs want something else besides (rather than) monetary payments.

The most common form of remunerations in China's SOEs is cash payments (salary plus bonus). Due to the fact that the shares are owned by the government, and they were non-tradable before 2004 and became only partially tradable after, SOEs seldom use stock and options to motivate CEOs (Cao et al., 2011). Meanwhile, some pointed out that the government can directly intervene in the SOEs and affect the salary for CEOs (Chen et al., 2006), this view gives one explanation why the CEO pay is not sensitive to the firm's performance.

This research provides an alternative explanation: CEOs in China's SOEs care about something else, among which the most important thing is political promotion. With the understanding that CEOs in China's SOEs already have political titles, and SOEs are heavily regulated by the government, this research expects to answer two questions: first, what determines a CEO's political promotion? And second, why political promotion is attractive to these CEOs and how to prove it? The research finally studies the impact of the "biased" incentives in SOEs on corporate governance and performance.

For the first question, Qian and Xu (1993) already found evidences at the provincial level that economic performance is positively related to political promotion. Bo (2009) also found similar results, who used a Logit model to study the firm-level data, and identified the importance of various factors in affecting the probability of being promoted. Our research therefore is more focused on the second question. We first find that the monetary payment for CEOs in China's SOEs is not sensitive to firm performance, indicating that these CEOs care little about the cash payments. Several case studies are provided to support this conclusion. The cases show that with the expectation of getting political promotion, CEOs have strong incentives to improve firm performance to get promotion opportunities. Instead, if there is no such expectation, CEOs' incentives to improve firm performance are quite small. As

supporting government reform is important for a better political career, these cases also show that CEOs care more about political promotion. Indeed, the research found that the probability of political promotion is strongly and significantly related to performance. We further carry out questionnaire to CEOs and find that our conjectures are confirmed.

A more detailed summary of previous literatures is given below.

### 2.2 Empirical Studies regarding corporate governance

In modern corporate governance, with the separation between ownership and management, executives such as CEOs of corporations become agents as they manage the daily business of the companies for their owners, i.e. the shareholders (Jensen and Meckling, 1976). This causes the rise of the agency problem where the goals of agent managers are not that of owners. The agency problem exists on many levels. For example, there are agency problem between shareholders and owners, between large shareholders and small shareholders, between shareholders and debt creditors, etc. The optimal design of contracts for executives can alleviate the agency problem. One is to ensure CEO's payments are dependent upon a certain level of corporate performance in business, making incentives for CEOs consistent with the interests of the owners. Two, the optimal contract reduces the chances of excessive risk taken by the CEOs, avoiding inefficient capital replacement and decreasing the agency problem between shareholders and external creditors.

In China, the agency problem has unique characteristics compared to that in US. First of all, the stock holdings of corporations in US are dispersive, meaning that the agency problem of corporate governance in US is mainly between shareholders and CEOs. In China, however, many listed companies have absolute stockholders, meaning the agency problem lies between large and small shareholders (Chen et al., 2006; Firth, Fung and Rui, 2006; Hou, Lee, Stathopoulos, and Tong, 2010). There are limited researches on this subject so far. Second of all, the owners of the SOEs in China are represented by the State-owned Assets Supervision and Administration Commission, who appointed the chairmen of the boards; the true owner is absent in corporate governance, which makes the agency problem severer in China's SOEs in comparison to corporations in developed countries (Quan, et. Al., 2010; Sheng, 2000).

The agency problem and ideal contract design theories assume that the Board of Directors represents the shareholders and decide CEO's payments with the purpose of making CEO's interests consistent with maximizing corporate value. In reality, however, the board is to some extent controlled by the CEOs. For example, CEOs decide the schedule and topics of board meetings. Due to time constraints, the board meetings discuss more about the corporation's daily business, and thus have limited supervision over the CEOs (Jensen, 1993). Based on this reason, Bebchuk, Fried and Walker (2002) proposed executives' rights theory. This theory believes that the board members cannot fully represent the interest of the shareholders, thus their behaviors are directed by their own interests, and agency problem between different shareholders arises. A position on the board indicates attractive payments and social reputation; on the other hand, CEOs have power to nominate board members. Together this

implies that board members have incentives to cater to the CEOs, rather than to supervise them. Thus an ideal contract design is difficult to realize, as CEOs often use power to rent-seek, and their payments are partly determined by themselves.

Similar to the theory of the agency problem, managerial power theory cannot be readily applied to China's SOEs as well. Although CEOs of these SOEs are entitled with greater managerial power, they have limited impact on the design of their payments. To be precise, the incentive contracts for CEOs in China's SOEs are neither designed by the SOEs' board nor by the CEOs themselves, but designed by the State-owned Assets Supervision and Administration Commission. CEOs can change their payments only via the manipulation of accrued profits (Lv and Zhao, 2008, Quan et al., 2010) or perquisite consumptions such as luxury accommodations, cars, and offices (Adithipyangkul et al. 2011). Only in the corporations where CEOs have dominating managerial power can these CEOs negotiate and manipulate their payments (Lv and Zhao, 2008).

Moreover, most of the CEOs in China's SOEs are not appointed through internal promotion or external recruitment, but rather directly appointed by the State-owned Assets Supervision and Administration Commission. SOEs' CEOs comply to the government's standardized assessment and appraisal procedures, thus the tournament theory by Lazear and Rosen (1981), CEO supply and demand theory (Himmelberg and Hubbard, 2000; Murphy and Zabojnik, 2004), and market-based perspective theory (Festinger, 1954) and other CEO pay theories are not appropriately applicable to China's SOEs.

## 2.3 Empirical Studies

### 2.3.1 Whether CEO pay is correlated to Corporate Performance

Using CEO pay incentives to resolve the agency problem has been the interest of many researchers. However, whether a payment incentive is an effective resolution to solve the agency problem and minimize conflicts between executives and shareholders is thus far still debatable.

One point of view is that the optimal contract design can provide incentives for CEOs to behave in a way that maximizes firms' value and reach a win-win situation for all concerned parties. McGuire, Chiu, and Elbing (1962) found that the sales of the corporation are significantly positively correlated to CEO pay. Tosi and Mejia (1989), and Ciscel and Carroll (1980) found similar conclusions.

Tosi and Mejia (1989) examined the extent to which monitoring and incentive alignment of CEO compensation and influence patterns of various actors on CEO pay vary as a function of ownership distribution within the firm. They found that the level of monitoring and incentive alignment was greater in owner-controlled than management –controlled firms. For both types of firms, there is a direct relationship between monitoring and the risk level to the CEO of annual bonuses and long-term income, although the relation was stronger among

owner-controlled firms. In the owner-controlled firms, there was more influence over CEO pay by major stockholders and boards of directors. In management-controlled firms, the CEO pay influence was separated from major stockholder and boards.

Ciscel and Carroll (1980) found that executives are paid for increasing profits, whether through sales growth or cost control. However, since the sales variable may also serve as a measure for firm size, and since asset size of the corporation also bears an important influence on CEOs' salaries, there is a strong indication that decisions concerning CEOs' salaries are influenced by several aspects of corporate performance. In addition, the level of CEO compensation is basically determined in a market for executives.

Moreover, Coughlan and Schmidt (1985) argue that the incentives for CEOs should target the market indicators such as market return, rather than accounting indicators such as sales. Their empirical study found significant positive relationship between CEO pay and market return, but they found no evidence that the payments are responsive to sales.

Conyon and He (2016) investigated the relation between CEO compensation and corporate fraud in China. They found a significantly negative correlation between CEO compensation and corporate fraud using data on publicly traded firms between 2005 and 2010. They argue that firms penalize CEOs for fraud by lowering their pay, and indicate that corporate governance mechanisms influence the magnitude of punishment. CEOs of privately controlled firms, firms that split the posts of CEO and chairman, and CEOs of firms located in developed regions suffer larger compensation penalties for committing financial frauds.

Hass, Johan, and Schweizer (2016) examined the relationship between performance persistence and corporate governance (as proxied for by board characteristics and shareholder structure). They found systematic differences in performance persistence across listed companies in China during 2001-2011, and empirically demonstrate that firms with better corporate governance show higher performance persistence. The results are robust over both the short and long terms.

Another point of view believes that when payments are too low they have little effect as incentives for CEOs, as they usually contribute more than what they are paid for. Jensen and Murphy (1990) found that for every 1000 US dollar increase in firm value CEO pay increase by $3.25 dollars, meaning there is a huge gap between CEO pay and shareholders returns. Firth et al. (2006) found similar conclusions for Chinese firms: although CEO pay is significantly related to corporate performance, the coefficient is very small.

Haubrich (1994) used a quantitative model, based on research by Grossman and Hart (1986), and Holmstroem and Milgrom (1991), to study how CEOs and shareholders allocate firms' profits. The study found supportive evidence for Jensen and Murphy's (1990) theory; however payments' low sensitivity to performance is not always the problem. It also found that if CEOs take risk-aversion lightly or even are risk-seeking, a lesser degree of sensitivity of CEO pay to corporate performance is a more reasonable choice: it provides enough incentives for

CEOs while avoiding taking excessive risks.

Conyon and Murphy(2000) document differences in CEO pay and incentives in the United States and the United Kingdom for 1997. After controlling for size, sector and other firm and executive characteristics, CEOs in the US earn 45% higher cash compensation and 190% higher total compensation. The calculated effective ownership percentage in the US implies that a median CEO receives 1.48% of any increase in shareholder wealth compared to 0.25% in the UK. The differences can be largely attributed to greater share option awards in the US arising from institutional and cultural differences between the two countries.

Buck, Bruce and Udueni (2003) present the first estimates of UK total executive rewards that include detailed LTIP valuations. It finds that, while increasing average total rewards, the presence of LTIPs is actually associated with reductions in the sensitivity of executives' total rewards to shareholder return. This raises doubts concerning both the effectiveness of the LTIP instrument and the validity of an agency perspective in this context.

John and Qian(2003) examined the incentive features of top-management compensation in the banking industry. Economic theory suggests that the compensation structures for bank management should have low pay-performance sensitivity because of the high leverage of banks and the fact that banks are highly regulated institutions. In accordance with this school of thought, the authors found that the pay-performance sensitivity for bank CEOs is lower than it is for CEOs of manufacturing firms. This difference is attributable largely to the difference in debt ratios. The authors also found that banks' pay-performance sensitivity declines with bank size.

Chen and Leng(2004) argue that the persistently low pay-performance sensitivity between executive compensation and firm performance has puzzled both practitioners and academics. They propose a hybrid model that incorporates both moral hazard and adverse selection problems to explain this puzzle. They found that the managerial labor market is heterogeneous in nature, not homogeneous as assumed by the pure moral hazard model and empirical work based on this model. They demonstrate that the optimal pay-performance sensitivity derived from the hybrid model is lower than that derived from the pure moral hazard model. Furthermore, they also show that pay-performance sensitivity is a function of the mix of types in the market. The more capable managers there are in the market, the more likely the market's average pay-performance sensitivity is high.

Kato and Kubo(2004) present the first estimates on pay-performance relations for Japanese CEO compensation, using unique 10-year panel data on individual CEO's salary and bonus of Japanese firms from 1986 to 1995. They found consistently that Japanese CEO's cash compensation is sensitive to firm performance (especially accounting measures), and that the "semi-elasticity" of CEO's cash compensation with respect to ROA is 1.3 to 1.4, which is in general agreement with prior estimates elsewhere. As such, their estimates do not support that Japanese corporate governance is unusually defunct with regard to the significance and size of the sensitivity of CEO compensation to accounting profitability. On the other hand, to be

consistent with the literature on Japanese corporate governance that tends to downplay the role of shareholders and stress the role of banks and employees, they found that performance of the stock market tends to play a less important role in the determination of Japanese CEO compensation. Finally, they found that the bonus system makes CEO compensation more responsive to firm performance in Japan.

Duffhuse and Kabir(2008) examined the widespread belief that executive pay should reflect firms' performance. They compile a hand-collected data set of compensation paid to executive directors of Dutch listed companies and analyze if executive compensation is indeed determined by firm performance. Their empirical analysis fails to detect a positive pay–performance relationship. The finding questions the conventional wisdom that executive pay helps align shareholder interests with those of managers. It is consistent with the view that powerful managers can influence their own pay. The results of the study suggest that other means of resolving agency problem and novel explanations of executive compensation may provide useful insights.

Garen (1994) argues that the sensitivity of the payments to the performance varies across firms. After dividing the CEO pay into salary and incentive pay, Garen discovered that sensitivity depends on firms' specific situations. When sales fluctuate strongly, the incentive pay is low while the basic salary is high; if the stock returns are high, and stock return is strongly related to market return, incentive pay is also low.

Cordeiro et al. (2016) study asymmetric performance benchmarking in Chinese executive compensation contracts between 2000 and 2010. They argue that while relative performance evaluation criteria are important in executive pay contracts, managerial power and influence will result in a decoupling between pay and performance. They show that Chinese managers are rewarded for superior performance but not penalized for inferior performance. Therefore, the sensitivity between executive compensation and firm accounting performance is asymmetric. It is significantly stronger when firm accounting performance is positive or firm performance exceeds industry or regional median benchmarks compared to cases when firm accounting performance is negative or is below industry or regional median benchmarks.

Yet another point of view believes that CEO pay have no significant relationship with firms' value or net worth of shareholders. The sensitivity to performance represents only a part of the CEO incentives.

Tosi, Werner and Mejia(2000) test the hypothesized relationships between firm size, performance, and CEO pay. They show that firm size accounts for more than 40% of the variance in total CEO pay, while firm performance accounts for less than 5% of the variance. They also found that pay sensitivities are relatively similar for both changes in size (5% of the explained variance in pay) and changes in financial performance (4% of the explained variance in pay). The meta-analysis also suggests that moderator variables may play an important role, but this paper is unable to test this.

Mishra, McConaughy and Gobeli(2000) found that firm performance has a generally positive, but diminishing relationship with the level of CEO pay-for-performance sensitivity to stock returns, consistent with the tradeoffs between incentives and risk sharing that underlie the use of pay-for-performance. Two moderating risk variables capture this tradeoff and significantly shape the pay-for-performance relationship: a firm's business risk and the standard deviation of its stock returns. At higher levels of pay-for-performance sensitivity, the future performance of higher-risk firms is more negatively related to sensitivity than for lower-risk firms. Their results support the notion that CEO risk aversion limits the benefits from incentive pay, and that when too much risk is placed on the CEO, firm performance suffers. Human resource managers should take these results into account when making changes in CEO pay-for-performance plans.

Bebchuk, Fried and Walker (2002) developed an account of the role and significance of managerial power and rent extraction in executive compensation. Under the optimal contracting approach to executive compensation, which has dominated academic research on the subject, pay arrangements are set by a board of directors that aims to maximize shareholder value. In contrast, the managerial power approach suggests that boards do not operate at arm's length in devising executive compensation arrangements; rather, executives have power to influence their own pay, and they use that power to extract rents. Furthermore, the desire to camouflage rent extraction might lead to the use of inefficient pay arrangements that provide suboptimal incentives and thereby hurt shareholder value. They found that managerial power and the desire to camouflage rents can explain significant features of the executive compensation landscape, including ones that have long been viewed as puzzling or problematic from the optimal contracting perspective. So the role managerial power rather than firm’s performance plays in the design of executive compensation is significant and should be taken into account in any examination of executive pay arrangements or of corporate governance generally.

Bebchuk and Fried (2004) argued that flawed compensation arrangements have been widespread, persistent, and systemic, and they have stemmed from defects in the underlying governance structure that enables executives to exert considerable influence over their boards. Given executives’ power, directors could not have been expected to engage in arm’s-length bargaining with executives over their compensation. The absence of effective arm’s-length dealing under today’s system of corporate governance—not temporary mistakes or lapses of judgment—has been the primary source of problematic compensation arrangements.

Managerial power also has other effects on firms besides pay-performance sensitivity. Boeker (1992) uses data from 67 organizations over a 22-year period to examine the likelihood of chief executive and top management dismissal as a result of organization performance and the distribution of power in the organization. Powerful chief executives are found to be less likely than less powerful chief executives to be dismissed during performance downturns. Instead, they displace blame for poor performance onto their subordinates, the top managers of the organization, who subsequently are replaced, while the chief executive remains. The role that board composition and organization ownership play in influencing the amount of power the

chief executive is likely to possess and explores wat action organizations with poor performance but powerful chief executives might take. Davis (1991) compares the agency theory of the firm with inter-organizational theory in examining the factors associated with the adoption of the poison pill-a takeover defense issued by a firm's board of directors that can dramatically increase the cost that a hostile buyer would have to pay to acquire the firm using a panel of Fortune 500 firms between July 1984 and August 1989. The pill's rapid spread is traced to a combination of ownership structure and other firm level factors and an interlock network diffusion process. The results support a social structural perspective on the market for corporate control in which the interlock network provides a social context favoring continued managerial dominance.

McConaughy (2000) studies 82 listed family firms, in which 47 had family members as CEOs and 35 has externally hired their CEOs. The result showed that the payment sensitivity of family members is lower than external appointments, but the corporate performance of the two types of corporations are relatively the same. This indicates that besides sensitivity, other factors also provide incentives for CEOs.

Gabaix and Landier(2006) develop a simple equilibrium model of CEO pay. They argue that CEOs have different talents and are matched to firms in a competitive assignment model. In market equilibrium, a CEO's pay changes one for one with aggregate firm size, while changing much less with the size of his own firm. Their model determines the level of CEO pay across firms and over time, offering a benchmark for computable corporate finance. The six fold increase of CEO pay between 1980 and 2003 can be fully attributed to the six-fold increase in market capitalization of large US companies during that period. We find a very small dispersion in CEO talent, which nonetheless justifies large pay differences. The data broadly supports the model. The size of large firms explains many of the patterns in CEO pay, across firms, over time, and between countries.

Brick, Palmon and Wald(2012) examined the relation between pay-performance sensitivity (PPS), the convexity of managerial compensation (Vega), and future stock risk and returns for a large sample of firms between 1992 and 2004. They found that higher PPS and Vega are both associated with lower future stock returns. Part of this negative relation can be explained by risk-averse managers decreasing equity risk in response to increases in PPS and Vega. However, even after correcting for lower future risk, future stock returns are negatively associated with the magnitude of option sensitivity, high option compensation to manager-owner agency problem.

Cooper, Gulen and Rau(2014) found evidence that CEO pay is negatively related to future stock returns for periods up to three years after sorting on pay. For example, firms that pay their CEOs in the top ten percent of excess pay earn negative abnormal returns over the next three years of an approximately -8%. The effect is stronger for CEOs who receive higher incentive pay relative to their peers and stronger for CEOs with greater tenure. They suggest that the results may be driven by high-pay related CEO overconfidence that leads to shareholder wealth losses from activities such as overinvestment and value-destroying

mergers and acquisitions.

Forth and Bryson(2014) decompose the share of the total wage bill accounted for by bonuses into the shares of employment in the PRP(performance-related-pay) and non-PRP sectors, the ratio of base pay between the two sectors, and the gearing of bonus payments to base pay within the PRP sector. We show that there was some growth in the share of total pay accounted for by bonuses in Britain in the mid-2000s. However this rise and subsequent fluctuations since the onset of recession in 2008 can be almost entirely explained by changes in the gearing of bonus to base pay within the PRP sector.

2.3.2 Corporate Governance and CEO pay' Sensitivity

Jensen and Meckling (1976) emphasized the impact of corporate governance on CEO pay' sensitivity to performance. They believe corporate governance has the ability to alleviate the agency problem. However, Jensen (1993) acknowledged the reverse control of executives over the board, and admitted that the supervision of the board over the executives is weakened.

Mishra and Nielsen (1999) study the largest 100 commercial banks in US. They investigated whether the independence of the board has any impact on sensitivity. The result is positive: the independence of the board increases the effectiveness of the payment contract, thus increases sensitivity. This is particularly true when firms' performance are poor.

Nevertheless, Capezio et al. (2011) argued that independence of the board is able to provide more efficient payment contracts. Using sample of Australian corporations, in which some chairmen of the board do not intervene in daily businesses and most of the board members are external independent directors, researchers showed that these corporations do not have higher sensitivity compared to those corporations with less independent boards.

Bertrand and Mullainanthan (2003) argued that less complicated work environment is very attractive to CEOs, thus they might be less eager to achieve when under supervised. Better corporate governance reduces such problems. By increasing sensitivity and intensity of supervision, CEOs are better motivated and firm value can be increased.

Kang, Kumar and Lee (2006) found evidence of a significantly positive relationship between stock option-based CEO pay and firms' long-term investments. Effective corporate governance enhances sensitivity and promotes increasing firm value.

Jia-nan and Huang (2007) intended to explore the impact of the managerial overconfidence on the relation between the pay performance sensitivity and risk. The result of this paper indicates that although the manager is risk-averse, the optimal pay performance sensitivity will be increasing in the higher risk region, and will be decreasing in the lower risk region when the manager's effort-averse coefficient and overconfidence coefficient are under a certain condition. In addition, when the manager is more overconfident, the optimal effort is

also increasing in the risk.

Cornett, Marcus and Tehranian (2008) tested whether the apparent impact of governance structure and incentive-based compensation on firm performance stands up when measured performance is adjusted for the effects of earnings management. Institutional ownership of shares, institutional investor representation on the board of directors, and the presence of independent directors on the board all reduce the use of discretionary accruals. These factors largely offset the impact of option compensation, which strongly encourages earnings management. Adjusting for the impact of earnings management substantially increases the measured importance of governance variables and dramatically decreases the impact of incentive-based compensation on corporate performance.

Edwards, Eggert, and Weichenrieder (2009) tested the impacts of concentrated stock-holding and the participations of labor union in board meetings on the CEO pay' sensitivity in Germany. The results showed that, when stock-holding is dispersed, CEO pay is significantly related to performance, meaning absolute stock holding of a corporation does not increase sensitivity. Moreover, interestingly, for the corporations whose largest shareholder is the Ministry of Finance of Germany, the sensitivity is insignificant.

Acharya et al. (2011) believed that better corporate governance attracts better CEOs. Based on this research, better corporate governance could save the cost of board supervision, and the money saved can be re-distributed to CEO pay, thus sensitivity is higher. However, if the CEOs' ability is below average, firms usually often offer more relaxed governance systems to attract better CEOs, in which case CEOs have the possibility to rent-seek as compensation. Meanwhile, research also found that CEO pay is not only related to firms' own corporate governance level but also related to the firms' competitors' governance level.

Armstrong, Ittner and Larker (2012) found evidence that corporate governance and the consultant committee can affect CEO pay. Poor governance implies higher CEO pay, indicating firms with better governance can increase sensitivity. On the other hand, if firms set up a payment consultant committee, this effect disappears, indicating corporate governance and the consultant committee are substitutions for each other in terms of affecting sensitivity.

Brown et al. (2012) used CEOs' social relationships as the measure for managerial power to study the effects of managerial power on CEO pay' sensitivity. The data showed that stronger social relationship is related to higher payments and lower sensitivity. Better corporate governance weakens the effect, meaning the former can impair managerial power.
Dicks (2012) found evidence of externality of corporate governance, which means better governance reduces agency costs and CEO pay. However, if one corporation improves its governance, the CEO pay at other corporations will be reduced. In light of this evidence, Dicks (2012) argued that the improvement of corporate governance has externalities that increase the welfare of all the investors. Meanwhile, the author also discovered that such improvements have a heterogeneous effect on corporations' value: large corporations benefit

while the small corporations suffer.

Luo (2013) reviewed recent research and theories on corporate governance and CEO pay' sensitivity in the emerging markets. His study showed that the effect of corporate governance on sensitivity depends on the environment. In order to systematically study such sensitivity, one must understand the culture, social institutions, and the methods of corporate governance in that environment.

Amzaleg et al. (2014) developed a simple model that suggests that reverse causality should also be considered. Their model predicts that when good performance is expected, a powerful CEO will push for a contract with higher PPS. The empirical analysis shows that when the CEO is the chairman of the board of directors and thus is more powerful in affecting his compensation scheme, he achieves a high PPS in good periods (in terms of corporate performance), compared to similar powerful CEOs in periods of bad performance, and also compared to less powerful CEOs in good periods.

Luo(2015) examined the determinants of executive compensation in Chinese banking industry during 2005–2012. He found that there is no significant positive pay performance relation, and CEO power does not necessarily exhibit higher levels of executive compensation. The ownership structure and compensation committee are significant in determining executive compensation in Chinese banks. It suggests that the government may ensure efficient monitoring functions when the pay incentive is ineffective.

Liang, Renneboog, and Sun (2015) argued that in regulated economies, corporate governance mechanisms such as executive compensation are less driven by market-based forces but more subject to political influence. They study the political determinants of executive compensation for all listed Chinese firms in the context of an exogenous shock that removed market frictions in share tradability. Under strong political constraints, state ownership reduced the managerial pay levels and increased pay-for-performance sensitivity (to asset-based benchmarks). Board independence and compensation committees do not curb managerial pay, and market-based factors do not have a significant influence.

Chizema et al. (2015) found a negative association between politically connected boards and top executive pay. They also found that politically connected boards are negatively associated with pay dispersion, i.e., the higher the number of political directors on the board the smaller the gap between top executive pay and average employee pay. In addition, they showed that politically connected directors weaken the pay-performance link. These findings support the view that political promotion provides additional incentives for top CEOs.

### 2.3.3 Government Intervention and CEO pay' Sensitivity

Crawford, Ezzell, and Miles (1995) studied US banking industry in the 1980s when the government relaxed the regulation of banks, thus CEOs' managerial power expanded and their stock holdings increased. As a result, adverse selection and moral hazard problems were

effectively reduced, and the sensitivity of CEO pay to performance in the banking industry increased. This result shows that government intervention has negative impact on sensitivity. Hubbard and Palia (1995) also studied US banking industry and found similar results.

Perry and Zenner (2001) investigated the same topic, and discovered that after the implementation of *The New SEC Compensation Disclosure Rules and Section 162(m)*, some of the CEO salaries that were above 1 million US dollars were cut to below 1 million US dollars. But after bonuses and stock options were taken into account, the aggregate CEO pay were still increasing. This means that although the implementation of this new law failed to reduce CEO pay, it did increase CEO pay' sensitivity to performance.

Chen, Jeter and Yang(2015) used a more comprehensive sample of executives and of compensation components than in prior research. They compared managers' pay-performance sensitivity before and after 2001–2002, a period during which regulatory changes were initiated to increase scrutiny over managerial manipulation and improve financial reporting quality. The results showed that pay-performance sensitivity using either market-based or accounting-based measures of performance increased significantly following these events. They further decomposed executive pay into cash-based and equity-based components, and found evidence of an increase in the link between performance and executive compensation for five of six measures for each performance metric. Their study showed that the impact of SOE on executive incentives and compensation is an improvement rather than weakening in the alignment of managerial and shareholder interests.

### 2.3.4 Other Firms Characteristics and CEO pay' Sensitivity

John and John (1993) analyzed in detail the optimal management compensation for the cases when the external claims are equity and risky debt, and equity and convertible debt. In addition to the role of aligning managerial incentives with shareholder interests, managerial compensation in a levered firm also serves as a recommitment device to minimize the agency costs of debt. The optimal management compensation derived has low pay-performance sensitivity. With convertible debt, instead of straight debt, the corresponding optimal managerial compensation has high pay-to-performance sensitivity. A negative relationship between pay-performance sensitivity and leverage is derived.

Lippert and Moore (1994) found that compensation contracts of chief executive officers of large firms typically provide for a low linkage between compensation and stock performance. They tested predictions of various theoretical models of managerial behavior using pay-performance sensitivity measures. Results showed that even though the sensitivity measures are low on average, they vary cross sectional, in a manner broadly consistent with predictions from the literature on efficient contracting.

Zabojnik (1996) found that the pay-performance sensitivity of linear incentive contracts can increase with increasing production uncertainty, depending upon the timing and nature of this uncertainty. This paper provides a possible explanation for the failure of empirical tests to

yield convincing support for a negative relationship.

Scharfer(1998) analyzed the relationship between firm size and the extent to which executive compensation depends on the wealth of the firm's shareholders. This paper used a simple agency model to motivate an econometric model of this relationship. Estimating this model on chief executive officer (CEO) compensation data using nonlinear least squares, I determine that pay-performance sensitivity appears to be approximately inversely proportional to the square root of firm size. It also analyzed the properties of pay-performance sensitivity for executives working for the same firm and showed that it has similar properties as CEO pay-performance sensitivity.

Aggarwal and Samwick (1999) examined compensation contracts for managers in imperfectly competitive product markets. they show that strategic interactions among firms can explain the lack of relative performance-based incentives in which compensation decreases with rival firm performance. The need to soften product market competition generates an optimal compensation contract that places a positive weight on both own and rival performance. Firms in more competitive industries place greater weight on rival firm performance relative to own firm performance.

Ke, Petroni and Safieddine(1999) investigated the relation between CEO compensation and accounting performance measures as a function of ownership structure. They use publicly-held property-liability insurers to consider the relation for firms with diffusely-held ownership and use privately-held property-liability insurers to consider the relation for firms with closely-held ownership. They found a significant positive association between return on assets and the level of compensation for publicly-held insurers. Consistent with optimal contracting theory, they found no such relationship for privately-held insurers. Results suggest that within closely-held firms CEO compensation is less based on objective measures like accounting information and more on subjective measures.

Cichello(2005) provided evidence that when properly controlling for firm size, the negative effect of variance in stock returns on estimated pay–performance sensitivities is greatly diminished, using a comparable sample of CEOs. In particular, when using dollar returns as the measure of firm performance, it is imperative to properly control for firm size.

Werner, Tosi and Mejia (2005) investigated how the ownership structure is related to the firm's overall compensation strategy. They showed that there are significant differences in the compensation practices that apply to all employees as a function of the ownership structure. The results show that for owner-controlled firms and owner-managed firms there is significant pay/performance sensitivity for all employees. In management controlled firms, changes in pay are related to changes in size of the firm. These findings lead us to conclude that ownership structure not only affects upper management's pay, but also the pay of all employees through substantial differences in the firm's compensation practices.
Zhang, Cahan and Allen(2005) examined whether the sensitivity of pay to performance is associated with the amount of insider trading that managers undertake. Because insider

trading profits represent an alternative form of compensation, they expect that firms will consider the compensation component provided by insider trading when designing remuneration contracts. Employing a proxy for insider trading that captures the degree to which managers trade on private information, they found evidence that an increased (a decreased) level of insider trading is associated with a decreased (an increased) pay-performance sensitivity.

Xiaoqiang and Pan(2007) examined the influence of pay-performance sensitivity on the relation between internal cash flow and investment. They found that investment-cash flow sensitivity is not only affected by financial constraints caused by asymmetric information, but also affected by the shareholder-manager agency problem, and symmetric information theory have more explaining power. They also found that the relation between investment-cash flow sensitivity and pay-performance sensitivity is affected by the nature of controlling shareholder ownership.

Dutta(2008) characterized optimal pay-performance sensitivities of compensation contracts for managers who have private information about their skills, and those skills affect their outside employment opportunities. The model presumes that the rate at which a manager's opportunity wage increases in his expertise depends on the nature of that expertise, whether it is general or firm-specific. The analysis demonstrates that when managerial expertise is largely firm-specific, the optimal pay-performance sensitivity is lower than its optimal value in a benchmark setting of symmetric information. Further-more, when managerial skills are largely firm-specific, the optimal pay-performance sensitivity decreases as managerial skills become a more important determinant of firm performance. Unlike the standard agency theoretic prediction of a negative trade-off between risk and pay-performance sensitivity, the paper identifies plausible circumstances under which risk and incentives are positively associated. This paper provides an explanation of why empirical tests of risk-incentive relationships have produced mixed results.

Zhen and Min(2008) showed that the consistency of senior executives' pay and shareholders' interests, namely pay-performance sensitivity, must not improve company's performance. Attempts to improve company's performance through raising senior executives' pay-performance sensitivity should be determined by two factors: performance index and performance risk. Research to the medical biological listed companies in China indicated that there is different pay-performance sensitivity on different performance index and there is not consideration on performance risk in the agreement.

Babenko(2009) showed that share repurchases increase pay-performance sensitivity of employee compensation and lead to greater employee effort and higher stock prices. This paper finds that after repurchases, employees and managers receive fewer stock option and equity grants, and that the market reacts favorably to repurchase announcements when employees have many unvested stock options. Managers are more likely to initiate share repurchases when employees hold a large stake in the firm. Moreover, since employees are forced to bear more risk in firms that repurchase shares, they exercise their stock options

earlier and receive higher compensation.

Chang, Choy and Wan (2012) examined the impact of SOX on stock ownership and pay-performance sensitivity of CEOs using annual compensation data of S&P 1,500 firms in 1994–2005. Consistent with our expectations, they found that in light of SOX: stock ownership and the total pay-performance sensitivity of CEOs have decreased substantially, indicating that SOX induces a weaker incentive alignment between shareholders and CEOs. In contrast, they found that after SOX stock ownership and the total pay-performance sensitivity of CEOs have remained unchanged in regulated industries.

### 2.3.5 Research on CEO pay' Sensitivity to Performance in China

Most of the literature mentioned above studied corporations and firms in developed countries such as the US. As we discussed in the introduction, these studies cannot be directly applied to cases in China. There are many research that examined enterprises in China in its particular environment, and provided references that are theoretically important and practically valuable.

Wei (2000) demonstrated that the incentive mechanism of CEO pay is not complete in China, and CEO pay is not related to corporate performance, although CEO pay is positively related to corporate size. Cheng (2002) found complete opposite results, and concluded that CEO pay is significantly and positively related to corporate performance.

Zhang (2002) found evidence that CEOs' holding of stock options can affect corporations' performance, but the number of shares does not change the effect. This means the effectiveness of using stock options as long-term incentives is limited.

Buck, Liu and Skovoroda (2008) reported Chinese executive pay–performance sensitivity, with international comparisons, to examine whether China's unique institutional environment has produced outcomes consistent with those for Western market economies. This same unique environment makes possible the first estimates of two-way causation based on panel data analysis. The results show that executive pay and firm performance mutually affect each other through both reward and motivation.

Conyon and He (2011, 2012) further investigated the effects of corporate governance on payment sensitivity. On the one hand, they found evidence supporting the positive relationship between CEO pay and corporate performance. On the other hand, they found the independence of the board can affect payment sensitivity.

Cao et al. (2011) studied CEOs of SOEs that have government background. Their research showed that, if a CEO has prospects of political promotion, his monetary payment is lower and sensitivity is weaker, but the performance of the SOE is better. This showed that political promotion can be potentially a substitution of monetary payments, providing incentives for CEOs.

Adithipyangkul et al. (2011) studied perquisite consumption. They found evidence of a positive relationship between perquisite consumption and current and future ROA, indicating that perquisite consumption such as luxury housing accommodations and offices and opportunities of going abroad on a tour of investigation, can provide incentives for CEOs. Li, Qin, and Huang (2010) also found evidences that support this argument.

There are researches that pay attention to the more particular events that may impact CEO pay than those listed above. When “the Measure” was put forth in 2009, Shen and Li (2010) found that a large share of CEO pay is lucky pay, meaning that CEOs get compensated because of having good luck (Bertrand and Mullainathan, 2001). Lucky pay is more significant in SOEs. After “the Measure” was implemented, CEO pay in SOEs increased rather than decreased, and the existence of lucky pay is more significant. Wang et al. (2012) found similar evidences. Using data of listed companies between 2007 and 2010, they found that (1) CEO pay is not related to performance; (2), this phenomenon is more pronounced in SOEs; (3) after the implementation of "the Measure”, CEO pay in SOEs increased rather than decreased, indicating “the Measure” had failed to reach expected results.

Ren, Fu, and Zhang (2011) studied the banking sector and confirmed that “the Measure” had little impact on CEOs’ incentives, CEO pay are not significantly related to corporate performance, and CEO pay policies need continuous reform. Fu and Li (2012) demonstrated that “the Measure” has short-term effects, and argued that it does not have long-term impacts on CEO incentive mechanism.

Hu (2015) researched why executive pay performance sensitivity is lower in SOEs than in private enterprises in China. He explore this problem from the perspective of social responsibilities, including taxes, employment and public service, and base his research on the A-share corporations listed from 2007 to 2012. He found the following. 1) In SOEs controlled by the central government, the heavier the actual tax burden, the more redundant the employees and the lower the pay performance sensitivity. However, these phenomena are weaker in SOEs controlled by the local government and not observed in private enterprises. 2) The pay performance sensitivity is lower in public welfare enterprises than in competitive enterprises in Central SOEs; however, the difference is not obvious in Local SOEs or private enterprises. 3) There is an asymmetric relationship between pay and performance in Central SOEs, and the impact of social responsibilities on pay performance sensitivity is heavier when performance declines.

“The Split”, another big reform, has allowed non-tradable shares to be tradable, thus pushed the establishment of maximizing gains for all shareholders and maximizing share value as the united corporate goal. With that background, CEO pay as incentives have become more effective, and have attracted attention of many researchers. Hou et al. (2010) discovered that after "the Split", the biggest shareholders' values and company share value have a stronger positive correlation, and shareholders are more motivated to design more incentive-driven CEO pay designs, creating a direct correlation between CEO pay and share values. In addition, the reform increased supervision on CEOs, which is beneficial for shareholders.

Zhang and Ding (2011), Lei, Li, and Jin (2010), and Zhang et al. (2010) showed that after "the Split", CEO pay increased dramatically. The correlation between payments and corporate performance also increased significantly. These results indicate that the abandonment of "the Split" played a positive role in improving the CEO incentive mechanism. Hu, Guan, and Li (2008) concluded that "the Split" helped to perfect corporate governance mechanisms and improve corporate performance. In addition, stock and options as incentive are more effective than salary. Zhang (2012) confirmed the results. These studies showed the importance of the reform in determining CEO pay and incentives.

Chen et al. (2015) used the Split share structure reform in China as a natural experiment to study how changes in controlling shareholder incentive affect the pay-for-performance sensitivity. The reform converts the shares owned by controlling shareholders from non-tradable to tradable shares. The removal of such market friction allows for a better alignment of interests between controlling and minority shareholders, which gives managers more incentives to improve corporate performance. They found that the pay-for-performance sensitivity improves greatly after the reform. Changes in the pay-for-performance sensitivity are also associated with firm ownership structure, the level of agency conflicts and governance quality.

### 2.3.6 Political promotion

In the theory of manager of corporate finance, management compensation incentive and political officials of political promotion was originally two unrelated research field, but the particular institutional background of China determines the indivisible relationship between the two. In China's economic system, state-owned economy accounts for a large proportion of the economy. In the key industries such as energy, iron, steel and communication that are closely related to the national economy and people's livelihood, state-owned economy has absolute dominance. In theory, all SOEs are essentially owned by every citizen but operated by the government or sector specific (mainly at all levels of the State-Owned Assets Supervision and Administration Commission) on behalf of the these citizen to exercise the rights of owners. Managers of the state-owned enterprise are nominated, and appointed by administrative means, which makes the managers of SOEs in China have political titles. Managers of SOEs are not only managers of companies, but also have the background of government officials. Their excellent operating performance can bring not only salary promotion, but also career advancement such as political promotion. In China's political system, for government officials, compared to monetary payment, political promotions are often more important, and even fatal attraction. Therefore, in the study of Chinese enterprises, especially state-owned CEO pay performance sensitivity to firm performance, the political promotion factors are not negligible. Some scholars believe that political promotion of SOEs executives have a significant incentive:

Cao et al. (2009) investigated the impact of CEO's compensation-based and promotion-based incentives on firm performance in China, where the CEOs of most SOEs are appointed by the

government and thus face dual incentives. They found that both monetary and political incentives are positively related to firm performance. More importantly, they pinpoint a substitution effect: the monetary compensation-based incentive is weaker when CEO incentives are heavily driven by political career concerns. Overall, the evidence suggests that, via a competitive arena in the external political job market, promotion helps mitigate weak incentives for CEOs in China. State control or political connection is not necessarily inconsistent with good economic incentives.

Cao et al. (2011) examined how incentives for political promotion affect compensation policy and firm performance in Chinese SOEs. In contrast to the conventional wisdom that political incentives tend to be misaligned with value maximization, they found that the likelihood that the CEO receives a political promotion is positively related to firm performance. In addition, as predicted by models of career concerns CEOs with a higher likelihood of political promotion have lower pay levels and lower sensitivity of pay to performance. Overall, the evidence suggests that competition in the political job market helps mitigate weak monetary incentives for CEOs in China. Moreover, the Chinese example suggests that state control and political connections are not necessarily inconsistent with good economic incentives.

Wang et al. (2014) used the panel data of listed companies in China's A-share market to study the relationship between incentives of political promotion and perquisite consumption. This paper discusses how CEOs of SOEs make choices facing the double incentives of getting promoted and getting more perquisite consumption. It finds out that political promotion and perquisite consumption have asymmetric substitution effect, meaning that if the CEO is more likely to be political promoted, he/she will use less perquisite consumption. Further study shows that political promotion affects the level of perquisite consumption in two ways: first, political promotion directly reduces perquisite consumption; second, political promotion plays the role to motivate better firm performance, which increases perquisite consumption. Overall, the first effect is bigger than the second.
Hao (2015), using personal data of 82 executives from state-owned commercial banks, analyzed the relationship between executive monetary compensation and political promotion. The empirical results show that, both increases in salary and political promotion will encourage better management of banks, reducing the risk of bankruptcy. In addition, salary incentives and political promotion incentive can substitute each other

Liu and Xiao (2015) studied different behaviors of CEOs under political promotion motive and increasing salary motive, using the perspective that CEOs of SOEs have the double identity of "governor" and "businessman". The study finds out that the probability of getting political promoted is not related to firm performance but non-economic indicators; different promotion mechanisms lead to different behaviors of executives; political promotion is related to firms' social responsibility but not related to efficiency of investment. They believe that political promotion incentives for SOEs target for non-economic indicators while performance-pay targets the enterprise performance.

Conyon, He, and Zhou (2015) studies China's star CEOs defined as members of the National

People's Congress (NPC) or the National Committee of the Chinese People's Political Consultative Conference (CPPCC) and politically connected CEOs who have previous government or military experience. They evaluate the effect of star CEOs and politically connected CEOs on firm performance and CEO compensation. They found that announcement date returns, CEO compensation and incentives are all higher in firms that have star CEOs. However, the mechanism explaining these various premiums is largely the political connectedness of these star CEOs. Nevertheless, they found only modest evidence that star-CEO status directly determines firm performance. Therefore, their analysis strongly suggests that compensation and performance premiums are mostly driven by CEO political connections, as opposed to CEO talent/star effects.

Indeed, He, Wan, and Zhou (2015) found evidence of significantly positive cumulative abnormal returns when CEO succession is accompanied with increased political connections. They show that the market reaction to political connections is significantly stronger for external successors and for poorly performing firms, while it is significantly weaker for firms in high-tech industries and firms located in more developed regions. Their findings suggest that Chinese investors do value political connections, and such valuation is conditioned by successor origin, prior firm performance, industry, region, and ownership structure.

In contrast, others argued that the attractiveness of political promotion will distort the objective of maximizing the value of the enterprise, which may bring about a negative effect.

Xu (2012) studied the interactions between political promotion and salary inequality and its effect on CEO incentives, using data of listed companies in China’s A-share market between 2005 and 2009. They found that monetary compensation and political promotion are not only a simple alternative, but have other interactions. When the vice president of the company has a higher chance of promotion, salary inequality brings about a tournament effect, which improves the firm performance; when the chance of promotion of the vice president is small, salary inequality brings about a negative effect on firm performance.

Zheng et al. (2012) used case study to show that in order to achieve political promotion, executives of SOEs have a strong incentive to build the image of engineering. Therefore political promotion becomes one of the direct causes of image projects of SOEs. The image projects, including but not limited to public welfare donations, are carried out in order to enhance the corporate or executive personal image of the media in the short term.

Wu (2015) studied the influence of the political promotion incentive of the state-owned enterprise executives on the political behavior. The article selects two kinds of the most typical political catering behavior of the over-investment and earnings management. Empirical results show that: first, political promotion incentives will cause executives of SOEs to make over-investment in order to obtain political promotion and meet the political needs of the local government. The incentive pay provides another incentive that weakens the above one. Secondly, SOE executives will meet the SASAC's financial performance appraisal to make earnings management behavior, and incentive pay will weaken the positive

correlation. In all, political promotion incentives are distorted incentives that generate fake good performance of firms. The enterprise will ultimately suffer from the over-investment carried out by CEOs.

### 2.3.7 Summary

To sum up, the literature aforementioned provided various evidences on the determinants of CEO pay and their effects on CEO incentive mechanism. The table of reference below summarizes all the related empirical papers and shows the research gap that this thesis tries to fill.

Table of reference: A summary of related empirical studies

| Paper | Topic | Gaps |
|---|---|---|
| McGuire et al. 1962<br>Tosi and Mejia, 1989<br>Ciscel and Carroll, 1980 | Optimal contract design can provide incentives for CEOs to behave in a way that maximizes firms' value | Ownership of the firms not investigated |
| Conyon and He 2016 | The effect of penalty | Only private firms are studied |
| Jensen and Murphy, 1990<br>Haubrich, 1994<br>Firth et al. 2006 | CEO pay is positively related to firm performance, but the coefficient is too small | This findings are not in line with our observations for China's SOEs |
| Conyon and Murphy 2000 | Compare CEO remunerations in the US and the U.K. | Remunerations are in monetary terms. Other forms of remunerations are not considered |
| Chen and Leng 2004<br>Boeker, 1992<br>Davis, 1991<br>Gabaix and Landier, 2006<br>Dutta, 2008 | Propose a moral hazard model/managerial power (and other models) to explain the low pay-performance sensitivity between CEO pay and firm performance | Moral hazard problem is not unique for China. Therefore this model cannot explain the high pay-performance sensitivity in other countries. For China, there must be some other reasons |
| Tosi et al. 2000<br>Cordeiro et al. 2016 | Different measure of firm performance, e.g., firm size, relative performance, etc. | Fail to account for the special design of remuneration for China' SOE |
| Cooper et al. 2014<br>Forth and Bryson 2014<br>Brick et al. 2012 | Consider different form of monetary payments in the remuneration | These forms are in monetary terms. Political promotion is not considered |
| Wei 2000<br>Zhang 2002<br>Buck et al. 2008<br>Cao et al. 2011 | Study the pay-performance sensitivity for case of China and found mixed results | Pay is measured in monetary terms. Political promotion is not considered |
| Ren et al. 2011<br>Hou et al. 2010<br>Zhang and Ding 2011<br>Zhang 2012 | Study the effects of SOE's salary limit on firm performance | Does not explain why CEOs of SOE still have incentive to improve firm performance even if their salary has the limit |

| | | |
|---|---|---|
| Cao et al. 2011<br>Conyon et al. 2015 | Propose the importance of political connections and political promotion | In this thesis, I use survey data and case studies to formally test the importance of political promotion in providing CEO incentives |

In short, the CEO remuneration design has been one of most frequently researched areas. However, there are two major gaps between these existing literatures and this thesis. The first gap is that nearly all the previous literatures presume that CEOs respond to monetary payment. Given this presumption, their theoretical studies mainly discuss why should we and how to use incentive compatible monetary payment to motivate CEOs' effort; and their empirical studies mainly investigate the effects of such incentive pay on promoting CEO effort and firm performances. These studies include those most famous and important research papers such as McGuire et al (1962), Jensen and Murphy (1990), Chen and Leng (20014), and so on. However, as more and more studies that show the very weak relationship between CEO's incentive pay and firm performances, it is reasonable to question this presumption that serves as the fundamental of the incentive pay theory. In fact, Mullainathan and Bertrand (2003) show that, under certain conditions, CEOs pursue a quiet life rather than monetary payments. This paper draws our attention that CEO might concern something else rather than simply monetary payment. Admittedly, there are literatures that investigate other goals of CEO, such as building an empire (Baumol, 1959 and Willianson, 1964). However, these papers do not consider the fact that different institutional design and culture might affect the CEO's objectives. For case of enterprises in China, particularly the SOE, economic profit maximization was not these enterprises' first objective in the first place (Sheng, 2015), not to mention these SOEs use monetary payment to motivate CEOs to improve firms' profitability. Therefore, this thesis fills this gap by investigating the role of political promotion as an alternative motivation mechanism for CEOs.

The second gap between the existing literature and this thesis is, from empirical studies point of view, that previous studies treat SOE and non-SOE in the same framework, if these studies focus on the enterprises in China. The ownership of the firm does not really matter because both SOE and non-SOE are analyzed by the same model, which implicitly imply that SOE and non-SOE share the same objective. These studies include Wei (2000), Buck et al (2008), among others. This thesis studies SOE, with the particular emphasis on the different objective of SOE compared to non-SOE. Admittedly, there are other studies that focus on SOE as well. Nevertheless, these studies are subjected to the first gap mentioned above. They consider the salary limit (Ren et al, 2011; Zhang and Ding, 2011, Zhang 2012), or different form of monetary payment such as perquisite consumption (Cooper et al 2014; Brick et al. 2012), or effect of reform on the non-tradable shares of SOE (Chen et al. 2015), and so on. But they are still constrained by the presumptions that CEOs in SOE do care about monetary payment, the same objective for CEOs in non-SOEs. Therefore, the proposition of political promotion as the alternative objective of CEOs in SOEs truly distinguish the SOE and non-SOE.

The table above shows how this thesis forms the research question. Previous studies argue that by connecting CEO pay with firm performance, CEOs will be better motivated to improve firm

performance. However, when some studies found that the pay-performance sensitivity in reality is not large enough to justify the argument, most of the following studies resort to do an anatomy of monetary payments, or propose a different model. There are few studies that recognize the unique characteristics of China's SOEs and the potential effects of political promotion. Therefore, this thesis fills this gap.

The reform on "the Split" is more important compared to the administrative regulations such as "the Measure". Nevertheless, these studies treated CEO pay as one variable and neglected the fact that CEO pay is composed by various parts. Even though some research examined the different effects of cash and salary payments and long-term incentives of stocks and options, they fail to consider the interactions between the two parts. As in "the Measure" the upper limit of overall CEO pay was set, but did not regulate the structure of the payments. Particularly, the implicit payments such as appropriation of public funds and perquisite consumption are not effectively regulated. When "the Measure" limited the explicit remuneration of CEOs, they compensated themselves by resorting to implicit payments. This example illustrates that the study of CEO pay should not overlook the structural effects of the payments.

# Chapter 3. Methodology and Data

## 3.1 Methodology: mixed research strategy

The methodology used in this paper is a mixed research method. We first use the data of all China's SOEs and non-SOEs listed in A-share market to test the traditional incentive pay theory following Jensen and Murphy (1990)'s framework. With the findings that do not support the incentive pay theory, we further investigate the role of political promotion. However, due to the strictly confidential of political promotion data, it is not possible to use large sample regressions to test the hypothesis. In light of this problem, nevertheless, we manually connect data of CEO political promotion and the firm level financial accounting data of several firms and analyze these examples in form of case study. Of course, while case study may well serve as a preliminary evidence of the role of political promotion, it cannot guarantee an unambiguous conclusion, and it certainly cannot provide any insight of quantitative estimate of how large the effect of political promotion has on CEOs' incentives. Therefore, we further design a questionnaire and conduct a survey to increase the sample size. The survey analysis is also a second-best choice due to the confidentiality of political promotion data. However, the survey results do help us to reach certain conclusions, which we discuss in detail in chapter 7 and 8.

To elaborate, compared to previous related studies, the test of Jensen and Murphy (1990)'s theory by using data of all China's SOE and non-SOE listed in A share market has several differences. Although the target is to test the same theory, the sample used in this study has more observations. The time span is longer and updated. Moreover, this study also takes into account two additional dummy variables that have important impact on CEO remunerations in China's SOEs. The first dummy is the event of the Split in year 2004 so that previous

non-tradable stocks held by CEOs or directors of listed firms gradually become tradable. The payment in the form of stocks is believed to have the effect of providing incentives to CEOs to improve firm performance, but this is true only if CEOs can sell these stocks and benefit from share price increase resulting from improvement of firm performance. Therefore, the Split in 2004 is chosen as the first dummy that is related to Jensen and Murphy (1990)'s theory. The second dummy variable is the salary limit of CEOs of SOEs implemented in 2009. Since 2009, the state has implemented salary limits for CEOs working in SOEs. A similar salary limit particularly to CEOs working in financial sector was implemented in 2014. Such salary limit, according to Jensen and Murphy (1990)'s theory, would dampen CEO's incentives to exert high effort. For the test in this study to be robust, the year 2009 was chosen as the second dummy.

If the empirical findings are consistent with Jensen and Murphy (1990)'s prediction, then it can be argued that CEOs in China's SOEs are motivated by monetary payments, and incentive pay can improve firm performance. However, as shown below, the findings contrast the theory significantly. The question rises naturally: are CEOs in China's SOEs motivated by something else? This study proposes that political promotion is the most important motivation. To test this proposition, due to lack of data and difficulty to measure political promotion, this study use case studies and survey studies.

This paper includes two case studies, in which two SOEs are analyzed. This paper shows that although the monetary payments of CEOs were fixed, the performance of the two SOEs improve significantly in the year when the CEOs were politically promoted. This proposes the possibility that political promotion can be an important motivation in CEO remuneration. To better address this possibility, a questionnaire is designed and sent to 100 respondents. These respondents are CEOs or directors of the board working either in SOEs or non-SOE. The questionnaire asks related questions in the indirect manner so that preferences to political promotion or monetary payments of CEOs among different firm ownerships can be implied. The survey shows that political promotion is the dominating motivation for CEOs working in SOEs.

### 3.2 Data Sources

This empirical analysis focuses on all of China's SOEs listed on the Shanghai and Shenzhen stock exchanges. The sample year is 2003 to 2012, while in the robustness check, the researcher extends the sample year to 2014. All firm-level data comes from WIND database and Chinese Stock and Market Accounting Research database (CSMAR). These databases are the most commonly used databases, in which firm-level financial structure, corporate governance, and accounting data are available.

Referring to Jensen and Murphy (1990), Himmelberg and Hubbard (2000), and Cao et al., (2011), the variables that these research studies included were monetary payments to CEOs, allowance, stock and options, perquisite consumption of CEOs, equity structure of the firm, information about the board, firm size, profitability, stock market performance, etc. In this

research the same variables will be used.

The sample period starts in 2003 in this research, because before this year, listed companies seldom systematically reported CEO remuneration. After eliminating the outliers (firms with missing observations), the total observations is 17330, in which SOEs have 6873 observations and non-SOEs have 10457 observations. To illustrate that CEOs of SOEs are not sensitive to monetary payments, this thesis compares the SOE group to non-SOE group. This is the reason why non-SOEs are included in the sample.

For political promotion data, the researcher manually collected each CEO's resume and identified the "current position", "previous position", "the year when promoted", "promotion types", etc. The definition of these variables and other variables mentioned before will be introduced in the following section.

### 3.3 Variable Definition and Statistics

The definitions of variables regarding corporate governance are summarized in Table 3.3.1:

Table 3.3.1: Variables Definition

| Variables | Definition |
|---|---|
| Compensation | CEOs get compensation from the listed firm, which contains salary, allowance, bonus, perquisite consumption, stock and options, and political incentive. However only fixed salary is considered in this version. |
| Performance | Operating results of listed firms. The researcher uses different indices to measure firms' performance, including return on assets (ROA), return on equity (ROE) and annual stock returns (RET). |
| State | Dummy variable. If the listed firm is a state-owned enterprise then state=1, otherwise state=0. |
| Dual | Dummy variable, if the CEO and the board chairman is the same person then dual=1, otherwise dual=0. |
| Boardsize | The size of the board, measured by the natural logarithm of the number of board directors. |
| Depend | The independence of the board, measured by the percentage of independent directors |
| Meeting | Number of board meetings in a year |
| Logexcuhldn | Shares held by CEOs |
| G_sale | Growth rate of sales |
| Size | Size of the firm, measured by the natural logarithm of firms' assets |
| Lev | Total debt over total equity |
| Fix_ind | Industry fix effect |
| Fix_year | Year fix effect |

The chosen variables in Table 3.3.1 follow the conventional literatures such as Jensen and Murphy(1990), Conyon and Murphy(2000), Jensen and Murphy(2010) Adithipyangkul et al., (2011), and Conyon and He(2011, 2012). More precisely, the dependent variable is the "compensation", which includes basic salary, allowance, bonus, perquisite consumption, and

stock and options. The current work only considers the basic salary, allowance, bonus for SOEs, which is viewed as short-term payment. The reason for this treatment is that, first of all, as mentioned before, SOEs do not use stock and options in the CEO remunerations; second of all, the researcher compares the sensitiveness of monetary payments to firm performance between SOEs and non-SOEs. Both stock and options for non-SOEs and political promotion for SOEs are considered as long-term incentive pay respectively. Thus using monetary payments makes more sense for the comparison.

The explanatory variable "performance" includes accounting indices such as return on assets (ROA) and return on equity (ROE). It also includes market index such as annual stock return (RET). As is well known, Chinese stock market is inefficient, and market index reveals firm performance poorly. Thus, the researcher uses all three indices in the robustness check.

For control variables, "state" is the dummy for SOE. "Dual" is the dummy that equals to 1 if the CEO is also the director of the board. This dummy is included following the theory of managerial power (Bertrand and Mullainathan, 2001； Bebchuk et al., 2002) which believes that if the CEO is also the director, he has strong power of designing the performance pay. "Boardsize" measures the number of board members. It is argued that the size of the board has impact on corporate governance, as large size makes the decision more rational while small size increases the efficiency (Lipton and Jay,1992; Dalton，1996； Yermark, 1996). "Depend" is calculated as the share of the independent directors in the board. Traditionally, independent directors are assumed to monitor the board more efficiently, thus may affect the design of CEO remunerations and firm performance (Baysinger and Butler, 1985; Hermalin, 1988； Beasley, 1996). "Meeting" is the number of board meetings in a year. It proxies the level of corporate governance (Vafeas, 1999). "Logexcuhldn" is the log value of shares held by CEOs. "G-sale" is the growth rate of the sales. "Size" is the log value of the asset size of the firm. "Lev" is the leverage defined as total debt over total equity. All these variables are standard in the literature.

Next, the researcher defines the variables regarding political promotion. A CEO is "politically promoted" if he departs from the firm and work for one of the following: one, an officer of the central government, local government or military.; two, a member of the Standing Committee of the National People's Congress (NPC), Chinese People's Political Consultative Conference (CPPCC), or the Secretary of the Communist Party Committee (CPC); and three, a CEO in larger SOEs, parent company, or appointed also as Party Secretary of the firm. There are two examples of political promotion given in Table 3.3.2:

Table 3.3.2: examples of political promotion

| CEO | Year | Current Position | Year of Promotion | New Position | Salary | Performance |
|---|---|---|---|---|---|---|
| Mr. Zhu | 2006 | Changchun First Auto | 2007 | Vice Governor of Jilin Province | *** | ROA, ROE, asset size, etc. |
| Mr. Yu | 2006 | TANDE Co. Ltd. | 2007 | Secretary of CPC Committee | *** | ROA, ROE, asset size, etc. |

Due to lack of data, the information regarding political promotion cannot be directly measured. This is the reason why survey studies are conducted. For data already collected, the summary of statistics is shown below. Table 3.3.3 shows the average salary of SOEs and non-SOEs, and compares them by year. Noticeably, right after the annual salary reform for SOEs (2003), the average salary of CEOs of SOEs is lower than that in non-SOEs. Since 2010, however, the average salary in SOEs has been significantly higher than non-SOEs. To be sure, this does not necessarily imply that the absolute payment level in SOEs is higher than non-SOEs. On one hand, Table 3.3.3 only compares the basic salary, which underestimates the actual pay in non-SOEs. Other types of monetary payments (e.g. stock and options) are important for non-SOEs while they are missing in SOEs. On the other hand, SOEs are relatively larger than non-SOEs.

Table 3.3.3: Salary difference between SOEs and Non-SOEs

| | SOE | | NON-SOE | | | |
|---|---|---|---|---|---|---|
| Year | Obs. | Mean | Obs. | Mean | Diff | T value |
| 2003 | 849 | 474818 | 392 | 548406 | -73588 | -2.52** |
| 2004 | 856 | 593189 | 501 | 626014 | -32825 | -0.93 |
| 2005 | 837 | 642341 | 530 | 638987 | 3354 | 0.09 |
| 2006 | 851 | 761114 | 585 | 727770 | 33344 | 0.70 |
| 2007 | 887 | 1130000 | 679 | 1150000 | -20000 | -0.06 |
| 2008 | 869 | 1220000 | 749 | 1130000 | 90000 | 0.99 |
| 2009 | 545 | 1210000 | 1224 | 1140000 | 70000 | 0.92 |
| 2010 | 456 | 1440000 | 1671 | 1350000 | 90000 | 1.80* |
| 2011 | 372 | 1880000 | 1987 | 1580000 | 300000 | 3.03*** |
| 2012 | 351 | 2000000 | 2139 | 1660000 | 340000 | 3.40*** |

Note: *, **, and *** respectively denote the significant level of 10%, 5%, and 1%. All tables apply

Table 3.3.4 compares the average salary of financial SOEs and non-SOE financial firms. This comparison is meaningful. First, the observations of each type of firm are basically equal; second, the financial industry is less intervened by the government and the salary level is more market driven, and third, financial SOEs and non-SOE financial firms are similar in asset size. The result is evident—financial SOEs pay significantly less than non-SOE financial firms.

Table 3.3.4: Salary difference between SOE and Non-SOE financial firms

| | SOE financial firms | | NON-SOE financial firms | | | |
|---|---|---|---|---|---|---|
| Year | Obs. | Mean | Obs. | Mean | Diff | T value |
| 2003 | 4 | 1620000 | 3 | 1760000 | -140000 | -0.17 |
| 2004 | 4 | 2170000 | 4 | 2420000 | -250000 | -0.22 |
| 2005 | 4 | 2270000 | 3 | 5310000 | -3040000 | -1.31 |
| 2006 | 5 | 1710000 | 4 | 8420000 | -6710000 | -3.20*** |
| 2007 | 7 | 4170000 | 6 | 11000000 | -6830000 | -1.36 |
| 2008 | 6 | 4520000 | 7 | 10700000 | -6180000 | -1.47 |
| 2009 | 4 | 5930000 | 9 | 8390000 | -2460000 | -0.6 |
| 2010 | 3 | 6200000 | 12 | 9510000 | -3310000 | -0.94 |
| 2011 | 4 | 5560000 | 13 | 10400000 | -4840000 | -1.42 |
| 2012 | 7 | 5090000 | 11 | 9540000 | -4450000 | -2.26** |
| total | 48 | 3940000 | 72 | 8830000 | -4890000 | 5.32*** |

Note: *, **, and *** respectively denote the significant level of 10%, 5%, and 1%. All tables apply

Next, Table 3.3.5 compares the corporate performance between SOEs and non-SOEs. It shows **that there are no significant differences in terms of ROA, ROE, Leverage, sales growth** between the two types of firms. The only exception is the stock market return, which is significantly higher in SOEs. This is not uncommon, and the literature calls it "ownership discrimination".

Table 3.3.5: Comparison of variables among four types of firms

| | SOE | | Non-SOE | | | |
|---|---|---|---|---|---|---|
| variable | obs. | mean | obs. | mean | difference | T value |
| roa | 6873 | -0.0002 | 10457 | 0.0232 | -0.0234 | -0.94 |
| roe | 6873 | 0.0002 | 10457 | 0.0011 | -0.0009 | 0.90 |
| ret | 6873 | 0.0023 | 10457 | 0.0016 | 0.0007 | 4.45*** |
| lev | 6873 | 0.6861 | 10457 | 0.6288 | 0.0573 | 0.52 |
| g_sale | 6873 | 0.0195 | 10457 | 0.0479 | -0.0284 | -0.73 |

Note: *, **, and *** respectively denote the significant level of 10%, 5%, and 1%. All tables apply

## Chapter 4. Baseline Model and Estimation

### 4.1 Model setup and empirical results

The first question this research addresses is whether CEO salary in SOEs is sensitive to firm performance. Using standard model as in Jensen and Murphy (1990), Conyon and Murphy (2000), Jensen and Murphy (2010), and Adithipyangkul et al., (2011), the model that will be estimated is given by:

$$compensation_{i.t} = \alpha + \beta_1 performance_{i.t} + \beta_2 controls$$

This model differs from Jensen and Murphy (1990) who also used firm performance in the previous year as explanatory variable. The researcher found that there is serious collinearity between the performance in the current year and the previous year, and to avoid this problem, the researcher only used the current year performance in the regression. "controls" are other variables listed in Table 3.3.1.

Table 4.1.1 shows the estimated result for the full sample (SOEs and Non-SOEs). The "performance" is measured by "ROA", and the dependent variable "compensation" is measured by CEOs' basic salary times 1000 and then divided by firms' asset size.

Table 4.1.1: The sensitivity of CEO remuneration to ROA

| Parameter | Estimate | Standard Error | t Value | Pr > \|t\| |
|---|---|---|---|---|
| Intercept | 7.871 *** | 0.212 | 37.11 | <.0001 |
| roa | 0.656 *** | 0.072 | 9.08 | <.0001 |
| state | 0.023 | 0.021 | 1.11 | 0.269 |
| dual | 0.057 *** | 0.021 | 2.76 | 0.006 |
| boardsize | 0.157 *** | 0.046 | 3.38 | 0.001 |
| depend | 0.637 *** | 0.166 | 3.83 | 0.000 |
| meeting | -0.005 ** | 0.002 | -2.01 | 0.045 |
| logexcuhldn | 0.013 *** | 0.003 | 4.40 | <.0001 |
| g_sale | 0.001 | 0.000 | 1.36 | 0.173 |
| size | -0.358 *** | 0.009 | -39.74 | <.0001 |
| lev | 0.079 *** | 0.028 | 2.84 | 0.005 |
| fix_ind | control | control | control | control |
| fix_year | control | control | control | control |
| obs. | 6229 | | | |
| R-square | 0.3918 | | | |
| F | 33.65 | | | |

Note: *, **, and *** respectively denote the significant level of 10%, 5%, and 1%. All tables apply

From Table 4.1.1, the coefficient before "ROA" is 0.656 and is 1% significant. This shows that the CEO pay is sensitive to firm performance when pooling both SOEs and non-SOEs together. However, it also shows that when the return of the firm increases 1000 yuan, the salary only increases by 0.65 yuan, which is far lower than that in the US. For example, Jensen and Murphy (1990) showed that every 1000 dollar increase in profit results in a 3.25 dollar increase in CEO pay. They still argued that the incentive is insufficient for American firms, not to mention in the case of Chinese firms.

Next, the researcher carried out sub-sample studies of SOEs and non-SOEs, and compared the results between the two samples. With definition of all variables unchanged, Table 4.1.2 shows the difference of PPS between SOEs and non-SOEs to ROA.

Table 4.1.2: Difference of PPS between SOE and Non-SOE firms to ROA

| | SOE firms | | | Non-SOE firms | | |
|---|---|---|---|---|---|---|
| Parameter | Estimate | Std Error | t Value | Estimate | Std Error | t Value |
| Intercept | 5.987 *** | 0.251 | 23.89 | 9.083 *** | 0.312 | 29.11 |
| roa | 0.963 *** | 0.136 | 7.07 | 0.629 *** | 0.089 | 7.07 |
| dual | -0.060 ** | 0.030 | -1.98 | 0.099 *** | 0.027 | 3.71 |
| boardsize | 0.061 | 0.051 | 1.21 | 0.176 ** | 0.070 | 2.52 |
| depend | 0.265 | 0.192 | 1.38 | 0.766 *** | 0.244 | 3.14 |
| meeting | 0.001 | 0.003 | 0.28 | -0.005 | 0.003 | -1.58 |
| logexcuhldn | 0.032 *** | 0.005 | 6.83 | 0.008 * | 0.004 | 1.92 |
| g_sale | -0.001 | 0.004 | -0.28 | 0.001 | 0.001 | 1.18 |
| size | -0.268 *** | 0.011 | -24.96 | -0.415 *** | 0.013 | -31.83 |
| lev | -0.047 | 0.037 | -1.27 | 0.131 *** | 0.037 | 3.52 |
| fix_ind | control | control | control | control | control | control |
| fix_year | control | control | control | control | control | control |
| obs. | 2257 | | | 3972 | | |
| R-square | 0.4206 | | | 0.3680 | | |
| F | 17.47 | | | 20.44 | | |

Note: *, **, and *** respectively denote the significant level of 10%, 5%, and 1%. All tables apply

The result is that CEO salary in both SOEs and non-SOEs are sensitive to firm performance measured by ROA at 1% level. For the SOEs, every 1000 yuan increase in profit brings a 0.963 raise in the pay, which is higher than 0.692 for the non-SOEs. Although being significant, the incentives provided by the above "plan" seem too little.

In addition, the results in Table 4.1.2 are not quite consistent with the statistics in Table 3.3.3. In Table 4.1.2, the coefficient before ROA for SOEs is larger than that for non-SOEs, while in Table 3.3.3, SOEs pay less to CEOs than non SOEs. One potential explanation is that assets in SOEs are state owned, and maintaining state owned asset value is the prior target for them. For non-SOEs, maximizing shareholders' wealth is the prior target. Therefore, although both ROA and ROE are commonly used measurements of firm performance, increasing ROA has political motivation in SOEs. In light of this concern, the researcher re-regressed the model, using ROE as the measurement of performance, and Table 4.1.3 shows the results.

Table 4.1.3: Difference of PPS between SOE and Non-SOE firms to ROE

| | SOE firms | | | Non-SOE firms | | |
|---|---|---|---|---|---|---|
| Parameter | Estimate | Std Error | t Value | Estimate | Sd Error | t Value |
| Intercept | 4.922 *** | 0.236 | 20.88 | 8.645*** | 0.322 | 26.84 |
| roe | 0.007 | 0.006 | 1.04 | 0.020* | 0.012 | 1.68 |
| dual | -0.051 * | 0.028 | -1.79 | 0.090*** | 0.026 | 3.41 |
| boardsize | 0.130 *** | 0.047 | 2.75 | 0.184 *** | 0.069 | 2.65 |
| depend | 0.203 | 0.179 | 1.14 | 0.686*** | 0.242 | 2.84 |
| meeting | 0.002 | 0.003 | 0.76 | -0.005 | 0.003 | -1.47 |
| logexcuhldn | 0.036 *** | 0.004 | 8.24 | 0.002 | 0.004 | 0.52 |
| g_sale | 0.000 | 0.004 | 0.06 | 0.001 | 0.001 | 1.12 |
| size | -0.221 *** | 0.010 | -21.28 | -0.382*** | 0.014 | -27.18 |
| lev | -0.413 *** | 0.055 | -7.54 | -0.295*** | 0.071 | -4.15 |
| fix_ind | control | control | control | control | control | control |
| fix_year | control | control | control | control | control | control |
| obs. | 2229 | | | 3972 | | |
| R-square | 0.4427 | | | 0.3720 | | |
| F | 18.87 | | | 20.49 | | |

Note: *, **, and *** respectively denote the significant level of 10%, 5%, and 1%. All tables apply

Not surprisingly, the coefficient before ROE is not significant for SOEs, while it is still 10% significant for non-SOEs. Both Table 4.1.2 and Table 4.1.3 illustrate that the CEO pay in SOEs is not sensitive to firm performance in terms of ROE, or the sensitiveness is too small to provide adequate incentives in terms of ROA.

For a robustness check at the current stage, the researcher also used annual stock return (RET) as the measurement of the performance and re-estimated the model. Table 4.1.4 reports the difference of PPS between SOEs and non-SOEs.

Table 4.1.4: Difference of PPS between SOE and Non-SOE firms to RET

| | SOE firms | | | Non-SOE firms | | |
|---|---|---|---|---|---|---|
| Parameter | Estimate | Std Error | t Value | Estimate | Sd Error | t Value |
| Intercept | 5.443 *** | 0.253 | 21.53 | 7.735 *** | 0.319 | 24.27 |
| ret | -0.003 | 0.016 | -0.18 | 0.033 | 0.023 | 1.46 |
| dual | -0.062 ** | 0.030 | -2.05 | 0.140 *** | 0.029 | 4.87 |
| boardsize | 0.084 * | 0.050 | 1.66 | 0.103 | 0.070 | 1.47 |
| depend | 0.252 | 0.193 | 1.31 | 0.603 ** | 0.255 | 2.37 |
| meeting | 0.002 | 0.003 | 0.62 | -0.005 | 0.003 | -1.42 |
| logexcuhldn | 0.041 *** | 0.005 | 8.36 | 0.015 *** | 0.004 | 3.63 |
| g_sale | 0.001 | 0.005 | 0.31 | -0.002 | 0.004 | -0.58 |
| size | -0.249 *** | 0.011 | -22.82 | -0.347 *** | 0.013 | -26.10 |
| lev | -0.162 *** | 0.034 | -4.79 | 0.070 ** | 0.030 | 2.33 |
| fix_ind | control | control | control | control | control | control |
| fix_year | control | control | control | control | control | control |
| obs. | 2131 | | | 2782 | | |
| R-square | 0.3970 | | | 0.4001 | | |
| F | 15.65 | | | 17.52 | | |

Note: *, **, and *** respectively denote the significant level of 10%, 5%, and 1%. All tables apply

Both SOEs and non-SOEs have insignificant coefficient before RET. This shows that CEO pay will not be raised if stock return increases. This result may be specific in the case of Chinese stock exchange market, because this market is believed to be inefficient.

The above exercises show that CEO pay is sensitive to ROA in SOEs, but the coefficient is too small to provide adequate incentives. The pay is not sensitive to ROE or RET, confirming that monetary payment cannot be the most important incentive to CEOs. The sensitiveness in non-SOEs is significant using both ROA and ROE, but the coefficients are too small to make economic sense. One potential explanation for non-SOEs is that the previous regressions only use basic salary as measurement of compensation. Other types of monetary payment, such as bonus and stock and options, are long-term payment and are believed to provide more important and direct incentives to CEOs (Baker et al., 1988). For SOEs, however, there is merely no practice of using stocks and options as incentive pay to CEOs, and their cash pay is not sensitive to performance. It is natural to ask, what provides these CEOs with incentives to manage the firms (we do observe that the performance of SOEs are improving very fast)? The researcher next studies political promotion.

### 4.2 Discussion about the findings and the role of political promotion

Traditionally it is believed that non-SOEs care more about the profit and have better incentives and compatible compensation packages for their CEOs. Thus, corporate governance theory would predict that CEO compensations in SOEs are less sensitive to the firm performance than that in non-SOEs. However, our results report in Table 4.1.2 contrast the theoretical predictions. These results, although also found in Kato and Long (2006), Firth

et al. (2007), Conyon and He, (2011), and Jiang, Zhu, and Wang (2014), have absolutely different interpretations. For example, Jiang et al. (2014) argue that SOEs in China place explicit requirements in terms of firm performance on CEOs. These CEOs further suffer stronger social surveillance, and thus have less moral hazard problems. This interpretation is not intuitive, because there are no direct monitors of CEOs in China's SOEs, thus the monitor should be inefficient. In addition, SOEs have broader social responsibilities in China, particularly for those owned by the central government. These social responsibilities, such as policy finance, employment oriented industries, are not economical. The unique role of SOEs in China leads to less emphasis on firm profitability, and indeed, few SOEs appraise their CEOs using criteria of firm performance such as return on assets or return on equity. Therefore, the sensitivity of CEO remuneration to firm performance in SOEs should be smaller than that of non-SOEs, which is not the case according to the regression results.

In fact, we notice that classic CEO remuneration theory assumes that CEOs pursue monetary payments. If this assumption holds good, together with our regression results, we should be able to observe that: 1, CEOs of SOEs get higher monetary payments than those in non-SOEs, because the sensitivity of remuneration to firm performance is larger in the former; 2, if the CEOs of SOEs cannot get enough monetary payments that are equivalent to firm performance, these CEOs would leave the job. However, neither of the above two phenomenon is observed. The average monetary payments to CEOs of SOEs is only 76% of that in non-SOEs, and we seldom see CEOs voluntarily leave the job. The second fact is more evident particularly when we consider the two "salary limit" act. As mentioned before, the central government set a salary limit on CEO monetary payments respectively in 2009 for financial SOEs and 2014 for other SOEs. No CEOs voluntarily left the job. Instead, as we discuss more in case studies, these CEOs generally work harder. This fact tells us that, CEOs of SOEs must care something else.

Another important comment regarding the comparison of remuneration sensitivities to firm performance between SOEs and non-SOEs is that, the comparison is based on one important presumption following the traditional theory that the CEO pay is determined by firm performance for both SOEs and non-SOEs. However, this is not the case for China's SOEs. Most CEOs in China's SOEs have political titles and ranks. In other words, they are managers of the SOEs as well as public servants in the government. Therefore, most of their salary is determined according to their political ranks. If CEO pay in SOEs is determined by the exogenous political rank while that in non-SOEs is determined by firm performance, the comparison of the sensitivities makes little sense. Moreover, the SOEs are also ranked, which affects the rank of their CEOs. The rank of SOEs is determined by many variables, such as industry, the position in the industry and locations. The most important determinant is, however, the size of the firm. Generally, the larger the firm size, the higher rank the firm, and the higher political rank of its CEO, and the more monetary payments this CEO can get. On the other hand, for two firms with the same profitability, the one with larger size earns more profit. This tells that the larger the SOE's size, the higher its CEO's political rank and monetary payments, and the more profit this SOEs can earn, given the profitability of SOEs unchanged. If this is true, the sensitivity of CEO's remuneration to firm performance would

be very strong. But such relationship is not explained by corporate governance theory. Instead, it can be explained by the unique exogenous payment structure of SOEs in China.

Therefore, we provide an alternative explanation of our regression results, which we believe is more reasonable. The high sensitivity of remunerations to firm performance in China's SOEs is not driven by a more efficient incentive pay design, but by the fact that the firm size affects both political rank (hence payment) and firm performance. This appeals to our central theme that CEOs of SOEs care something more other than monetary payments, and that is political promotion. Even if these CEOs care about monetary payments, the only way they can increase it is by political promotion or work in a private firm. The latter is certainly very rare in reality, thus political promotion could be their most important motivation to stay in SOEs. Getting political promotion not only brings higher monetary payments but also more power and implicit right to seek rent.

The results reported in Table 4.1.3 confirms our conjecture somehow, where the firm performance is measured by return on equity. By avoiding the effect of asset size, the sensitivity of remunerations to firm performance in non-SOEs is stronger than that in SOEs.

## Chapter 5. The Importance of Political Promotion in SOEs

The empirical results obtained in Section 4 are inconsistent with Jensen and Murphy (1990)'s prediction. To explain these results, this study proposes that political promotion plays the role of providing CEOs of SOEs incentives to exert effort. This proposition comes with the understanding that China's SOEs has special institutional design. SOEs are enterprises, but they are closely connected with politics. This section introduces more background of SOEs, their development and reform and their political status. With this information, political promotion comes naturally.

### 5.1 Background of SOEs

In international practices, SOEs only refer to enterprises controlled or owned by a country's central government or federal government. In China, SOEs also include those controlled by local governments. The will and interests of the government determine the behavior of the state owned enterprises (Unirule Economic Institute, 2015).

No matter in theory or in the history of economic development, SOEs play different roles in different stages of economic development, and their status in the national economy is not the same. The emergence of SOEs began after the First World War. With the transformation from market capitalism to state monopoly capitalism, many countries began to intervene in and regulate economic activities. At the same time, under the impetus of the new technological revolution, the production scale of enterprises is expanding day by day, and the market economy, which is maintained by free competition, has caused social instability. In this case,

western countries began to plan and lead production. From the beginning of 1945, the UK nationalized a series of basic industries and the Bank of England, and the French government took over the energy sector, insurance sector, the financial sector and some big companies. At the same time, Japan and the United States also established a number of SOEs. These SOEs are mainly concentrated in the energy sector, the infrastructure sector, the provision of public product sector and the development of science and technology department.

After the Second World War, many developing countries promoted nationalizing firms and central planning of economies in order to revitalize the national economy and industrialization (Zhang, 1990). We observe two climaxes of such nationalization activities. The first climax was between the late 1950s and the mid-1960s, which was followed by the upsurge of the national liberation movement that was mainly aimed to protest against the colonial enterprise and the colonial economy management of enterprises, including banks, tax authorities, customs, and large enterprises where colonists have enough monopoly or manipulation power. The climax of the nationalization is actually the continuation of the national liberation movement in the economic field. The second climax was in 1970s, which was inspired by the victory of the oil producing countries in the Middle East to recover the sovereignty of oil resources. The developing countries set off a trend to recover the sovereignty of natural resources. In this trend, some countries nationalized key sectors of the national economy that have significant impact on the countries' development. They also took over mine resources, agricultural and fishery resources. The development of SOEs in developing countries are viewed as being vital to safeguard national sovereignty, to strive for economic independence, to lay the foundation for the development of the national economy and the transformation to market mechanism and complete the maintenance of the normal operation of the economy and promote the balanced development of regional economy and other aspects of the national economic system, to promote the development of other economic sectors, and to promote technological progress. At the same time, however, the state-owned economy in practice gradually revealed highly monopoly, unclear property rights, government, management confusion and other defects. Since the middle of 1970s, many developing countries have adopted various measures to rectify and reform the state-owned economy, but only minor achievements have been made in China.

The nature of the so-called SOEs lies in the ownership structure. The so-called "owned by every citizen", in essence, implies that production materials are owned by all the people of the country. When the planned economy is implemented in China, the concept of "owned by every citizen" is embodied in the form of the concrete realization of the state ownership system. This realization has the status that employees or labors own the capital and other production materials. As a result, China's SOEs were formed as a national investment vehicle. The essence is the economic combination of the actual work of the workers and their ownership of other factor input for production. Under the system of "owned by every citizen", each worker was treated as having equal ownership right on the asset of SOEs. SOEs play the role of connecting workers and other factor inputs and assets (Komiya, 1987).

SOEs are categorized as follows. The special legal person enterprise is fully funded by the

government and its legal status is clearly defined, and it is regulated by the state through special laws and policies. This kind of SOEs is endowed with mandatory social public goal and no economic goal, that is to say, their function is to provide public service. These SOEs include national defense facilities, urban public transport, urban greening and water conservancy. Such enterprises need to be subsidized by the public finance to maintain normal operation.

The solely SOEs are completely funded by the government, and are subject to the company law. This kind of enterprises are firstly based on the public goal, and the economic target comes only as the second (Warner 2001). This kind of enterprises is typical in natural monopoly enterprises and resource enterprises, such as railways, running water, natural gas, electricity and airports. From an economic point of view, products or services of this type of enterprises should be priced at marginal cost or average cost to maximize the welfare of the country, rather than seeking to grab more of the surplus from the consumers. However, these enterprises have been run inefficiently. The government subsidizes these firms with large fiscal transfers. Competitions are not allowed by the government (Otsuka et al. 1998). The prices of the products are also determined by the government. For example, the retail prices of petro, diesel, and gas are supervised by the SASAC, and private oil companies were forced to shut down.

The state holding enterprises are funded by the government, and are also subject to the company law. These enterprises have both social and public goals and economic goals, but economic goals do not have priority. Instead, social responsibilities of these firms are so large that making economic profit is considered as necessary to support these responsibilities (Gao and Chi, 1997; Gu, 2001). This kind of enterprise mainly includes pillar industry of the quasi natural monopoly and national economic development, such as electronics, automobile, medicine and airport. It should be noted that such enterprises do not directly provide public services, but they pay dividends and bonuses to the national fiscal income and indirectly provide public services. Under special circumstances when these enterprises incur loss, the government will compensate them with fiscal subsidies. However, after the compensation, dividends and bonuses cannot be waived. Of course, the government can directly exempt the hand in of dividends when the SOEs are running deficit.

We also have another type of SOEs that are usually called state shareholding companies. A stricter definition/name of these firms is "national shareholding companies". The government is just ordinary shareholders, and the firms are subject to the corporate law. There is no doubt that this kind of enterprises has no compulsory social and public goals, and the economic goal is the top priority. The reform of SOEs started with the idea of transforming SOEs of types introduced above to the type of state shareholding. But this process is slow and problematic.

SOEs are a kind of special enterprises, as pointed out in the definition. Its capital is entirely or mainly invested by the state, and its total capital or the main stock are owned by the state. It is different from other enterprises which are wholly or mainly invested by the private sector (organization and individual). SOEs in China have many features. In the first place, it is

engaged in the production and business activities, but its goal includes both economic and non-economic ones. State owned enterprises should carry out national policies, and take the responsibility to coordinate economic activities (Lu and Perry, 1997). For some important industries and products, even though it would not generate profit for a substantial period of time, SOEs still invest in these industries. The idea is that when such industries become mature and the infrastructure become efficient so that private investment can also be profitable, SOEs would step out and give room to private capital. Nevertheless, in reality, most of these industries are still not profitable after several years when SOEs invest in. Even if some of these industries finally become profitable, private capital is prohibited from competition.

In the second place, although the SOE is an organization, the state or the government is the only owner and financial supplier. This is different from the partnership, cooperative enterprises and the general company, and it is also different from private owned enterprises. The economic activities and management decisions are not directly intervened by the highest level state government or the central government. Instead, in accordance with the "unified leadership and decentralized management" principle, relevant state organs at all levels or its authorized departments manage SOEs' activities on behalf of SOEs' owners, or, put it more directly, the central government.

In the third place, SOEs must be established in accordance with the law as all other enterprises, but their basis and applicable laws are different. SOEs are subject to special SOE law, although parts of its articles are in line with the general company law. Compared with the general company law, the special SOE law is different from the procedure of establishing the enterprise, the rights and obligations of the enterprise, and the management of the state to the enterprise. The legal procedure established by the SOE is more strict and complicated than other enterprises. The SOEs tend to enjoy preferential policies so that they are given some privileges, such as the monopoly of financial support, preferential credit and in the use of resources, raw material supply, the national order and product promotion, foreign trade and other aspects of the preferential loss supplement. Of course, SOEs are also affected by the policy of countries and relevant departments that they must undertake many special obligations, such as the need to implement the national plan, price limit, limit the autonomy of production and management, to give priority to the protection of national and social needs and to meet the requirements of national economic regulation.

### 5.2 China Economic Reform and SOE Reform

The Reform and Opening Up policy of China began with the adoption of a new economic development strategy at the Third Plenary Session of the 11th Central Committee of the Chinese Communist Party in late 1978. Under the leadership of Deng Xiaoping, who had returned to the political arena after his three previous defeats, the Chinese government began to pursue an Opening Up policy, in which it adopted a stance to achieve economic growth through introduction of foreign capital and technology while maintaining its commitment to socialism.

The obvious aim of this policy shift was to rebuild its economy and society that were devastated by the Cultural Revolution. The policy shift also appears to have been prompted by the recognition that the incomes of ordinary Chinese were so low in comparison with incomes in other Asian economies, that the future of the Chinese state and the communist regime would be in jeopardy unless something was done to raise living standards of its people through economic growth (World Bank 1997).

The government subsequently established a number of areas for foreign investment, including the special economic zones, open coastal cities, the economic and technology development zones, the delta open zones, the peninsula open zones, the open border cities, and the high-tech industry development zones. The establishment of these zones provided the trigger for massive inflows of foreign investment, primarily from companies in Hong Kong and Taiwan. At the same time, China promoted its socialist market economy concept. The changes brought an entrepreneurial boom that resulted in the emergence of huge numbers of entrepreneurs and venture businesses within China (Liu and Wu 2006).

The positive consequences of the Reform and Opening Up policy have been economic development and rising national income. Naturally, there have also been negative effects, and these have become increasingly obvious over the years. The problems outlined below are closely linked to people's living standards.

First, there are now regional disparities in income levels, and the gap between rich and poor is now extremely wide. Under the socialist planned economy, living standards were relatively low, but there was no big gap between rich and poor. The idea, taken from the writings of Mencius, that inequality is more lamentable than poverty, has been applied throughout the society. With the shift to the Opening Up policy, however, Deng Xiaoping indicated that it was acceptable for some regions to become wealthy before others. The result was a huge wealth disparity between coastal and inland regions, and between the cities and rural areas. For example, income in Guangdong Province is about eight times higher than that in Gansu Province.

Apart from a massive influx of foreign investment, entrepreneurial activity within China was also encouraged. This led to the establishment of countless foreign-owned companies, private enterprises, individual enterprises, and other types of business, in addition to the existing SOEs and township enterprises. These newly established enterprises are classified as "enterprises under other ownership structures." Many of them operate more efficiently and pay their employees more than state-owned or township enterprises. This has been reflected in a growing income gap between the owners, directors, and executives of these enterprises and the employees of SOEs.

The existence of this income disparity under a socialist regime inevitably caused a variety of alarming social phenomena. Worship of money has spread among the people. Huge numbers of rural people have flooded into the cities in search of higher incomes, leaving many rural communities deserted and exposing China to the danger of future food shortages. There has

been a breakdown of law and order in the cities, and corruption is rife among party officials and government bureaucrats. Government organizations are involved in tax evasion and smuggling, while army, police, and court are operating businesses on the side. None of these phenomena are compatible with a socialist system, and they are indicative of inner contradictions in the political system.

China has maintained a one-party leadership on the political level, while moving to a market system on the economic level. The government has accelerated the shift to a market economic system, but it has so far failed to provide a clear definition of what is meant by a "socialist market economy." For this reason, the Party and government agencies no longer function as monitors and arbiters of the market. Instead, these agencies have been given leeway to participate in business activities as direct players in the market. This situation has led them to involve in monopolistic trading and insider trading. The accepted wisdom among modern Chinese is that "those in authority (*quan*) will be able to acquire money (*qian*)."

As noted by Gao and Chi (1997, p4), “on one hand, SOE are of major importance; on the other hand, they are national burden”. The declining competitiveness of the SOEs, which are the actual and ideological pillars of the socialist economy, is a problem with serious implications for China's economic and industrial structures. In essence, the SOEs were social microcosms created to feed the people and realize the ideals of socialism. However, China began to move toward a market economic system under the Reform and Opening Up policy. One result was an influx of foreign companies with resources that made them powerful competitors in the international marketplace. The changes also triggered an upsurge of entrepreneurial activity within China. Private and individual enterprises staked their survival on business efforts that enhanced their competitiveness. Meanwhile, the SOEs were unable to modify their corporate cultures that had evolved in China's planned economy. In the face of this onslaught, many lost their advantage in such areas as manufacturing, domestic sales channels and exports. Inextricably linked to this problem is the financial system. China's main financial institutions are state-owned banks. Under the planned economy, state-owned banks tended to see lending to SOEs as a mechanism for distributing fiscal funds. The SOEs that received these loans similarly regarded them less as loans than as allocations of public money. When the economy was opened up, however, there was a massive inflow of foreign investment. The government was forced to establish financial policies and exercise macro-level controls, while state-owned banks were required to provide support for leading enterprises under the government's financial policies, and to improve their credit assessment capabilities. Unfortunately, credit assessment capabilities of state-owned banks have not been developed, and there was a tendency to provide continuing credit to SOEs in an environment influenced by guidance or interference from the Party and the government. Now that SOEs are experiencing financial problems, state-owned banks are inevitably being left with a growing amount of non-performing loans. Most SOEs are in need of reform, and urgent steps are needed to take to reform a financial system that is still based on state-owned banks.

A wide range of reforms are needed in contemporary China. The tasks given highest priority and urgency are the reform of SOEs, the reform of the financial system, and the reform of administrative organizations. This report explores the current situation of these “SOE

Reforms" and “Supply-Side Reform,” and considers the future outlook. The “SOE Reforms" and “Supply-Side Reform” are more important than the many other reform programs in China. This is because the SOEs, the financial system and the administrative organizations are the three pillars of state administration; all these areas are closely interwoven; and successful reform in one of these areas brings progress in the others. Moreover, the Communist Party has been able to start work on the reform process, for it still has the power to lead the state. As China shifts further toward a market economic system, the people will inevitably adopt values that do not depend on traditional ideology.

What is certain is that, regardless of how the reforms proceed, the outcome of these reform will vary from the expectations of people. In a situation where one party has absolute power, administrative reform will inevitably lack thoroughness in such areas as enforcing discipline within the party. The SOEs may be corporatized or privatized, but there is a danger that the process will remain incomplete if the state is the shareholder, that is, if only the mode of ownership is changed. The same applies to financial system reform. Since executives of state-owned banks are also senior Party officials, it is still not clear whether the banks will be able to totally eliminate Party interference.

In China, a state-owned enterprise is a company whose assets are owned by the state (government). The State Council, China's equivalent of a cabinet, can exercise ownership rights over the SOEs at any time. For a long period after the establishment of the People's Republic of China, SOEs played a central role in economic development. However, years have passed already since the first emergence of reports on the worsening financial problems that have affected many SOEs since China's transition from a planned economic system to a market economy. SOE reform becomes emergent now.

The expansion of management autonomy during the first stage of SOE reform (1978 - 86) was followed by the introduction of the "management subcontracting" system during the second stage (1987 - fall 1992). Unfortunately, neither of these changes solved the problem of deteriorating business performance in the state-owned sector and, in the fall of 1992, the government launched a new reform process designed to establish a modern corporate system. It is not possible to examine and analyze developments at each stage of the SOE reform process in details here. The following is a brief overview aimed at clarifying the significance of the present stage of the reform.

In the overall context of SOE reform, the present phase of the reform process is characterized as the establishment of a modern corporate system. The "modern corporate system" basically means a system modeled on the joint-stock company and limited company structures that exist in the market economy nations. After October 1992, the Chinese authorities decided to shift from a policy adjustment approach to reform, which emphasized the devolution of authority and the transfer of profits that were characterized by the expansion of management subcontracting system, to an approach based on the establishment of a modern corporate system. In 1995, the government announced a policy calling for the thorough supervision of large and medium-sized SOEs, and for the liberalization and revitalization of small SOEs. In

addition, the 1997 CCP National Congress adopted a policy calling for the reform of ownership structures of Chinese enterprises through the introduction of the joint-stock system, and the reform of industrial structure through the restructuring of loss-making enterprises. As discussed below, "Zhu Rongji's three-year SOE reform plan" (elimination of losses from SOEs) formed part of this phase of the reform process.

The government implemented "Zhu Rongji's three-year SOE reform plan" on March 1998. Following types of companies were covered by the plan. As of 1997, there were a cumulative total of 7,922,900 companies in China's industrial sector, including just over 98,600 state-owned industrial enterprises. Of which, 65,900 were self-accounting state-owned industrial enterprises, and among them, 14,820 were classified as large or medium-sized. Of all the state-owned industrial enterprises, 43.9% were operating at a loss. And among them, there were approximately 8,000 large or medium-sized enterprises. The three-year SOE reform plan does not cover all SOEs, and the main targets are those 8,000 large or medium-sized loss-making enterprises. Of these, just 2,300 were classified as high-priority targets for efforts to remedy loss-making performance (Wong, 2015).

"Zhu Rongji's three-year SOE reform plan" included several features so that following changes were supposed to make. First, once the majority of large and medium-sized state-owned industrial enterprises have reached the point at which losses are matched by profits, there will be a significant improvement in economic benefit and sharp rise in corporate profits. This will lead to the emergence of competitive large enterprises and corporate groups, and state-owned industrial enterprises will become considerably more influential in the economy. Second, as far as the 2,300 high-priority state-owned industrial enterprises were concerned, the targets were to end losses by around one-quarter in 1998, by another one-third in 1999, and of the remaining enterprises in 2000. Third, as far as the approximately 8,000 large and medium-sized state-owned industrial enterprises were concerned, the targets were to end losses by about one-third in 1998, by around another one-third in 1999, and of the remainder in 2000. Enterprises that have made losses over long periods are expected to be eliminated or sold to private sector.

The losses of state-owned textile enterprises have increased sharply in each of the five years after 1993. From 1.9 billion RMB in 1993, the scale of the losses has soared to 10.6 billion in 1996 and over 9 billion in 1997. In 1996, 42% of state-owned textile enterprises were operating in the red, and this ratio was 5 points higher than the ratio of loss-making state-owned industrial enterprises in all state-owned industrial enterprises, which was 37%. Moreover, loss-making textile enterprises accounted for about one-half of total employees working in the state-owned textile sector. The government's plan to take the industry out of red calls for the forced disposal of the 10 million textile machines by the end of the 20$^{th}$ century. If this effort to stem the losses of the textile industry succeeds, there are likely to be positive ripple effects on the reform of the state-owned sector as a whole.
The main mechanisms that will be used in re-employment projects are separation schemes, in which surplus employees from the state-owned sector would gradually be separated from their present companies and absorbed by new businesses in other sectors, such as the service

industry. Employees who were laid off would be sent to re-employment service centers where they would receive a variety of assistance, including living allowances, job training and job introductions. The cost of living allowances to those laid off would be shared by the government, enterprises and unemployment insurance funds. To increase employment opportunities and support re-employment, the government would also target accelerated growth in the non-state-owned sector and tertiary industries. The aim of the re-employment projects was to provide new jobs for 1.2 million surplus employees from the textile sector by the year 2000 (Wong, 2015).

The Zhu Rongji cabinet applied the following measures in an effort to ensure the achievement of the 1998 reform goals. First, the government maintained its policy of supervising large SOEs closely, while liberalizing smaller enterprises and promoted mergers and bankruptcies among SOEs. Second, special inspectors were assigned to monitor the management teams of large and medium-sized SOEs. On June 26, 1998, a graduation ceremony was held for the first group of 21 newly trained special inspectors for high-priority state-owned industrial enterprises. These people, all with ranks of vice-minister or higher, were assigned to the production facilities of SOEs. They had two tasks. The first was to assess the management team and business situation of each state-owned enterprise by interviewing departmental managers and staff. The other task was to inspect the financial statements, accounting ledgers and related documents in order to assess the performance of each enterprise in terms of parameters such as financial position, debt repayment capacity, earning power, profit distribution, asset management and maintenance and expansion of state wealth effect. In some cases, the supervisors recommended to the State Council of the central government that further inspections should be carried out by specialist accounting audit agencies. Third, the government endeavored to find appropriate solutions for the basic problems that laid-off workers had with their livelihoods, and used every available means to implement re-employment projects. Laid-off workers were sent to re-employment service centers, which guaranteed basic expenses and medical expenses. Fourth, the government worked to deal with the social security problems of the unemployed and laid-off workers. In 1997, the State Council issued a notification concerning the improvement of social security systems. Agencies and enterprises were instructed to establish a universal retirement insurance (pension) scheme, which is based on the social reserve system linked with individual accounts of urban workers throughout China, to create a new medical insurance scheme, and to strengthen commercial insurance and social relief scheme. In addition, the central government encouraged all cities which are directly administered by provincial governments and above to complete the establishment of basic existence guarantee systems for residents by the end of 1998. It also encouraged counties and townships, where conditions were appropriate, to establish the systems without delay. In addition, an urban housing reserve system was established, and housing reform was accelerated to encourage home ownership. Fifth, the government identified the state-owned textile sector as the starting point for the "three-year SOE reform plan," and it aggressively promoted reform in this area. As early as 1991, a major directive had been issued calling for the disposal of textile machines. However, only 210,000 machines were disposed of between 1992 and 1996, in part because preference was given to regional interests. While this measure actually reduced the total number of textile machines in

operation in the eastern coastal region, most of the machines removed from the plants in that region were relocated to plants in the western inland region. As a result, targets for the disposal of textile machines were mostly unfulfilled.

The government was determined not to repeat this failure during the reform process for state-owned textile enterprises. It opted for the forced disposal of textile machines through a combination of administrative and economic means to avoid relocation or sale of the machines. Six major cities were designated for pilot schemes for the disposal and restructuring of textile machines. The cities were Shanghai, which has traditionally been a major textile production center, Qingdao, Tianjin, Wuhan, Jinan and Dalian.

In March 1999, the Zhu Rongji cabinet issued new reform targets based on its review of progress in 1998. The first target is to turn around the performance of another one-third of the approximately 8,000 loss-making large and medium-sized state-owned industrial enterprises. The schedule basically calls for the solution of the problems of the remaining enterprises in the year 2000, and the government aims to reduce the percentage of loss-making enterprises to a normal level (15% or lower). The second target is to improve the performance of another one-third of the 2,300 high-priority loss-making state-owned industrial enterprises in 1999. The problems of the remaining enterprises will basically be solved in the year 2000. The third target relates to state-owned textile enterprises. The government is aiming to reduce the losses by 6.0 billion RMB by disposing of 10 million textile machines and restructuring and redeploying 1.2 million surplus workers. All three target figures are set at double of the previous year's target.

The Zhu Rongji cabinet has adopted the following reform measures to achieve the targets set down for 1999. First, it placed a limit on new industrial projects. Second, the government would maintain its policy of closely supervising large SOEs while liberalizing and revitalizing smaller SOEs. It would also promote further mergers and bankruptcies among SOEs. Third, the government would continue to appoint special inspectors to monitor the management teams of large or medium-sized SOEs. On January 8, 1999, the second group of 38 special inspectors graduated from training and were assigned to SOEs. Apart from this, another 60 special inspectors were been assigned to SOEs since January to oversee priority projects. Fourth, efforts to improve economic performance through work force restructuring continued. Appropriate steps were taken to overcome the livelihood problems of unemployed and laid-off workers, and all possible means are being used to put re-employment projects in practice and to establish social security systems. The Chinese authorities regarded the reduction of surplus workers as an important step toward the improvement of economic performance of SOEs. Since 1998, the government has worked to increase the economic benefits of employee reductions in SOEs by promoting the establishment of re-employment centers.

Unfortunately, the SOEs as a group are still in deficit. Even worse, China has not yet found the right way to solve this problem. Chinese academics and policymakers have put forward a variety of arguments and proposals concerning the problem of deficit by the SOEs, and many

measures have been tried. The problem of the SOEs is like a big, broken-down truck that is blocking the road to the development of China's economy. Some traffic can find its way around the wreck but the difficulty that it creates grows with time. People are reluctant to destroy the truck because of the thought of how useful it would be if only it worked.

There are about 300,000 SOEs in China but the real problem lies with the very large enterprises that need ongoing subsidies to survive. These large SOEs employ over 75 million people and provide essential goods and services in the economy so it is not economically or politically feasible to simply shut them down. For example, Sinopec (China Petrochemical Corporation) has a workforce estimated by Fortune magazine to be over one million. Another Chinese petroleum-based SOE, China National Petroleum Corporation, has a workforce estimated by Gordon Chang to be about one and a half million. There is already a serious unemployment problem particularly in rural areas and this is destined to become worse with the impact of China's entry into the World Trade Organization (WTO).

The dilemma is that the Party cannot stop propping up the SOEs because of the role of the SOEs as employers and providers of essential goods and services but as long as the Party keeps propping them up the SOEs have little incentive to change. Even when an SOE is nominally privatized the subsequent treatment of that enterprise by the Party indicates that it is still an SOE. Gordon Chang cites the case of a cement manufacturer in Sichuan province. The SOE was corporatized in 1988 and given the name Golden Summit. Shares of Golden Summit were listed on the Shanghai Stock Exchange in 1993 and private investors own about four percent of the stock. The Board of Directors of Golden Summit consists entirely of government/party officials. When another SOE, Dadu River Steel, could not pay its workers the local government/party forced Golden Summit to take over Dadu River Steel and its obligations. When other cement making SOEs, even in areas distant from Sichuan, were in financial difficulties the national government/party officials forced Golden Summit to accept them and their liabilities. So when a nominally privatized SOE had some chance of success the government/party saddled it with debilitating burdens and demonstrated that it was in reality still an SOE.

The purpose of the reform program enunciated by Deng Xiaoping in 1978, The Four Modernizations Program, was not per se to create an efficient economy. Its purpose was to modernize in order to stave off catastrophic collapse and thus preserve the power of the Party. Some reforms have been real and some sham, but none have seriously lessened the control of the Party. One of the supposed reforms that look like a move toward a market economy but is in fact a sham is the shift from government grants to cover SOEs' deficits to requiring the SOEs to depend upon loans from the state commercial banks. The state banks must make the loans but the SOEs do not have repay the loans. Thus the state banks takes the saving deposits of the Chinese public and gives those funds to SOEs which will never repay. The loans to the SOEs are shown on the books of the State banks as assets but they are entirely worthless. It is estimated by Standard & Poor that at the end of 1999 the proportion of non-performing loans in the state commercial banks of China was in the range of 50 to 70 percent. The Central Bank of China admits that proportion was at least 25 percent. In 2000 the government

organized a recapitalization of the state commercial banks in which non-performing loans with a nominal value equivalent to $157 billion were transferred asset management companies, in exchange for government securities. The asset management companies are not likely to obtain any substantial return from those bad loans. What the asset management companies are likely to end of with is worthless equity in the SOEs. In effect, the government instead of giving grants to cover the deficits of the SOEs year-by-year accepted responsibility for the accumulated deficits all in one big block. Interestingly the Central Bank put the proportion of non-performing loans in the state commercial banks at 25 percent after the recapitalization, the same figure it gave for the proportion before the recapitalization. This indicates that the true proportion before recapitalization was at least 50 percent, consistent with the Standard & Poor's estimate.

As China continues its transition to a market economy, the transformation of SOEs remains a formidable challenge. In China, SOEs are conceived as an improvement upon state agencies. Many Chinese SOEs are similar to their European counterparts, formerly private companies that were nationalized following the Communist revolution (World Bank 1997). Other SOEs were created by national, provincial, or local governments (Bian 2005).

### 5.3 SOEs' political status

Chinese SOEs have historically been a vital instrument for provision of social services and an instrument of state policy (Bian 2005; Steinfeld 1998). Chinese workers' lives and interactions with the government were generally mediated by the SOE for which he or she worked. SOE employees received their housing, medical care, children's education, and pension through their workplace. Indeed, one's work affiliation (*danwei*) was more than a job; it was an integral part of one's identity (Bian 2005). Aside from the material aspects of one's life, political "participation" was also structured through the *danwei* (Bian 2005; Wang 2004b). More importantly, working in SOEs is a sort of "permanent" job, and the welfare for workers in SOEs has been viewed as much better than that in the private sector. Such welfare does not only include monetary payments, but also housing, flexible hours, pensions, and so on. In this aspect, SOEs in China are not profit-orientated. They should not be viewed as firms in the economic sense. Operating and managing SOE, therefore, should not be connected with profit maximization. Instead, because the owner of the SOE, i.e., the government, has relatively less knowledge of the definition of profit and the pattern for competition, the central theme of SOE becomes maximization of asset size. Meanwhile, CEOs of SOE have no incentive to improve the profitability of firms. Instead, they have incentives to increase the asset size and take social responsibilities. Such incentives do not come from monetary payments because it has nothing to do with firms' profitability. Such incentives, therefore, must come from somewhere else, and in our study, we argue for the political promotion.

SOEs historically provided an important source of revenue for governments in China. The need for Chinese SOEs to generate revenues sufficient to support the government, particularly local and provincial governments, will obviously generate a distinctive pressure. The issue of

"control" is most transcendent for SOEs in China. In Western political discourse, there is a long-standing concern that government bureaucracies can be an unaccountable, unrestrained force. As a result, structural mechanisms have been incorporated into the design of government agencies, such as legislative oversight, executive appointment of leadership, yearly budget review and opportunities for public review and comment (Aberbach and Rockman 1988; Gruber 1987; McCubbins, Noll, and Weingast 1987; Wilson 1989). These structures are intended to inhibit bureaucratic discretion and keep control in the hands of political leaders.

Ambivalence about control is new to Chinese political culture. For a long time, political control of China's SOEs has been prized even at the expense of efficiency. SOEs are in the midst of transition from centralized state management to firms and companies that are in line with traditional firm theories. In order for SOEs to function as effective enterprises, as China's government has been continuously arguing and trying to do, no political control is demanded, and if there is any, the government should only control the asset but not people that are running SOEs. However, it is questionable whether or not policymakers are truly willing to surrender SOEs as state instruments. In an interview of a senior official, Koppell (2005) concluded that the government was not ready to let go.

Chinese policymakers are aware of the situation that economic progress depends upon the revitalization of SOEs. The first phase of SOE transformation (*gaizhi*) included the decision to essentially privatize the smaller enterprises while retaining the larger companies (Garnaut et al. 2005; Green and Liu 2005). Under the motto "Seize the large" while "letting go and enlivening" the others (*zhuada fangxiao*), many SOEs have seen their ownership restructured (Garnaut et al. 2005; Organization for Economic Co-operation and Development [OECD] 2000). However, for most SOEs, particularly those large SOEs, it is more appropriate to characterize the reform as corporatization rather than privatization; the "new owners" of these reformed SOEs are, in fact, state entities including holding companies and other SOEs (Broadman 1999; Lin and Zhu 2000; OECD 2000). Along with changes in the ownership structure, we do not see significant weakness of hierarchical command that government ministries had over the management of these companies.

Economists traditionally view public enterprises as vehicles of curing market failures (Atkinson and Stiglitz 1980). Public enterprises are controlled by governments maximizing social welfare, and improve on the decisions of private enterprises when monopoly power or externalities introduce divergence between private and social objectives. Public enterprises are productively efficient, and charge prices that more accurately reflect social marginal costs. This is certainly not the case for SOEs in China. Observers of such enterprises stress two features inconsistent with the conventional view: public enterprises are highly inefficient, and their inefficiency is the result of political pressures from the politicians who control them.

The economic reform process that China embarked upon after 1979 differed considerably from other transitional economies – such as Russia, the CIS and Eastern Europe – in eschewing "big bang" or "shock therapy" policies in favor of economic gradualism. This

process saw incremental liberalization of agriculture and the non-state sector (McKinnon, 1994; Oi, 1999; Fishman, 2005) and the gradual establishment of the necessary institutions to facilitate "marketization" (McMillan and Naughton, 1992; White and Liu, 2001; Hassard et al., 2006a, b, 2007; Cooke, 2008). In large part, this process reflects a policy of decentralization of control from the central government to local levels, with a consequent shift in ownership and property rights (Meyer et al., 2002; Sutherland, 2003; Fishman, 2005; Hassard et al., 2007; Cooke, 2008). It has also led to a far greater role for market transactions.

SOEs have naturally played a central role in this reform process. In certain accounts, however, the SOE sector has been viewed as anachronistic (Chen and Faure, 1995; Ding et al., 2000). They have been depicted variously as "industrial dinosaurs", "muscle-bound goons" or the "relics of a failed economic experiment" (Woetzel, 2008). SOEs have been characterized as possessing a lack of managerial incentives, little concern for profit, low employee motivation and mobility, a tendency to maximize asset size and as being ready for dismembering (Meyer et al., 2002). Others have described their dramatic decline in simple terms of number of enterprises and contribution to Chinese industrial output (Tsui and Lau, 2002). This so-called "pessimistic" view argues that a significant proportion of the less "open" and less "transparent" SOEs pose a significant "problem" to the further development of market-based practices in the Chinese economy (Woetzel, 2008). In sum, the view traditionally expressed is that a significant percentage of SOEs are value destroying, their managers lack real business acumen, and within them significant enterprise reform is difficult to effect (Putterman and Dong, 2000; Tsui and Lau, 2002).

The so-called administrative level of SOEs reflects the idea of "official standard" in management. In the era of the planned economy, state-owned enterprises in fact had no administrative level for most of employees. However, the CEO, or the chief director are appointed by the central government, therefore they had political titles. For instance, when the central government owned enterprises were established, their chief directors or CEOs were assigned with the political title of "Fu Bu", and other levels of political titles were extended down. This setting has become the tunnel of "normal" personnel changes.

The SOEs are divided into central and local SOEs. The central government owned enterprises (C-SOE) are directly managed by the SASAC, while the local SOEs (L-SOE) are affiliated to the local government or other central ministries. There are many corresponding levels of political titles associated with COEs and other employees of these firms. For example, these levels are ranked from highest to lowest as: Bu (ministerial), Fu By (vice-ministerial), Ting, Fu Ting, Ju, Fu Ju, Chu, Fu Chu, Ke and Fu Ke.

With Chinese economy transforming from planned economy to market economy, the problems of running firms by the government have become obvious. During the Reform and Opening Up over the past 30 years, the separation of the government and enterprises has been the core issue of the reform of SOEs, but so far no fundamental solutions have been realized.

In the list of 115 central enterprises listed on the SASAC website, the chiefs (the corporate

chairman, party secretary and general manager) of the top 54 enterprises have the title of Fu Bu. However, not all chiefs only have the title of Fu Bu. The chiefs of some "key" SOEs are assigned with Bu level. For example, the former chairman of the Commercial Aircraft Corporation of China, party secretary Zhang Qingwei had the level of Bu, because he served as director of the national defense science and technology commission.

It is known that C-SOEs whose chiefs have the title of Fu Bu include Chinese four state-owned insurance companies (China Life Insurance Group, China People's Insurance Group, China Taiping Insurance Group, China Export and Credit Insurance Corp Chinese), the five major state-owned commercial banks (Bank of China, Agricultural Bank Of China, China Construction Bank, Industrial and Commercial Bank of China, Bank of Communications), and The Export-Import Bank of China, China Development Bank, China Agricultural Development Bank and other financial central enterprises. Some C-SOEs are directly governed by the State Council, such as the China Investment Corp. and the CITIC Group China. In addition, the China National Tobacco Corp. is also Fu Bu level. In addition, Firms such as China Railway Corporation and the China Investment Corp., directly under the control of the SASAC, have the political level of Bu, with their chiefs the political title of Bu.

In 1999, "The Resolution about Reform and Development of SOEs" was passed in the Forth Plenary Session of the Fifteenth Central Committee. In this resolution, the Chinese government decided that no political titles would be assigned to SOEs anymore. However, such decision was not carried out easily. There were strong voices that oppose such reform, because no political title would imply significant welfare loss for employees. Political title is not only a symbol of "nobility" according to China's traditional culture, but also a guarantee of employment with respectful welfare. The hierarchy in SOEs regulations tells that the power is associated with political level. The higher level, the more discretionary power. These powers includes the facility of arranging jobs for relatives, access to higher level governors or governors in the central government, more information and ability to determine positions. Indeed, these powers also bring economic gain, not only in monetary terms, but also general well beings.

In January 2000, the Beijing Municipal Economic Commission said levels of SOEs would be re-assigned by new standards. The political level used in SOEs would be abandoned. Managers and board staff would be hired from the market. In the same year, the General Office of the State Council forwarded the notice of Economic and Trade Commission, which requested the government and enterprises to change their relationship from "political subsidiary" to "property controlled". The second round of intensive proposition for abandoning the political level of SOEs was in 2008-2009. The background of this discussion was the outbreak of the financial crisis and the overall listing of large SOEs. It is "obvious" that SOEs whose CEOs or chief directors are governors are not appropriate for public listing in the stock market, particularly in overseas market. Although in 2008, Shanghai and many other cities passed similar documents that requested SOEs to abandon the political connections, the actual process of SOEs' corporatization and getting rid of political characteristics is very slow.

## Chapter 6. Case Studies

Due to strict confidentiality of political promotion data, we cannot use econometric methodology to formally test our argument. Instead, we choose two case studies in this subsection to demonstrate the ideas. Admittedly, more researches, especially more data analysis, are needed before we can confidently conclude any causality relationships between CEOs' political promotion motives and firm performance. However, our case studies can be a starting point, particularly if we carefully choose the timing of the case during which two strict salary limit were enforced by China's government. We believe our cases have some explanation power to illustrate our argument. The survey analysis in the next section provides more robust support to our argument.

Our hypothesis is that, CEOs in China's SOEs care more about political promotion instead of monetary payments. This hypothesis is akin to the career concern theory. We show that CEOs that lead better firm performance are more likely to be politically promoted. On the other hand, the monetary payment of these CEOs does not grow as fast as firm profit. These two phenomenon together show that these CEOs care political promotion more than monetary payments, because the latter is in-efficient to provide CEOs with incentives. Otherwise, these CEOs will choose to leave their job to pursue higher payment, which is certainly not the case.

This thesis selects two cases for this purpose. The objective of the case study is to show the how the opportunities for political promotion affect the incentives and behaviors of SOE's CEO. Therefore, the first criterion for selecting the cases is that the political promotion actually took place. Equally importantly, if we do observe the changes of CEO behaviors or the changes of SOE's performances before and after the CEO was politically promoted, to justify that these changes were largely the result of the political promotion, we need to control other changes that happened around the same time of the political promotion. The most relevant control variable is, of course, CEO's monetary payment. Therefore, the second criterion for selecting the cases is that the monetary payment of the CEO before and after the political promotion did not change significantly. If there is no change of CEO's monetary payment, then this can be the ideal case. In addition, if after the political promotion, the CEO works in government rather than another SOE but with larger asset size (which is also equivalent to political promotion as introduced in chapter 5), then the evidence of the case can be stronger. This is because in such cases, we rule out the CEO's motivation of working in an enterprise to some extent. Given these criteria, we found two cases that suit our purpose perfectly.

### 6.1 Case One: Former CEO of China Development Bank and Agricultural Bank of China: Mr. Jiang

6.1.1 Background information about Agricultural Bank of China (hereafter ABC)

The predecessor of the Agricultural Bank of China is the Agricultural Cooperative Bank established in 1951. Since the late 1970s, the Bank has evolved from a state-owned

specialized bank to a wholly state-owned commercial bank and subsequently a state-controlled commercial bank. The Bank was restructured into a joint stock limited liability company in January 2009. The Bank was listed on the Shanghai Stock Exchange and the Hong Kong Stock Exchange, respectively in July 2010, which marked the completion of transformation into a public shareholding commercial bank.

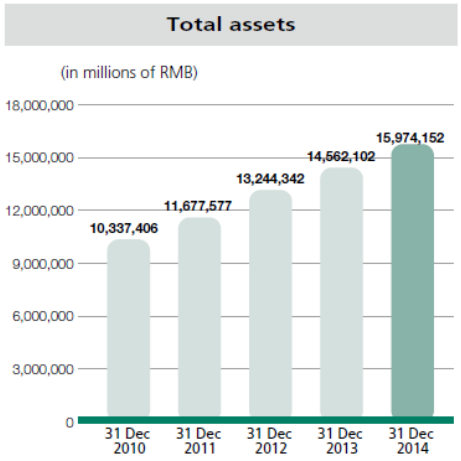
As one of the major integrated financial service providers in China, the Bank is committed to catering to the needs of farmers and capitalizing on the synergy between the urban areas and rural areas. The Bank strives to expand into the international market and provides diversified services so as to become an international first-class large-scale commercial bank. Capitalizing on the comprehensive business portfolio, extensive distribution network and advanced IT platform, the Bank provides a wide range of corporate and retail banking products and services for a broad range of customers and conducts treasury operations and asset management. Our business scope includes, among other things, investment banking, fund management, financial leasing and life insurance. At the end of 2014, the Bank had total assets of RMB15,974,152 million, loans and advances to customers of RMB8,098,067 million and deposits of RMB12,533,397 million. Our capital adequacy ratio was 12.82%. The Bank achieved a net profit of RMB179,510 million in 2014.

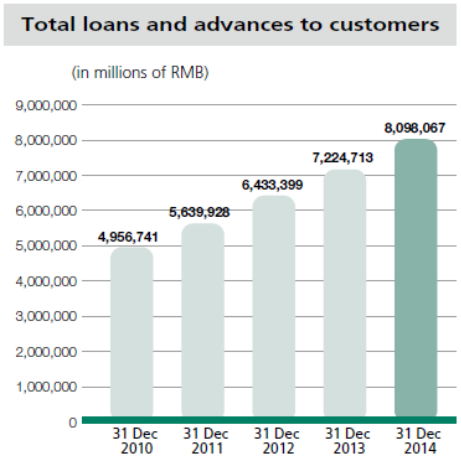
The Bank had 23,612 domestic branch outlets at the end of 2014, including the Head Office, the Business Department of the Head Office, three specialized business units managed by the Head Office, 37 tier-1 branches (including branches directly managed by the Head Office), 353 tier-2 branches (including business departments of branches in provinces), 3,515 tier-1 sub-branches (including business departments in municipalities, business departments of branches directly managed by the Head Office and business departments of tier-2 branches), and 19,702 other establishments. Our overseas branch outlets are consisted of eight overseas branches and two overseas representative offices. The Bank had fourteen major subsidiaries, including nine domestic subsidiaries and five overseas subsidiaries.

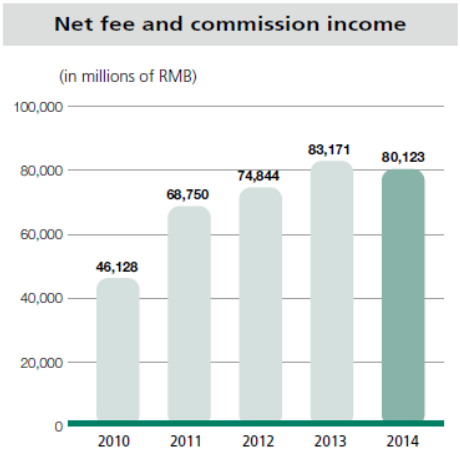
In 2014, the Bank was included in the list of Global Systemically Important Banks for the first time. The Bank ranked No. 47 in Fortune's Global 500, and ranked No. 9 in The Banker's "Top 1000 World Banks" list in terms of tier 1 capital. The Bank's issuer credit ratings were assigned A/A-1 by Standard & Poor's; the Bank's deposits ratings were assigned A1/P-1 by Moody's Investors Service; and the long-/short-term foreign-currency issuer default ratings were assigned A/F1 by Fitch Ratings. The Bank's outlook ratings assigned by the above credit rating agencies were "stable".

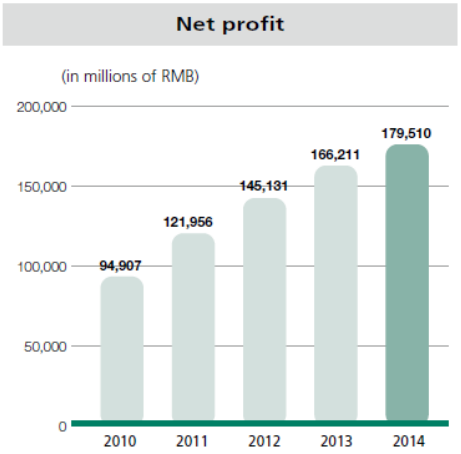
6.1.2 Financial Highlights of ABC

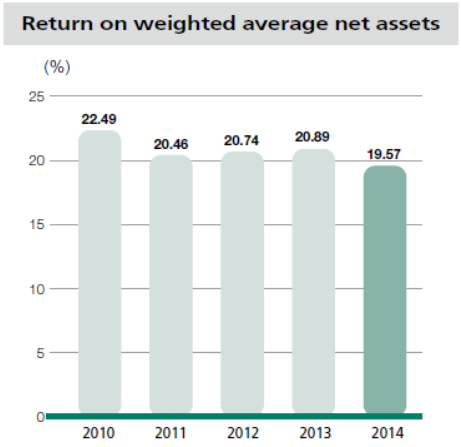
Figure 6.1.1 shows the financial highlights of ABC for the past 5 years.

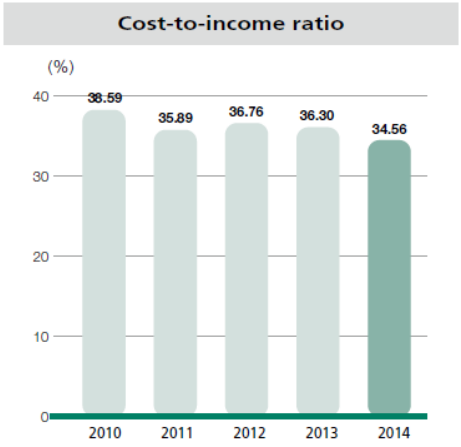


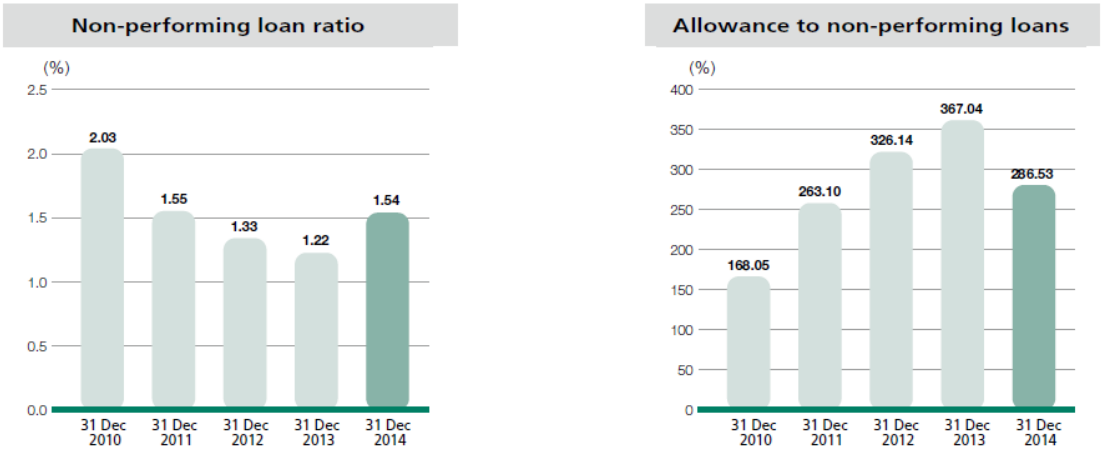



Figure 6.1.1: Some financial data about ABC. Source: ABC annual report 2014

In 2014, ABC achieved a net profit of RMB179,510 million, representing an increase of RMB13,299 million or 8.0% over the previous year. This was primarily due to the increase in net interest income and the decrease in cost-to-income ratio, as shown by Table 6.1.1 below.

Table 6.1.1: Changes of significant income statement (in millions of RMB, except for percentages)

| **Item** | **2014** | 2013 | Increase/ (decrease) | Growth rate (%) |
|---|---|---|---|---|
| Net interest income | **429,891** | 376,202 | 53,689 | 14.3 |
| Net fee and commission income | **80,123** | 83,171 | (3,048) | -3.7 |
| Other non-interest income | **14,112** | 6,398 | 7,714 | 120.6 |
| **Operating income** | **524,126** | 465,771 | 58,355 | 12.5 |
| Less: operating expenses | **223,898** | 198,607 | 25,291 | 12.7 |
| Impairment losses on assets | **67,971** | 52,990 | 14,981 | 28.3 |
| Profit before tax | **232,257** | 214,174 | 18,083 | 8.4 |
| Less: Income tax expense | **52,747** | 47,963 | 4,784 | 10.0 |
| **Net Profit** | **179,510** | 166,211 | 13,299 | 8.0 |
| Attributable to: | | | | |
| Equity holders of the Bank | **179,461** | 166,315 | 13,146 | 7.9 |
| Non-controlling interests | **49** | (104) | 153 | — |

Net interest income is the largest component of our operating income. In 2014, net interest income was RMB429,891 million, representing an increase of RMB53,689 million compared to the previous year, and accounting for 82.0% of ABC's total operating income. The changes in volume and interest rates resulted in an increases of RMB39,044 million and RMB14,645 million in net interest income, respectively.

Table 6.1.2 presents the average balance, interest income/expense, and average yield/cost of interest-earning assets and interest-bearing liabilities. On the asset side, as for 31 December 2014, ABC's total assets amounted to RMB15,974,152 million, representing an increase of RMB1,412,050 million, or 9.7%, compared to the end of the previous year. Net loans and advances to customers increased by RMB837,474 million, or 12.1%. Net investment in securities and other financial assets increased by RMB355,532 million, or 11.0%. Cash and

balances with central banks increased by RMB139,263 million, or 5.3%, primarily related to growth in deposits from customers. Deposits and placements with and loans to banks and other financial institutions increased by RMB273,534 million, or 38.7%, which was mainly due to the rise in lending. Financial assets held under resale agreements decreased by RMB227,634 million, or 30.9%, primarily due to the decrease in bonds held under resale agreements.

In particular, corporate loans amounted to RMB5,147,410 million, representing an increase of RMB418,553 million or 8.9% over the end of the previous year, primarily because ABC strengthened its services to the real economy, focusing on meeting the credit needs of national key economic zones, major projects, strategic emerging industries and small and micro enterprises (SMEs). ABC further adjusted the credit structure and allocated more resources to major urban branches and the banking business in rural areas. It achieved steady growth in corporate loans. Retail loans amounted to RMB2,396,639 million, representing an increase of RMB303,334 million or 14.5% over the end of the previous year. This was primarily related to its continuing to prioritize the development of retail lending activities in respect of marketing, credit policies, diversification of business lines and resource allocation. ABC also improved the efficiency of the loan approval process of the retail loan approval center, largely by simplifying the approval procedures for retail loans. The residential mortgage loans and card overdraft rapidly increased. Discounted bills amounted to RMB157,349 million, representing an increase of RMB64,526 million or 69.5% over the end of the previous year, primarily because ABC appropriately expanded bills discounting according to market conditions. Overseas and other loans amounted to RMB396,669 million, representing an increase of RMB86,941 million, or 28.1%, over the end of the previous year, largely as a result of its further leveraging the marketing synergies between domestic and overseas lending activities, which boosted trade finance in its overseas branches.

Regarding the investment, ABC's net investment in securities and other financial assets increased by RMB355,532 million, or 11.0%, to RMB3,575,630 million compared the end of the previous year. Non-restructuring-related debt securities investments increased by RMB326,070 million over the end of the previous year, primarily because ABC seized the opportunities arising from the market by appropriately increasing its investment in debt securities when the yield on debt securities investment was historically on a high level. The balance of financial bonds was RMB1,619,951 million, including bonds of RMB1,364,811 million issued by China's policy banks and of RMB255,140 million issued by commercial banks and other financial institutions.

On the liability side, ABC's total liabilities in 2014 increased by RMB1,223,968 million or 8.9%, over the end of the previous year to RMB14,941,533 million. Deposits from customers increased by RMB721,986 million or 6.1%, while deposits and placements from banks and other financial institutions increased by RMB152,347 million or 16.9%. Financial assets sold under repurchase agreements increased by RMB104,234 million or 389.1%, primarily due to the increase in debt securities sold under repurchase agreements. Debt securities issued increased by RMB58,906 million, or 22.1%, primarily due to newly issued Tier 2 capital

bonds and medium-term notes.

In particular, deposits from customers increased by RMB721,986 million or 6.1%, over the end of the previous year to RMB12,533,397 million. Regarding customer structure, corporate deposits increased by RMB125,876 million or 2.9%, over the end of the previous year, and retail deposits increased by RMB498,671 million or 7.2%, over the end of the previous year. Regarding deposit maturity, the proportion of demand deposits decreased by 2.3 percentage points compared to the end of the previous year to 52.3%. The shareholders' equity amounted to RMB1,032,619 million, comprising ordinary shares of RMB324,794 million, preference shares of RMB39,944 million, capital reserve of RMB98,773 million, investment revaluation reserve of RMB3,118 million, surplus reserve of RMB78,594 million, general reserve of RMB156,707 million and retained earnings of RMB329,989 million. Net assets per share were RMB 3.05.

Table 6.1.2: Balance sheet of ABC

| Item | 2014 Average balance | 2014 Interest income/ expense | 2014 Average yield/cost (%) | 2013 Average balance | 2013 Interest income/ expense | 2013 Average yield/cost (%) |
|---|---|---|---|---|---|---|
| **Assets** | | | | | | |
| Loans and advances to customers | **7,768,137** | **470,829** | **6.06** | 6,910,717 | 414,270 | 5.99 |
| Debt securities investments[1] | **3,129,864** | **125,161** | **4.00** | 2,907,104 | 108,609 | 3.74 |
| Non-restructuring-related debt securities | **2,674,907** | **110,961** | **4.15** | 2,421,297 | 93,377 | 3.86 |
| Restructuring-related debt securities[2] | **454,957** | **14,200** | **3.12** | 485,807 | 15,232 | 3.14 |
| Balances with central banks | **2,508,561** | **40,018** | **1.60** | 2,362,857 | 37,517 | 1.59 |
| Amounts due from banks and other financial institutions[3] | **1,290,817** | **63,281** | **4.90** | 1,283,012 | 52,988 | 4.13 |
| **Total interest-earning assets** | **14,697,379** | **699,289** | **4.76** | 13,463,690 | 613,384 | 4.56 |
| Allowance for impairment losses[4] | **(342,809)** | | | (302,266) | | |
| Non-interest-earning assets[4] | **864,443** | | | 686,625 | | |
| Total assets | **15,219,013** | | | 13,848,049 | | |
| **Liabilities** | | | | | | |
| Deposits from customers | **11,997,284** | **221,706** | **1.85** | 11,170,828 | 194,903 | 1.74 |
| Amounts due to banks and other financial institutions[5] | **1,185,258** | **36,510** | **3.08** | 997,433 | 33,784 | 3.39 |
| Other interest-bearing liabilities[6] | **321,079** | **11,182** | **3.48** | 221,108 | 8,495 | 3.84 |
| **Total interest-bearing liabilities** | **13,503,621** | **269,398** | **2.00** | 12,389,369 | 237,182 | 1.91 |
| Non-interest-bearing liabilities[4] | **902,096** | | | 727,613 | | |
| Total liabilities | **14,405,717** | | | 13,116,982 | | |
| **Net interest income** | | **429,891** | | | 376,202 | |
| **Net interest spread** | | | **2.76** | | | 2.65 |
| **Net interest margin** | | | **2.92** | | | 2.79 |

Notes: 1. Debt securities investments include debt securities investments at fair value through profit or loss, available-for-sale debt securities investments, held-to-maturity investments and debt securities classified as receivables.

2. Restructuring-related debt securities include receivables from the MOF and special PRC government bonds.

3. Amounts due from banks and other financial institutions primarily include deposits and placements with and loans to banks & other financial institutions, and financial assets held under resale agreements.

4. The average balances of non-interest-earning assets, non-interest-bearing liabilities and allowance for impairment losses represent the average of their respective balances at the beginning and the end of the reporting period.

5. Amounts due to banks and other financial institutions primarily include deposits and placements from banks & other financial institutions and financial assets sold under repurchase agreements.

6. Other interest-bearing liabilities are principally comprised of debt securities issued.

In 2014, the net interest margin was 2.92% and the net interest spread was 2.76%, increased by 13 and 11 basis points compared to the previous year, respectively. The recorded interest income of ABC was RMB699,289 million in 2014, representing an increase of RMB85,905 million over the previous year. The increase in interest income was primarily due to the increase in the average balances of interest-earning assets by RMB1,233,689 million and the increase of 20 basis points in the average yield of interest-earning assets.

### 6.1.3 ABC's business review

In 2014, to actively cope with the complicated and severe economic and financial environment, ABC further accelerated the transformation of corporate banking business and continued to improve its service capability. The Bank continued to support infrastructure construction projects such as highway, railway, hydraulic engineering and connectivity, and focused on high quality projects in strategic emerging industries such as advanced manufacturing industry and energy-saving and environmental protection. The Bank also strengthened support to modern service industries including tourism, medical care and pensions industries. Its goal is to develop its brand as a new-type banking services provider through promoting the development of new-type urbanization. The Bank established a list of key overseas clients and a database of key overseas projects to improve the banking service synergies between domestic and overseas markets. To strengthen its customer base, the Bank improved and expanded the three-level core customer list. It strictly implemented the strategy of expanding its customer coverage to small and micro customers through devoting more credit support to SMEs with higher credit ratings. Integrated services in branch outlets were improved significantly through accelerating the construction of corporate banking service capability of branch outlets. More efforts were made to specific marketing and synergistic marketing in order to establish a comprehensive, multidimensional and multi-layer marketing mechanism. The Bank adhered to the development strategy for investment banking, focused on the development of high end investment banking businesses, including bond underwriting, syndicated loans and asset securitization and fully utilized the intermediary function of financial consultation and assets management. ABC made great effort into product innovation and promotion in key areas, especially for core customers and major marketing projects, so as to expand the coverage of key products including supply chain financing, custody service and cash management. As of the end of 2014, ABC had 3.45 million corporate banking customers, of which 75.5 thousand customers had outstanding loan balances.

ABC is small and micro enterprise oriented. It actively continued its efforts in exploring effective business models for providing services to SMEs by large commercial banks and adopted measures to solve the difficulty and to alleviate the high cost of SMEs in financing. To solve the difficulty of SMEs in financing, ABC formulated a separate credit plan and provided separate financial resources to SMEs, commenced the pilot operation of providing collective SMEs with services in batches, developed new financial products for SMEs and improved the financial service quality. To alleviate the high cost of SMEs in financing, for repayment method, quality SMEs were allowed to borrow new loans to settle existing loans so as to avoid bridge financing with the third party with high interest rates. This innovation was awarded the Best Small and Micro Financing, the Best Service Provider for Small and Micro Enterprises, and the Best Bank of Small and Micro Enterprise Financial Service by financial media. At the end of 2014, ABC's loans to SMEs amounted to RMB974,920 million, representing an increase of RMB161,619 million or 19.9% over the end of the previous year. The growth rate was higher than that of the total loans of the Bank by 7.8 percentage points.

6.1.4 Human resources: remunerations

Remuneration design in ABC has been "improving" from the traditional political title related to performance related. In 2014, ABC adopted a market-oriented approach and adapted to the "new normal" economy and the transformation of the Bank. It optimized the structure of the County Area Banking Division by restructuring the Rural Industrial Banking and Urbanization Banking Department, County Area Policy and Banking Innovation Department and further improving the management of front, middle and back offices of its County Area Banking Business to adapt to the latest development trend of the construction of new urbanization and the operation system of new agriculture. In order to provide structural support to new businesses, ABC established the Small and Micro Enterprises Banking Department to adapt to the specialized operation of SMEs business; it set up the Assets Management Department in order to enhance the marketing and research abilities of the assets management business; it implemented reform on inter-bank market business specialized operation and adjusted related institutions and functions accordingly; and it further established the Internet Banking Department and the Internet Banking Promotion Office for the application of Internet technology in the financial services. In addition, ABC set up the Operation Center so as to establish an integrated management system and an operation platform for back offices. A data governance system and upgraded the Information Center as a tier-1 department were established to enhance the information governance. Meanwhile, the product research and development mechanism were reorganized by placing greater emphasis on the product innovation capability of the front offices, improving the combination of business and technology within product innovation and shortening product research and development process. In doing so, ABC built a new performance evaluation center to improve the mechanism of performance evaluation.

Focusing on the foundation-level staff, ABC optimized the job evaluation system in branch outlets to provide staff with more career development opportunities. It refined and strengthened the incentive system for managers and staff of branch outlets so as to facilitate

their personnel development. ABC put human resources as the major resources and core element for the reform and development of the Bank. It strengthened the training and development focusing on leading managers, professional talents and foundation-level backbone personals. It further enhanced its selection and training system to facilitate the promotion of outstanding young management talents. Moreover, it strengthened appraisal and evaluation system and conducted stringent management and supervision to build up a learning, innovative, practical and self-disciplined operation and management teams. A promotion mechanism was established to provide fast promotion for outstanding staff. ABC also carried out the selection appointment for various professional positions in the Head Office and branches so as to improve staff career development paths. It also conducted management trainee program, young talent development program in the County Areas and international talents recruitment program to select key personnel urgently needed for business development. These changes, aiming at improving the efficiency of the Bank, nevertheless, were implemented mainly at the staff level. The top managers, such as directors of the board and CEOs, were still subject to the appointment of the central government.

In 2014, ABC continued to improve the remuneration management system which strengthened the linkage of remuneration with economic value added and business transformation. It also strengthened remuneration and benefits management of the branches, subsidiaries and senior management and refined long-term incentive measures such as deferred payment of performance-based wages. It also refined remuneration incentive system of key positions and talents. The remuneration allocation of the internal incentive and external competitiveness were improved. Minimum wages protection and differentiated allowance policy were established for foundation-level staff. ABC allocated more remuneration resources to branch outlets so as to encourage its employees to serve the branch outlets for the long run. It improved the management mechanism for Annuity Scheme and Retirement Benefits Fund and accelerated the market-based management of Annuity Scheme. However, the remuneration at the CEO level is not performance-related but simply fixed. This generates a paradox where employees below the CEO level are getting incentive pay (or at least more close to this scheme) but CEO himself/herself is not. The incentives for CEOs and directors of the board are distorted in ABC, according to the traditional theory.

## 6.1.5 Shareholders information

The shareholders' information is summarized in Table 6.1.3.

Table 6.1.3: details of changes in share capital (unit: shares)

| | 31 December 2013 | | Increase/decrease during the reporting period (+/-) | | | 31 December 2014 | |
|---|---|---|---|---|---|---|---|
| | Number of shares | Percentage[4] (%) | New shares issued | Others[3] | Subtotal | Number of shares | Percentage[4] (%) |
| **1) Shares subject to restrictions on sales[1]** | **9,891,764,707** | **3.0** | **—** | **—** | **—** | **9,891,764,707** | **3.0** |
| 1. State-owned shares[2] | 9,891,764,707 | 3.0 | — | — | — | 9,891,764,707 | 3.0 |
| 2. Shares held by other domestic investors[2] | — | — | — | — | — | — | — |
| 3. Shares held by foreign investors[2] | — | — | — | — | — | — | — |
| **2) Shares not subject to restrictions on sales** | **314,902,352,293** | **97.0** | **—** | **—** | **—** | **314,902,352,293** | **97.0** |
| 1. RMB-denominated ordinary shares | 284,163,529,197 | 87.5 | — | — | — | 284,163,529,197 | 87.5 |
| 2. Foreign-invested shares listed overseas[2] | 30,738,823,096 | 9.5 | — | — | — | 30,738,823,096 | 9.5 |
| **3) Total number of shares** | **324,794,117,000** | **100.0** | **—** | **—** | **—** | **324,794,117,000** | **100.0** |

Notes: 1. "Shares subject to restrictions on sales" refers to the shares held by shareholders who are subject to restrictions on sales in accordance with laws, regulations and rules or undertakings.

2. "State-owned shares" refers to the shares held by the MOF, Huijin, the SSF and the SSF-Account III for state-owned shares transfer managed by the SSF. "Shares held by other domestic investors" refers to the shares held by strategic investors of A-shares and the all others of A-shares under off-line placement. "Shares held by foreign investors" refers to the shares held by foreign cornerstone investors. "Foreign-invested shares listed overseas" refers to the H shares as defined in No. 5 Standards on the Content and Format of Information Disclosure of Companies with Public Offerings — Content and Format of the Report of Change in Corporate Shareholding (Revision 2007) of the CSRC.

3. "Others" refers to the shares released from restrictions on sales due to the expiry of the lock-up period relating to such shares. Positive numbers represent increases whereas negative numbers represent decreases.

At the end of 2014, ABC had a total of 376,360 shareholders, including 27,749 H-Share shareholders and 348,611 A-share shareholders. The top 10 shareholders are listed in Table 6.1.4 below:

Table 6.1.4: Top 10 shareholders (unit: shares)

**Total number of shareholders** 376,360 (as set out in the registers of A shares and H shares as of 31 December 2014)

**Particulars of shareholding of the top 10 shareholders**
(the data below are based on the registers of shareholders as of 31 December 2014)

| Number of shareholders | Nature of shareholders | Type of shares | Increase/decrease during the reporting period (+,-) | Shareholding percentage (%) | Total number of shares | Number of shares subject to restrictions on sales | Number of pledged or locked-up shares |
|---|---|---|---|---|---|---|---|
| Huijin | State-owned | A shares | — | 40.28% | 130,831,990,282 | — | None |
| MOF | State-owned | A shares | — | 39.21% | 127,361,764,737 | — | None |
| HKSCC Nominees Limited | Overseas legal entity | H shares | 1,757,851 | 9.04% | 29,352,457,991 | — | Unknown |
| SSF | State-owned | A shares | — | 3.02% | 9,797,058,826 | 9,797,058,826 | None |
| Ping An Life Insurance Company of China, Ltd. — Traditional — Ordinary Insurance Products | Other | A shares | 5,118,554 | 1.48% | 4,818,024,933 | — | None |
| SSF-Account III for state-owned shares transfer | State-owned | A shares | — | 0.41% | 1,325,882,341 | 94,705,881 | None |
| Standard Chartered Bank | Overseas legal entity | H shares | — | 0.37% | 1,217,281,000 | — | Unknown |
| China Life Insurance Company Limited — Dividend distribution — Individual dividend — 005L — FH002 Hu | Other | A shares | -199,359,528 | 0.37% | 1,188,757,000 | — | None |
| State Grid Yingda International Holdings Group Limited | Other | A shares | — | 0.23% | 746,268,000 | — | None |
| China Shuangwei Investment Corporation | Other | A shares | — | 0.23% | 746,268,000 | — | None |

Note: 1. Huijin (Central Huijin Investment Ltd.) was established through state investment in accordance with the Company Law of the PRC on 16 December 2003 as a wholly state-owned company with a registered capital of RMB828,209 million. The State Council has authorized Huijin to make equity investments in major state-owned financial enterprises to preserve and appreciate the value of these state-owned financial assets. Huijin can exercise rights and assume obligations as an investor on behalf of the state to the extent of its capital contribution. Huijin does not engage in other commercial activities or intervene in the normal operations of major state-owned financial enterprises which are controlled by Huijin.

2. The MOF, Ministry of Finance, is a ministry under the State Council, and is empowered to perform its duties in respect of state finance and taxation.

Clearly, the shares of ABC are strictly owned by the state. CEOs and other employees do not hold shares of the bank.

### 6.1.6 Background of Mr. Mr. Jiang

Mr. Jiang received a master degree in economics from Southwestern University of Finance and Economics and is a senior economist. He previously served as Director of the General Planning Department and General Manager of the international business department of ABC and Vice Director of the banking department of People's Bank of China (PBOC). He used to serve concurrently as President of Shenzhen Branch of the PBOC and Governor of Shenzhen branch of State Administration of Foreign Exchange (SAFE), and President of Guangzhou branch of the PBOC and Governor of Guangdong province branch of the SAFE. He was appointed as Executive Assistant President, Director of the General Office and Director of Labor Union Working Committee of PBOC in June 2000, Deputy Governor of Hubei province in September 2002, Chairman of the Board of Directors of Bank of Communications

in 2004, and Vice Chairman of the Board of Directors and President of China Development Bank (CDB) in September 2008. Between 2008 and 2011, Mr. Jiang was the Vice President of the Board of Directors and CEO of CDB. He was promoted as the President of the Board of Directors of ABC in 2011. In 2014, he was further promoted as the Vice Party Secretary of Jilin Provincial Committee of CPC.

6.1.7 Firm Performance under management of Mr. Jiang and his remunerations

Table 6.1.5 is the timetable of Mr. Jiang's career and his firm performance accordingly.

Table 6.1.5: Mr. Jiang's career timetable and corresponding firm performance.

| Year | Position | Asset | Net Profit | RoA | RoE | Payment |
|---|---|---|---|---|---|---|
| 2008 | CDB | 3821.2 | 20.8 | 0.62 | 5.97 | 100 |
| 2009 | CDB | 4541.1 | 31.9 | 0.76 | 8.76 | 100 |
| 2010 | CDB | 5112.3 | 37.1 | 0.77 | 9.49 | 100 |
| 2011 | CDB/ABC | 6252.3/11677.5 | 45.6/121.9 | 0.8/1.11 | 10.76/20.4 | 100 |
| 2012 | ABC | 13244.3 | 145.1 | 1.16 | 20.7 | 86 |
| 2013 | ABC | 14562.1 | 166.2 | 1.2 | 20.9 | 86 |
| 2014 | ABC/VS-Jilin | 15974.1 | 179.5 | 1.18 | 19.6 | |

Table 6.1.5 shows clearly that during his office at CDB between 2008 and 2011, the asset and the profit of the bank rose steadily. The average growth rate of the net profit was around 30%, and it was monopolistically increasing. Both of the return on assets (RoA) and return on equity (RoE) rose steadily, showing a stably improving firm performance. However, the payment to Mr. Jiang was fixed at 1 million yuan annually. The monetary remuneration was not sensitive to the firm performance at all. In addition, the Chinese government passed a strict salary limit regulation on financial firms in 2009. Therefore, Mr. Jiang must have been very clear that his monetary payments would be limited if he continued to work in CDB.

The conclusion that we can obtain from this case is obvious: according to the traditional theory of remuneration sensitivity analysis, if a CEO's remuneration was fixed for the prevailing time as well as for the future, he would have little incentive to work hard to improve the firm performance. This is certainly not the case for Mr. Jiang and CDB. Our conjecture of explanation for this case is that Mr. Jiang cares something else other than monetary payments, and it is political promotion. Indeed, Mr. Jiang was promoted in 2011 to ABC. The promotion was based on the evaluation of CDB performance during his incumbency.

The experience in ABC serves as a robustness check. During Mr. Jiang's office between 2011 and 2014, the net profit of ABC grew steadily as well, with the average annual growth rate of 13.7%. Although this speed is slower than CDB, ABC is a much larger bank, and it is a commercial bank rather than a purely policy-oriented bank like CDB. The RoA and RoE grew steadily as well. Interestingly, the monetary payments for Mr. Jiang was still fixed (at 860 thousand). The fixed monetary payments, together with improving firm performance of ABC

and promotion in 2014, repeats our story as told before. What is more interesting here is that Mr. Jiang's monetary payment in ABC was lower than that when he worked in CDB. The evidence is therefore very persuasive to demonstrate that he cared political promotion rather than monetary payments.

## 6.2 Case Two: Former CEO and Director of the Board in Chang Chun First Auto (FAW): Mr. Zhu

### 6.2.1 Background information about FAW

FAW Group is a global leader in the vehicle manufacturing industry with a 60-year history of innovation. Founded in 1953, FAW employs 120,000 people around the world and sells products in over 70 countries. As a Chinese state-owned automotive corporation, the company's total assets are valued at 244.575 billion yuan RMB. FAW is a diversified maker of quality light, medium, and heavy-duty trucks, automobiles, municipal buses and luxury tourist coaches, custom bus chassis, and mini-vehicles with total sales in excess of 18 million vehicles worldwide.

China FAW Group Corporation, commonly referred to as FAW due to its original name of First Automotive Works, broke ground for its first factory on July 15, 1953. FAW produced China's first Jiefang commercial truck in 1956, and in the year 1958, China's first Dongfeng car and first Hongqi luxury sedan rolled off the production line. Since then, FAW has been at the forefront of China's automotive industry.

FAW Group Corporation is headquartered in China's northern city of Changchun, Jilin Province. FAW Group's domestic production facilities, subsidiaries, and engineering development and test centers are located in 18 locations throughout China. Manufacturing plants are located in northeastern China's Jilin, Liaoning and Heilongjiang provinces, eastern China's Shandong province and Tianjin municipality, southern China's Guangxi and Hainan provinces, and southwestern China's Sichuan and Yunnan provinces. Products include a full range of passenger cars; light, medium, and heavy trucks; coach chassis; municipal transit and intercity buses; luxury tourist coaches; mini vehicles; engines; transmissions; axles; and components.

FAW maintains the lead market position within China while continuing to expand into new international markets. However, its top sales are cooperated brands from abroad, rather than domestic brands innovated by FAW its own. Compared to the private auto production companies, FAW is less innovative, and it is less sensitive to market demand changes.

### 6.2.2 Business of FAW

FAW's main business is the development, manufacturing and sales of passenger cars and accessories. Company's existing two holding subsidiaries, FAW Car Sales Co., Ltd. and FAW Mazda Car Sales Co., Ltd.; control two factories, transfer center, Hongqi manufacturing

department and other related departments. Company's existing Hongqi, Pentium, Ou Lang, Mazda and other passenger car products series. In 2014, the company sold more than one million vehicles, representing an increase of 18.04% over the same period last year to achieve operating income of 33.8 billion yuan, an increase of 14.09%.

Table 6.2.1 shows the sales of FAW in 2013 and 2014.

Table 6.2.1: sales of FAW in 2013 and 2014 (unit: number of cars)

| Industry | | 2014 | 2013 | growth |
|---|---|---|---|---|
| Car production | Sales | 293268 | 248441 | 18.04% |
| | Production | 301011 | 250494 | 20.17% |
| | Inventory | 18073 | 10532 | 71.6% |

FAW is committed to the development of independent passenger cars, and continues to strengthen the development of independent products. For example, in 2014, FAW successfully launched a variety of new products, to maintain the company's sustainable and stable development capabilities, enhance the core competitiveness of enterprises and brand influence. The company’s R&D investment costs about 512 million yuan, accounting for 5.85% of the company's audited net assets at the end of 2014.

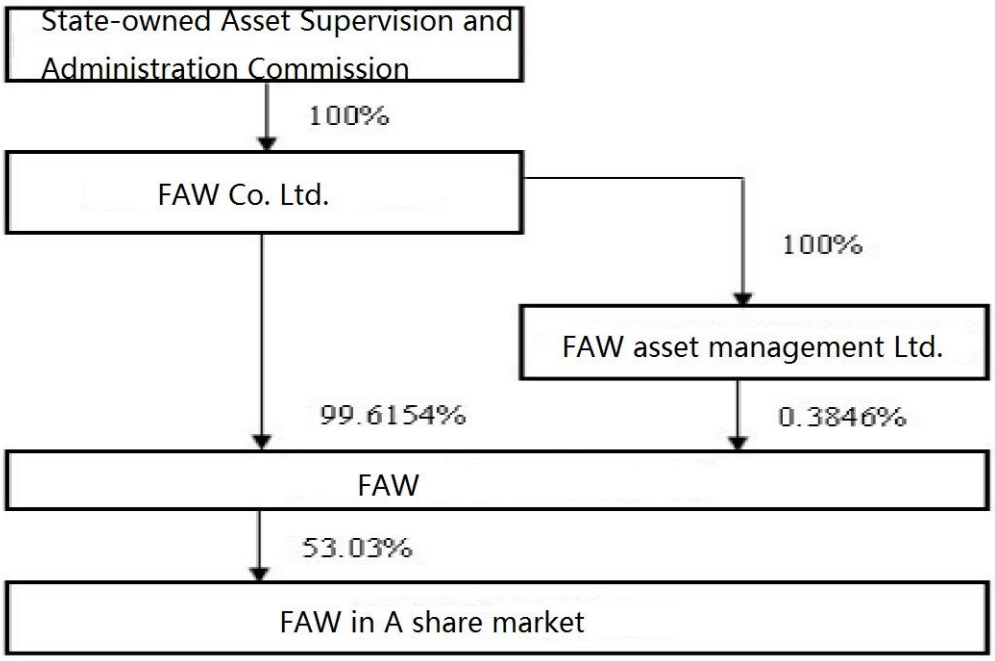
6.2.3 Shareholders information

Some of the top shareholders of FAW are listed in Table 6.2.2

Table 6.2.2: some of the largest shareholders of FAW:

| Name of share holders | Nature of shareholders | Number of shares | percentage |
|---|---|---|---|
| FAW Co. Ltd. | State-owned | 862983689 | 53.03% |
| China Foreign Economic and Trade Trust Co., Ltd | Private fund | 30660018 | 1.88% |
| Bank of Communications | Private fund | 14275072 | 0.88% |
| Everbright Bank | Private fund | 13633098 | 0.84% |

The above table shows the shareholders of the listed asset of FAW. In fact, the FAW Co. Ltd’s ownership can be shown by the following tree:




6.2.4 Human resources: remuneration

The company implements the performance pay system to provide equal opportunities for employees and equal opportunities to promote the company's sustained and healthy development and career of employees. Staff salaries are determined in accordance with national laws and regulations and related policies, combined with the actual situation of the company. The remuneration of directors and senior management personnel are determined by the assessment committee under the Board of Directors, taking into account of firm performance such as the annual production, operation performance and job responsibilities. The company's senior managers' remunerations consist of two parts: basic salary and performance pay, with the former paid monthly and latter paid according to the assessment of performance in the previous year.

The remuneration at the top manager level, i.e., CEO and directors of the board, nevertheless, are mainly not related to firm performance. This creates a similar paradox as in the case of ABC in which the highest manager's incentives to improve the firm performance are distorted, particularly when his/her subordinates have incentive pay.

6.2.5 Background information about Mr. Zhu

Mr. Zhu, male, was born in March 1961. He joined the Chinese Communist Party in May 1982, and started to work in August 1983. He got the bachelor degree from the Department of Chemical Engineering of Zhejiang University, and the master degree from the Department of Control Engineering of Harbin Institute of Technology.

Mr. Zhu served as CEO and Director of FAW between 2000 and 2007, then he was promoted

as the Vice Governor of Jilin Province.

6.2.6 Firm performance and Mr. Zhu's remunerations

Table 6.2.3 is the timetable of Mr. Zhu's career and the corresponding firm performance.

Table 6.2.3: Mr. Zhu's Career timetable and corresponding firm performance.

| Year | Position | Asset (billion) | Net Profit | RoA | RoE | Payment |
|---|---|---|---|---|---|---|
| 2000 | FAW | 6.74 | 0.27 | 4.42 | 5.85 | ?? |
| 2001 | FAW | 6.09 | 0.02 | 0.38 | 0.54 | ?? |
| 2002 | FAW | 6.66 | 0.24 | 3.9 | 5.54 | ?? |
| 2003 | FAW | 9.11 | 0.44 | 5.67 | 8.86 | ?? |
| 2004 | FAW | 6.97 | 0.31 | 3.86 | 6.13 | ?? |
| 2005 | FAW | 7.95 | 0.34 | 4.6 | 6.3 | ?? |
| 2006 | FAW | 8.29 | 0.28 | 3.52 | 6.45 | ?? |
| 2007 | FAW/Jilin | 9.57 | 0.56 | 6.34 | 9.56 | ?? |

The table shows that during Mr. Zhu's office, the firm performance exhibited fluctuations, and there was a major correction in 2001. However, starting from 2004, both RoA and RoE increased steadily. This improving firm performance did not benefit from the growing industry, rather, the average RoA and RoE of the car industry during 2004 and 2007 were decreasing.

Therefore, we can attribute the improving firm performance of FAW to Mr. Zhu's effort as the CEO. The interesting part is that, Mr. Zhu's monetary payments was based on his political rank, and was fixed for those years. According to the annual reports of FAW for years 2000~2007, Mr. Zhu did not earn any monetary payments from the company. His payment was instead paid by the government directly. In this case, Mr. Zhu would have little incentives to exert costly effort to improve FAW's performance while he was not compensated. In fact, this goes back to our earlier conjecture that Mr. Zhu must care something else rather than monetary payments.

Indeed, he was promoted as the vice governor of Jilin Province in December, 2007. According to our knowledge, a promotion of this level in China is determined at least half year earlier than the day when the promotion actually takes place. In other words, Mr. Zhu should be aware that a promotion was considered for him in early 2007, and FAW's performance in 2007 was the important criterion of this promotion. To "pass the final test", Mr. Zhu had strong incentives to improve FAW's RoA and RoE. This logic can be proved by data that both RoA and RoE of FAW showed a large jump up in 2007. For consistency, no other auto companies showed this strong improvement of firm performance in this year, and therefore FAW's performance was not the result of industry effect.

**6.3. Conclusions of the case study**

With the two cases discussed above, the evidences are clear. Both CEOs were promoted politically, and after promotion, both CEOs left the business and worked in government. The monetary payment to the two CEOs did not increase after the promotion. Quite interesting, due to various regulations, their monetary payment decreased. However, we observe clear evidence of the improvement of firms' performances in terms of both ROA and ROE before the political promotion took place. Such improvement cannot be explained by the changes of macroeconomic conditions or industrial conditions, because the competitors of these two firms in the same industry showed no such improvement that is comparable. This implies that the improvement of performances of these two firms can be attributed to managers' effort. Moreover, because the managers' monetary payment showed no increase and had no possibility to provide incentives, the conclusion is that the political promotion provided incentives for CEOs to put on more effort.

Therefore, these two cases support our conjecture that political promotion does play the important role of providing incentives for CEOs working in SOE.

## Chapter 7. Survey

The two above-mentioned case studies shows the role of political promotion in motivating CEOs of SOEs. The case study is a "second best" choice of analyzing the role of political promotion, given that the relevant data is unavailable. However, the two cases are only are persuasive, but not yet conclusive. The benefit of case studies is that, because it is difficult to measure the probability of a CEO getting politically promoted, the case studies can focus on the event that happened near the timing of the CEO getting promoted. Such qualitative analysis serves as the reasons for the hypothesis of the importance of political promotion. To increase the sample of the analysis, and to directly test the significance of the role of political promotion as incentive mechanism for CEO, we use survey analysis. In the survey, we carefully design the questionnaire, and distribute it to 100 CEOs working in SOEs or private enterprises. The questions that are designed and incorporated in the questionnaire will be discussed more in detail in the next subsection. In short, we are trying to conduct a comparative analysis between CEOs from SOE and CEOs from private enterprises. The questions help to distinguish and identify the different incentives of CEOs working in different types of enterprises.

The selection of survey respondents is based on the following considerations. First, we hope to cover as much industries as possible. Constrained by the accessibility, we therefore choose the following industries: financial industry, mining industry, manufacturing industry, and real estate industry. These industries are in fact the most typical industries to which SOE belong. The second consideration is that we cover both central SOE and local SOE. This is to test whether there are potential differences of CEO incentives working at the central level and local level SOE. The motivation of getting political promotion is expected to be stronger at the central level. The third consideration is that we want to cover as much geographic regions as possible. Particularly, we expect that our sample SOE are located in all the regions of China, and the density of the geographic distribution roughly represents the actual distribution

of all SOE. In fact, in our sample, 10 firms are located in the North, 8 are located in the East, 6 are located in the South, 5 are located in the central area, 3 are located in the Southwest, 4 are located in the North west, and 4 are located in the Northeast.

Notice that the CEOs of these SOEs are all "big figure" and they have very high political rank, therefore, to access them, we rely on some of our private relationships in the government and request from the governors for recommendations. Luckily, these CEOs are supportive. We were honest to them in the sense that we told them this survey is only for academic researches, and the data will certainly not be public or for alternative use. However, the respondents were not aware about the research objectives and research questions. This is to avoid the bias or dis-honesty of their responses in the survey, as the survey touches quite sensitive topics.

We retrieved 54 responses, in which only 40 are complete and consistent. We use these 40 survey results to illustrate and test our hypothesis.

### 7.1. The Survey Questionnaire

The questionnaire is written in Chinese, as we are doing research for Chinese firms, and most CEOs working either in private enterprises or SOEs do not have sufficient English language skills. We introduce the design of the questions and the purpose of posting these questions. The translated version of the questionnaire is given in the appendix (we explain the purpose of each question below):

For the first part of the questionnaire, we want to distribute our samples across industries and regions. This is to avoid the cluster of samples and therefore biased conclusions. Particularly, if all the samples lie in the same industry or in the same region, cultural factors or other factors might generate survey results that all responses are in a similar pattern. In addition, we further divide the SOEs into central government owned enterprises (C-SOE) and local government owned enterprise (L-SOE). The idea is that CEOs in C-SOE might be more motivated by consideration of political promotion.

In the second part of the questionnaire, we record some basic accounting statistics of surveyed enterprises. Here, asset size, return on equity and return on assets, and net profit are traditional important variables. As we have argued in previous section, RoA and RoE in SOEs are lower than that in private enterprise, but one reason behind this result is that SOEs generally have larger asset size. The larger is the asset size, the more difficult it is to maintain RoA at high level. Therefore, to make our comparison of SOE and private firms reasonable, we control for the asset size in our regression in the previous section. In our survey, similarly, we also control for the asset size so that survey results of SOEs and private enterprises are comparable. Number of employees and their average annual salary are considered as the measure of wellbeing of working in different type of firms.

In the third part of the questionnaire, we record the CEO's basic resume. The age is quite important here because there are sharp differences of CEO ages between SOEs and private

enterprises. For CEOs working in SOEs, particularly C-SOEs, qualifications are important. The qualifications include the experience of working in the government sector or SOEs of lower political level. It is relatively less common to promote one's political level with "jumping mode". Instead, levels increases gradually step by step. As stated before, the lowest level is "Fu Ke" and the highest level is "Bu". The most commonly seen path of promotion is therefore as follows: "Fu Ke" to "Ke", then to "Fu Chu", "Chu", "Fu Ju", "Ju", "Fu Ting", "Ting", "Fu Bu", and finally to "Bu". In some SOEs, "Fu Bu" is the highest level. To complete this path, it might take years. This is the reason why CEOs of SOEs (who have the level of "Fu Bu" or above) are all over 50 years old. Also note that 60 years old is the retirement year. For private enterprises, there is no strict age limit, hence CEOs in this type of enterprises are relatively younger. In addition, the work experience of CEOs of SOEs might have strong impact on their motivations. The underline assumption here is that these CEOs are path-dependent. If their career lies on political promotion, then getting promoted is their incentive to extend effort. That is the reason we post the question that whether they have worked in the government and whether they have had political level higher than "Chu". Admittedly, some CEOs of SOEs come from "hard landing". Distinguishing these CEOs from others who earn the position by climbing the political promotion tree makes sense here.

We also have a question regarding CEOs' expectation of future working opportunities in this part. However, we avoid asking them directly whether they want to go back to the political system and working for government after they retire from working in SOEs. This way of designing the question is not acceptable because, on one hand, respondents might provide fake answers for any reasons (such as to hide their ambitions), and on the other hand, we want to obtain the results by asking related questions so that our hypothesis can be tested by implications of the answers indirectly. We believe that this way of treatment is more convincing.

The forth part of our questionnaire contains the monetary payments to CEOs and related welfare. Perquisite consumption is considered as one of the most important welfare of working in SOEs. In the literature, some even argue that perquisite consumption plays an important role of motivating CEOs. Therefore, to test whether perquisite consumption is important, we investigate whether there are significant difference of perquisite consumption between SOEs and private enterprises. If there is no significant difference, then it is hardly convincing to argue that perquisite consumption motivates CEOs of SOEs to work hard. This also applies to other welfares such as medical care. Indeed, SOEs had better welfare in the traditional view. Nevertheless, such judgement is applicable mostly to employees so that SOEs pay for their housing, medical care, children's educations and so on. At the CEO level, SOEs and private enterprises might not have significant differences. And better welfare to employees in SOEs is considered as social responsibility rather than economic outcome of the enterprise.

The last part of the questionnaire is about CEO's family. Marriage status and the working status of CEO's spouse could have important impact on the CEO's motivation of working in SOEs. As we discussed in the background introduction of SOEs, political title implies implicit

power. Because CEOs of SOEs have political title and they have political connections with government, it is relatively easier to send their children to "key schools" or famous school that are under control of government. Their spouse can easily find a job in SOEs as well, enjoying the welfares discussed above. This implies that, if a CEO's family members are more involved with SOEs, this CEO might have stronger incentives to work in SOEs, because this enables him or her to facilitate his or her family members' schooling and working. Last but not least, the time spent with family is a measure of working intensity of the CEOs. We conjecture that CEOs working in private enterprise are busier than those working in SOEs.

### 7.2. Analysis of the survey results

Among the 100 surveys we sent out, 54 were retrieved and only 40 were seen as efficient and complete. We summarize some basic statistics of the results before we discuss their implications for our hypothesis.

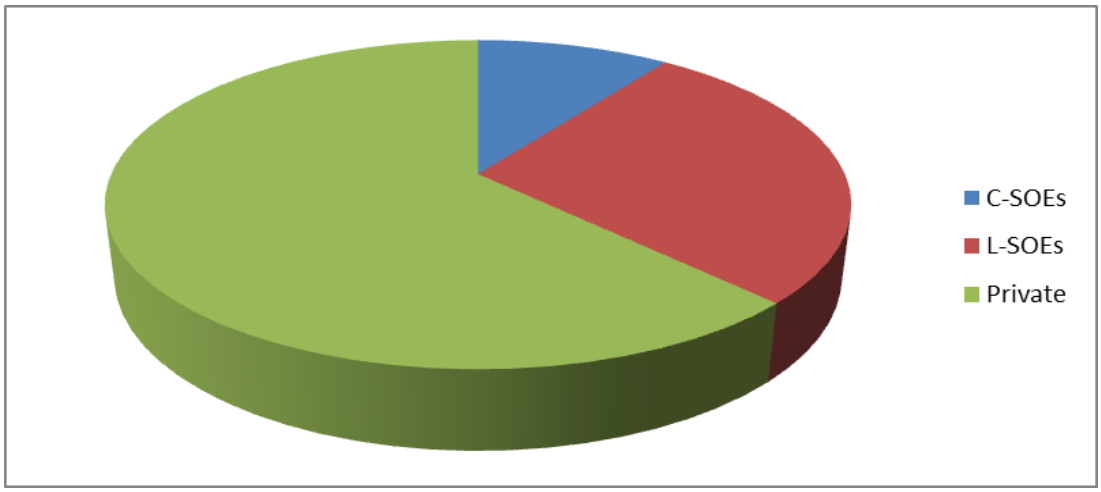
Table 7.2.1 below shows that among 40 samples, 15 of them are SOEs, with 4 C-SOEs and 11 L-SOEs. Two C-SOEs operate in the financial industry, and the other two C-SOEs operate in the manufacturing industry. For the 11 L-SOEs, two operate in the real estate industry, four operate in the mining industry, and the rest five operate in the manufacturing industry. There are also 25 private enterprises, where five of them operate in the financial industry, four operate in the real estate industry, five in the mining industry, eight in the manufacturing industry, and the rest 3 operate in the IT industry. The industries are well distributed and representative, and SOEs and private enterprises are comparable because in each target industries, we have both types of enterprises.

Table 7.2.1: Distribution of enterprises in various industries

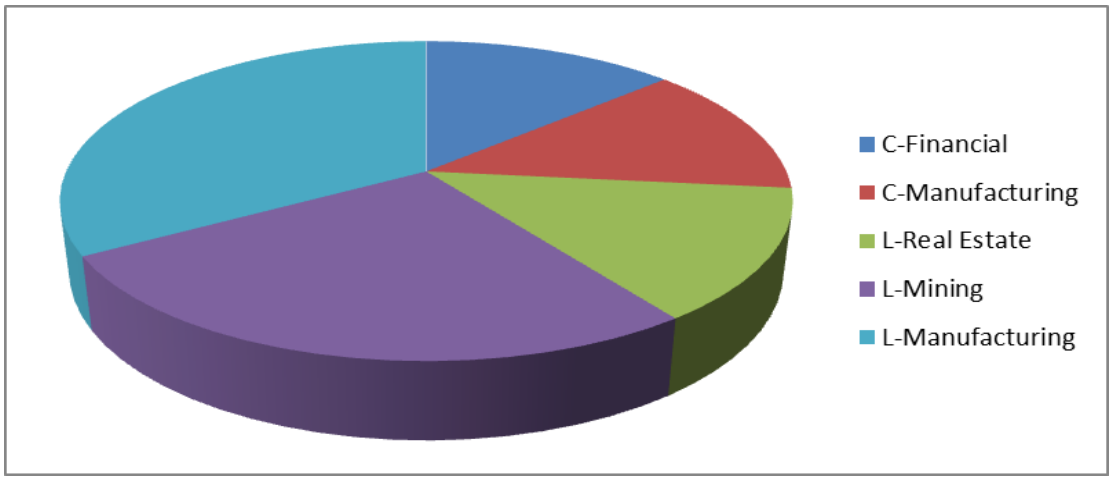
| Type of Enterprise | Number | Industry | Number | Industry division | Number |
|---|---|---|---|---|---|
| SOEs | 15 | Central SOEs: Financial | 2 | | |
| | | Central SOEs: Manufacturing | 2 | Equipment processing industry | 1 |
| | | | | Other Manufacturing Industries | 1 |
| | | Local SOEs: Real Estate | 2 | | |
| | | Local SOEs: Mining | 4 | | |
| | | Local SOEs: Manufacturing | 5 | Equipment processing industry | 3 |
| | | | | Other Manufacturing Industries | 2 |
| Private Enterprise | 25 | Financial Enterprises | 5 | | |

| | | | | | |
|---|---|---|---|---|---|
| s | | Real Estate Enterprises | 4 | | |
| | | Mining Enterprises | 5 | | |
| | | Manufacturing Enterprises | 8 | Equipment processing industry | 5 |
| | | | | Other Manufacturing Industries | 3 |
| | | Information Technology Enterprises | 3 | | |

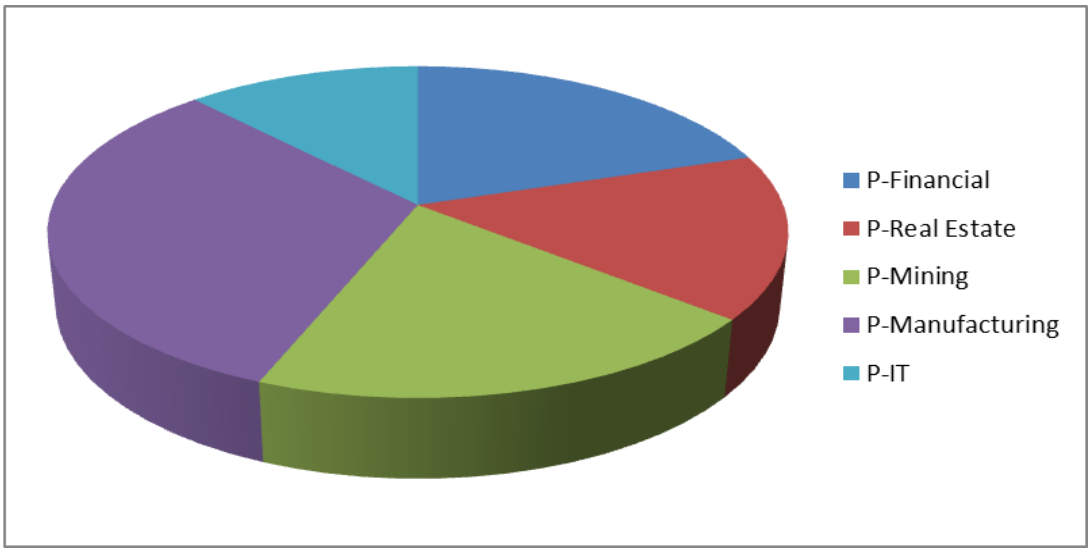
Figure 7.2.1 shows the distribution more clearly.




Distribution of enterprises ownership




SOEs' industries




Private enterprises' industries

Figure 7.2.1: summary of distributions of enterprises and their industries

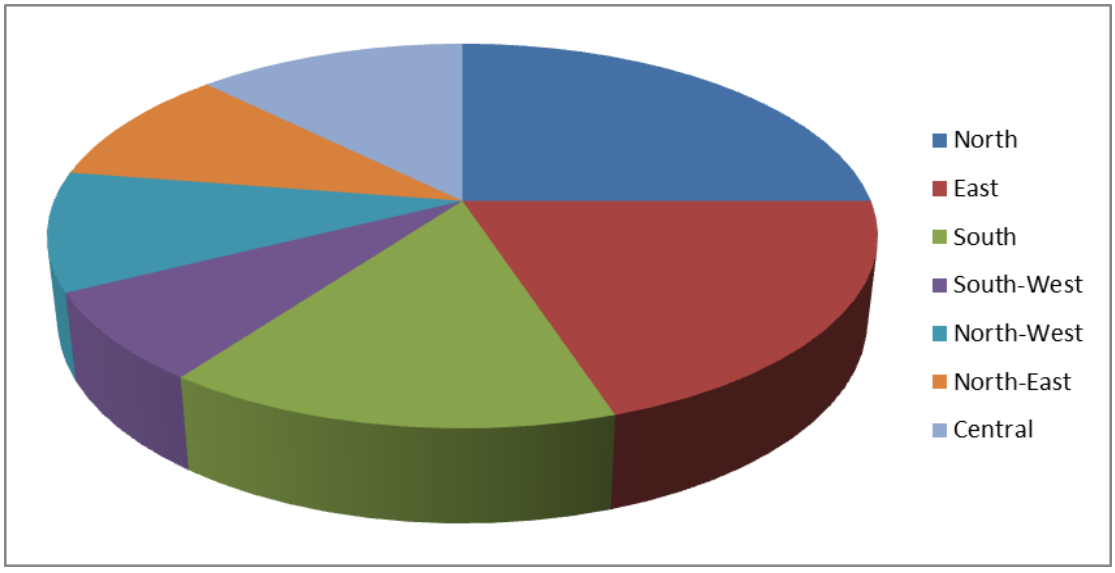
The geographical locations of our samples are summarized in Table 7.2.2. Four of the entire 40 samples, ten are located in the North (here, location means the location of the headquarters), eight are located in the East, six are located in the South, five are located in central China. The rest are located in the Northeast, Northwest, and Southwest. The distribution of locations is representative in the sense that we have enterprises from every economic region of China. Because the economy is quite diversified among regions, this distribution of geographical positions is more general. Moreover, industries might be clustered in one region. For example, the Northeast and Northwest are famous for mining industries, while the South is famous for IT and manufacturing industries. We summarize the detailed geographical position-industry distribution in Table 7.2.2 and Figure 7.2.2.

Table 7.2.2: Geographical distribution and industry distribution within a geographical region

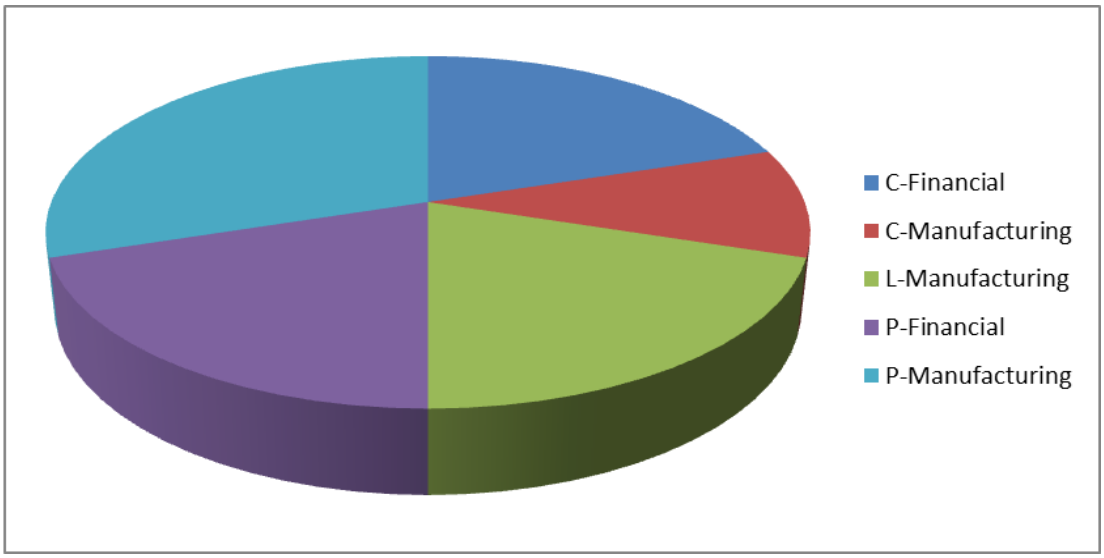
| **Regional Distribution** | **Number** |
|---|---|
| North | 10 |
| East | 8 |
| South | 6 |
| Southwest | 3 |
| Northwest | 4 |
| Northeast | 4 |
| Central | 5 |
| **Industry Distribution in North China** | **Number** |
| C-Financial | 2 |
| C-Manufacturing | 1 |
| L-Manufacturing | 2 |
| P-Financial | 2 |
| P-Manufacturing | 3 |

| **Industry Distribution in East China** | **Number** |
|---|---|
| C-Manufacturing | 1 |
| L-Real Estate | 1 |
| L-Manufacturing | 2 |
| P-Real Estate | 2 |
| P-Manufacturing | 2 |
| **Industry Distribution in South China** | **Number** |
| L-Real Estate | 1 |
| P-IT | 3 |
| P-Financial | 1 |
| P-Real Estate | 2 |
| P-Manufacturing | 2 |
| **Industry Distribution in Southwest China** | **Number** |
| P-Mining | 1 |
| P-Financial | 1 |
| P-Manufacturing | 1 |
| **Industry Distribution in Northwest China** | **Number** |
| P-Mining | 4 |
| **Industry Distribution in Northeast China** | **Number** |
| L-Mining | 4 |
| **Industry Distribution in Central China** | **Number** |
| P-Financial | 1 |
| P-Real Estate | 1 |
| L-Manufacturing | 1 |
| P-Manufacturing | 2 |

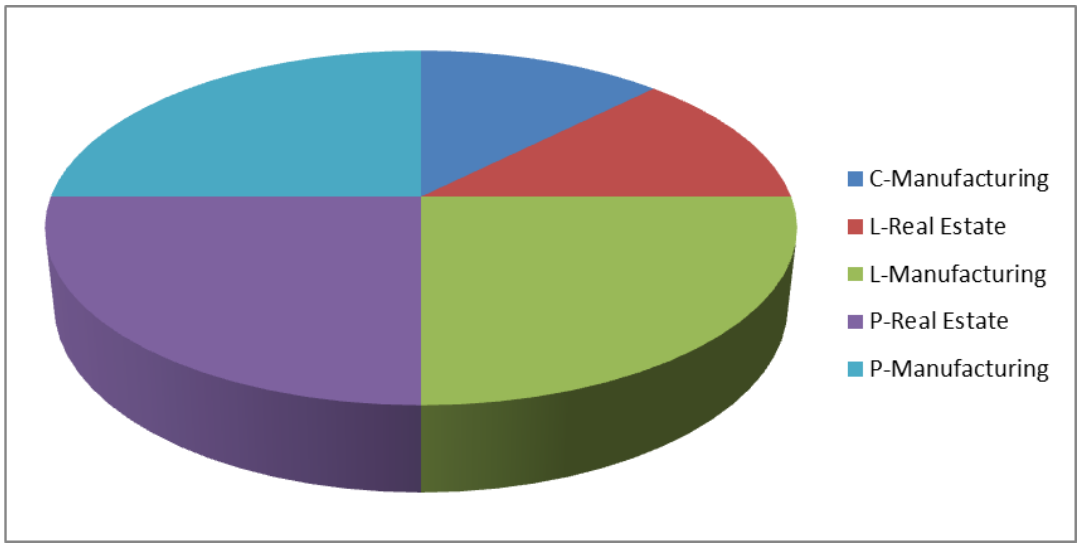
Note: "C-" is for C-SOE, "L-" is for L-SOE, and "P-" is for private enterprises.



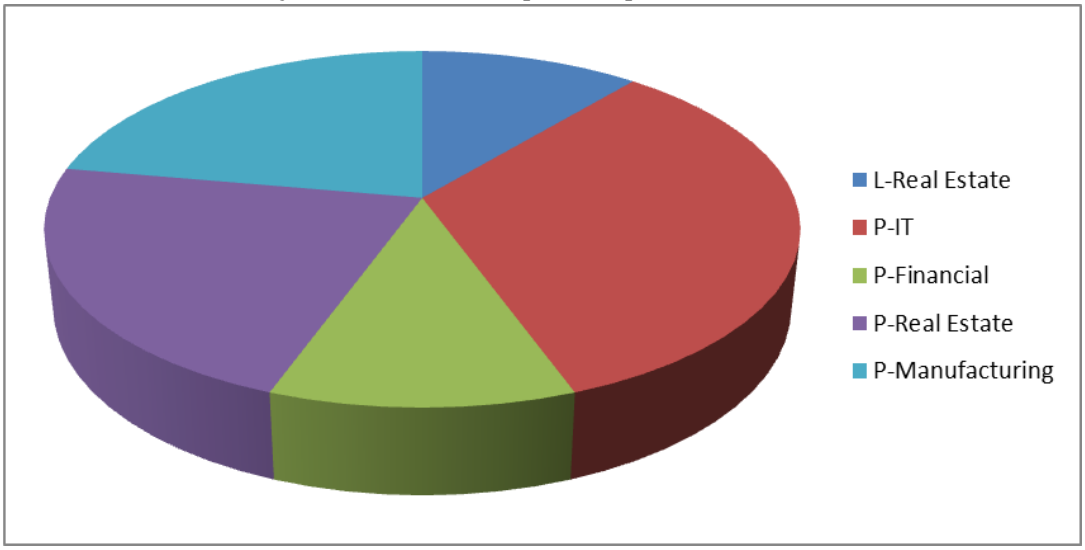

Geographical distribution of our sample



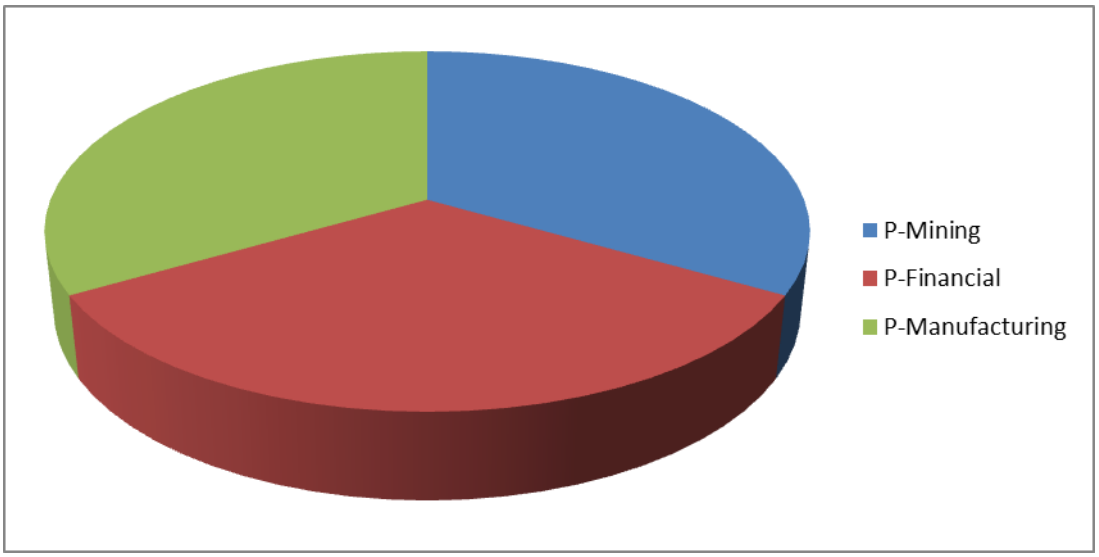

Industry distribution of sample enterprises in North China



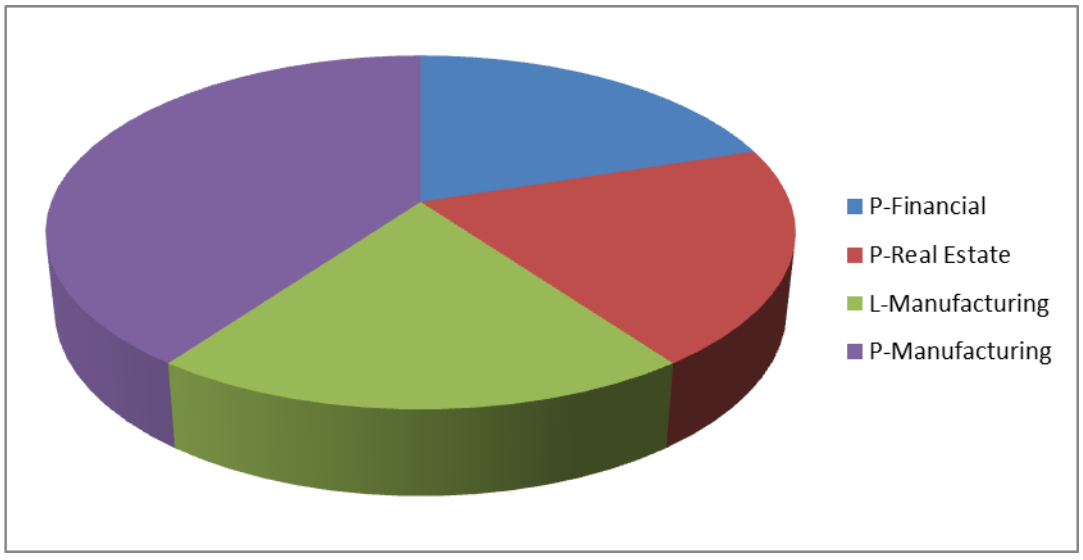

Industry distribution of sample enterprises in East China




Industry distribution of sample enterprises in South China




Industry distribution of sample enterprises in Southwest China




Industry distribution of sample enterprises in Central China

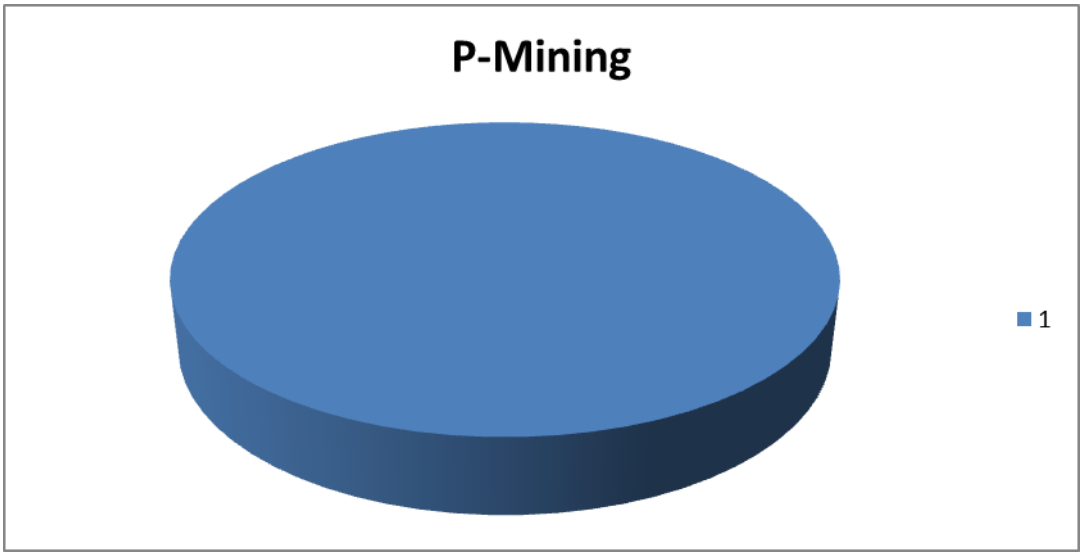


Figure 7.2.2: Industry distribution of sample enterprises in Northwest and Northeast China

Next, we summarize the CEOs' experience results. This can be seen from Table 7.2.3. For the 40 CEOs, 38 of them are male and 2 of them are female. Both two female CEOs come from private enterprises. The age distribution is in line with our expectations. Young CEOs aged below 50 mainly come from private enterprises. For the CEOs who work in SOEs, only 3 of them have the age of between 40 to 50 years old. The majority are above 50 years old.

For the positions in the enterprises, there are two private enterprises whose CEOs are also the owner of the enterprises. Because SOEs are owned by the state, their CEOs hold no shares of the enterprises, and they are only the managers. To be precise, as we also show later, not all managers in SOEs are titled with CEO. Some of them are titled as chief director. Yet, none of them hold any share of the enterprises. For private enterprises, some CEOs fully own the firm while some only own a part. There are two vice CEOs in private enterprises surveyed.

For civil work experience, all 15 CEOs from SOEs have such experience. There is also one CEO from private enterprise who used to work in the government. He gave up the opportunity of continuing serving as a civil governor and chose to open his own business. For those 15 CEOs from SOEs, 9 already had the political level higher than "Chu" during their service for civil work. It is important to mention here the political level higher than "Chu" points to the experience when the current CEOs were still serving as civil governor. This implies that 9 of CEOs from SOEs, although served as civil governor before, joined the SOE before they had a political level higher than "Chu". These CEOs have the political level as high as "Fu Bu" already, but such levels were raised up when they were already working in SOEs. The distinction of where the political level is raised is important here, as political promotion within enterprises is viewed as a motivation of working in SOEs.

The work experience in other SOEs before is asked. There are totally 16 CEOs from our sample who have experience of working in other SOEs, among which 1 CEO is now working in a private enterprise. Notice that CEO transferring among SOEs is quite common in China, even such transfer is inter-industry. The transfer, indeed, is a symbol of promotion. Typical transfer includes situations such as CEOs being transferred from an SOE of a smaller asset size to an SOE of a bigger asset size, from local government owned enterprises to central government owned enterprises and from vice CEO of one SOE to CEO of another SOE. Not surprisingly, all 15 CEOs from SOEs in our sample have experience of working in other SOEs. However, for the private enterprise work experience, none of the CEOs of SOEs have such experience. It seems that CEOs of SOEs all come from either government sector or other SOEs, and this political promotion system is quite exclusive for private sector.

Another important question asked in our survey is that if they leave the enterprises, do CEOs expect to work in the government sector? This question is designed particularly to capture CEOs' career plan. For the 15 CEOs from SOEs, 10 of them have such expectations, showing their willingness of working in the government sector again. For these CEOs, political promotion is important incentives. We will test these incentives further with the results from

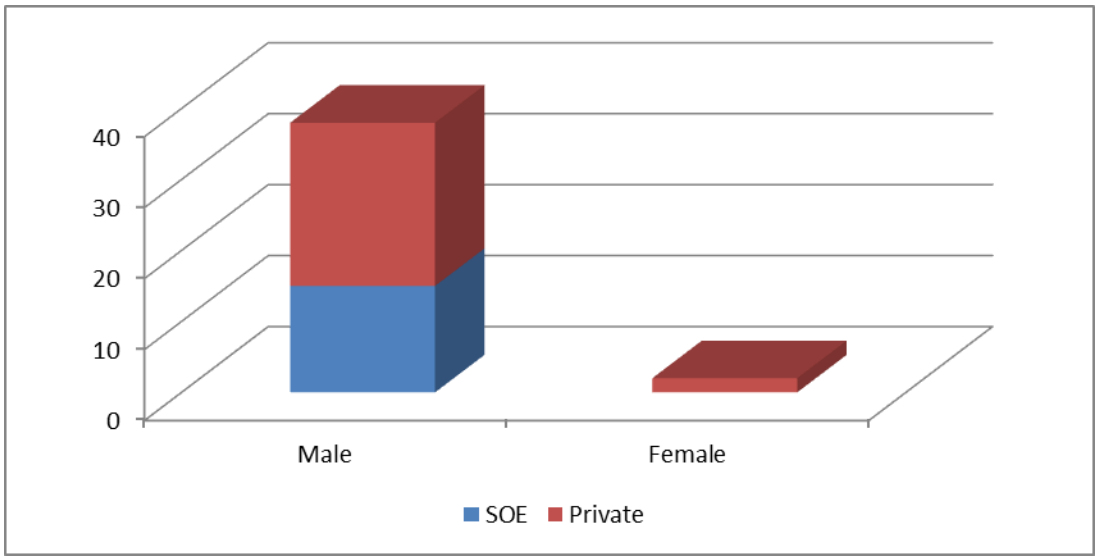
family background and monetary payments details. Finally, we ask whether their enterprises are required to carry on social responsibilities. The result is not surprising, all 15 SOEs have such social responsibilities while only 2 private enterprises have. Social responsibilities here refer to the non-economic activities that can bring profit loss or inefficiency. SOEs have much stronger pressure of being socially responsible than private enterprises, and their CEOs implement related policies required by the government. These policies harm the profitability, hence monetary income, of firms. Yet, following these policies has the advantage of increasing the likelihood of being politically promoted.

Table 7.2.3: Distribution of answers to CEO experiences

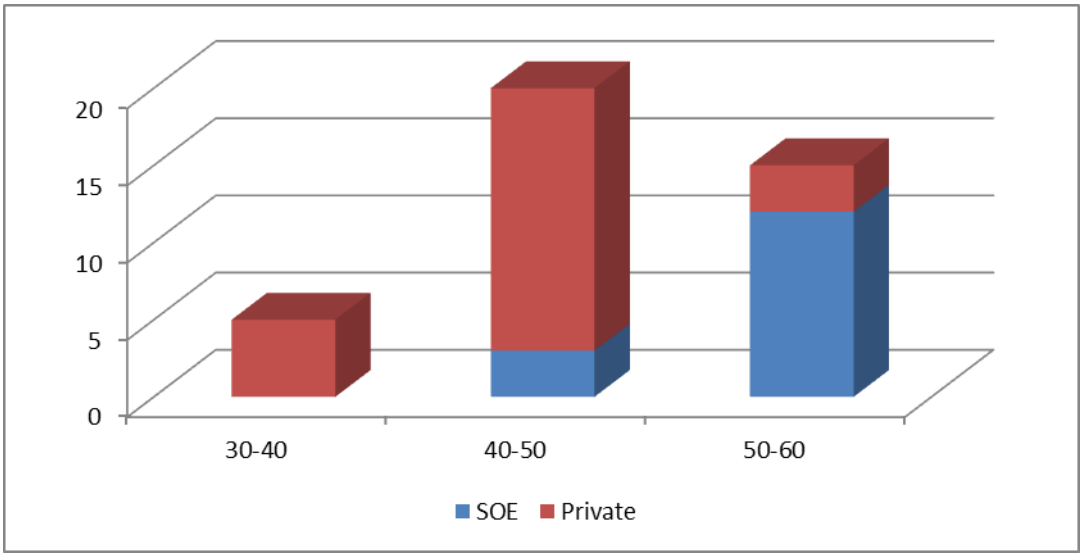
| **Question** | **Option** | **numbers** | **Ownership** | **Distribution of Enterprises of Different Ownership** |
|---|---|---|---|---|
| Your gender | Male | 38 | SOE | 15 |
| | | | Private | 23 |
| | Female | 2 | SOE | 0 |
| | | | Private | 2 |
| What is your age range | 30-40 | 5 | SOE | 0 |
| | | | Private | 5 |
| | 40-50 | 20 | SOE | 3 |
| | | | Private | 17 |
| | 50-60 | 15 | SOE | 12 |
| | | | Private | 3 |
| What is your current position in the business | owner & CEO | 2 | SOE | 0 |
| | | | Private | 2 |
| | CEO | 36 | SOE | 15 |
| | | | Private | 21 |
| | Executives | 2 | SOE | 0 |
| | | | Private | 2 |
| Do you have a civil service work experience? | Yes | 16 | SOE | 15 |
| | | | Private | 1 |
| | No | 24 | SOE | 0 |
| | | | Private | 24 |
| Political level higher than “Chu” during civil service | Yes | 9 | SOE | 9 |
| | | | Private | 0 |
| | No | 31 | SOE | 6 |
| | | | Private | 25 |
| Do you have work experience in other SOEs? | Yes | 16 | SOE | 15 |
| | | | Private | 1 |
| | No | 24 | SOE | 0 |
| | | | Private | 24 |
| Whether you have other | Yes | 10 | SOE | 0 |

| | | | | |
|---|---|---|---|---|
| private enterprises work or service experience? | | | Private | 10 |
| | No | 30 | SOE | 0 |
| | | | Private | 30 |
| If you leave your current position, do you expect to become a civil servant again? | Yes | 10 | SOE | 10 |
| | | | Private | 0 |
| | No | 30 | SOE | 5 |
| | | | Private | 25 |
| Does your enterprise have a mandatory social responsibility requirement? | Yes | 17 | SOE | 15 |
| | | | Private | 2 |
| | No | 23 | SOE | 0 |
| | | | Private | 23 |

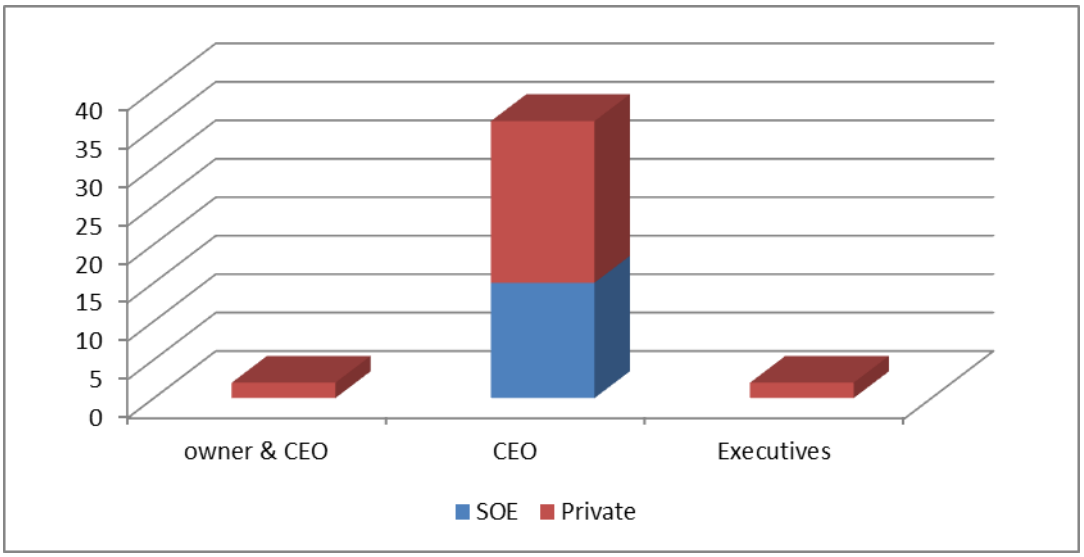
Figure 7.2.3 shows the distributions of answers.



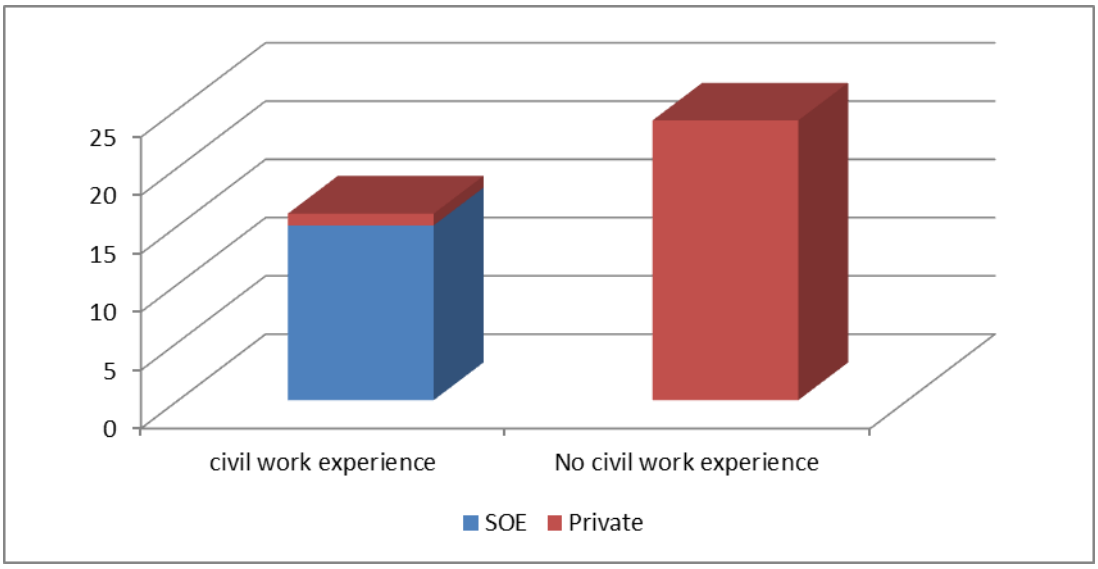

Gender distribution



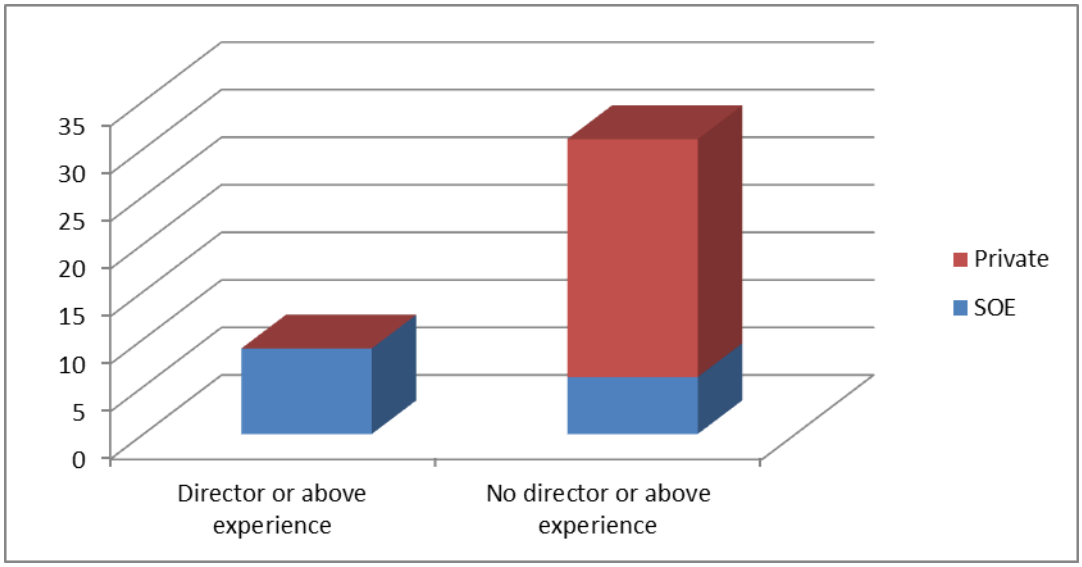
Age distribution



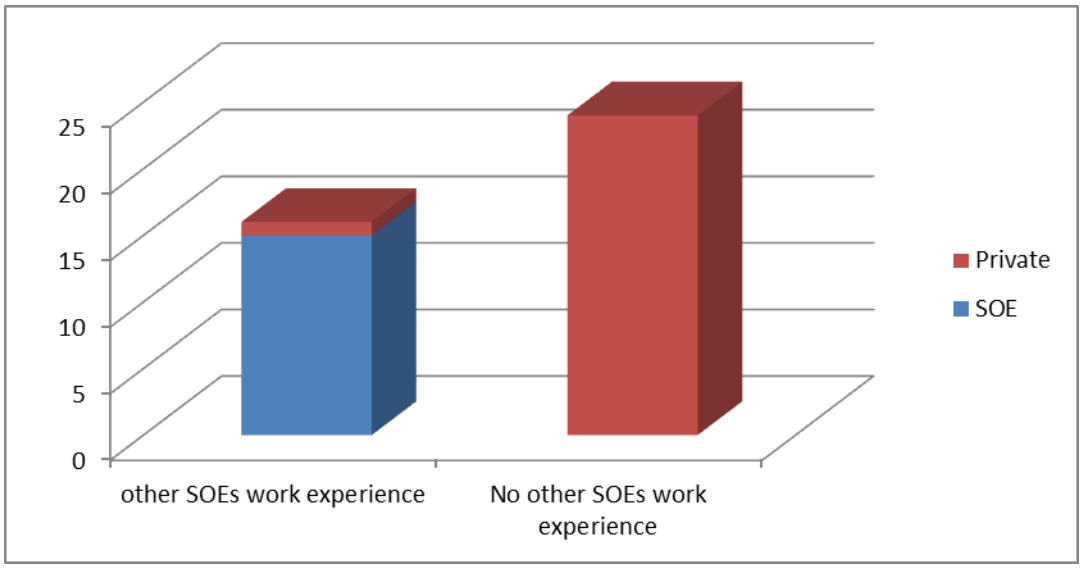

Position in the enterprise



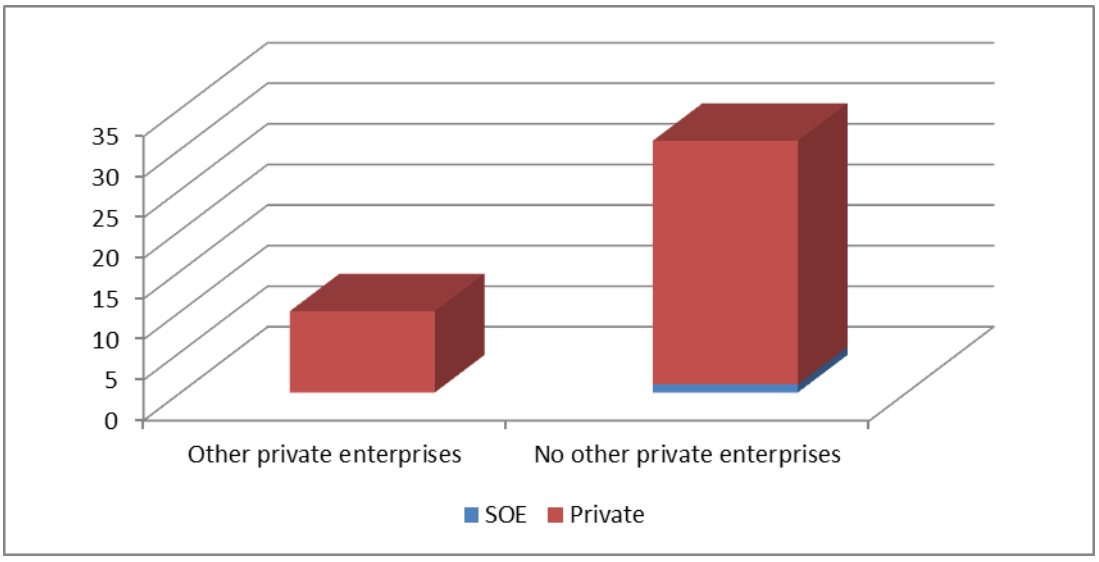

Civil work experience



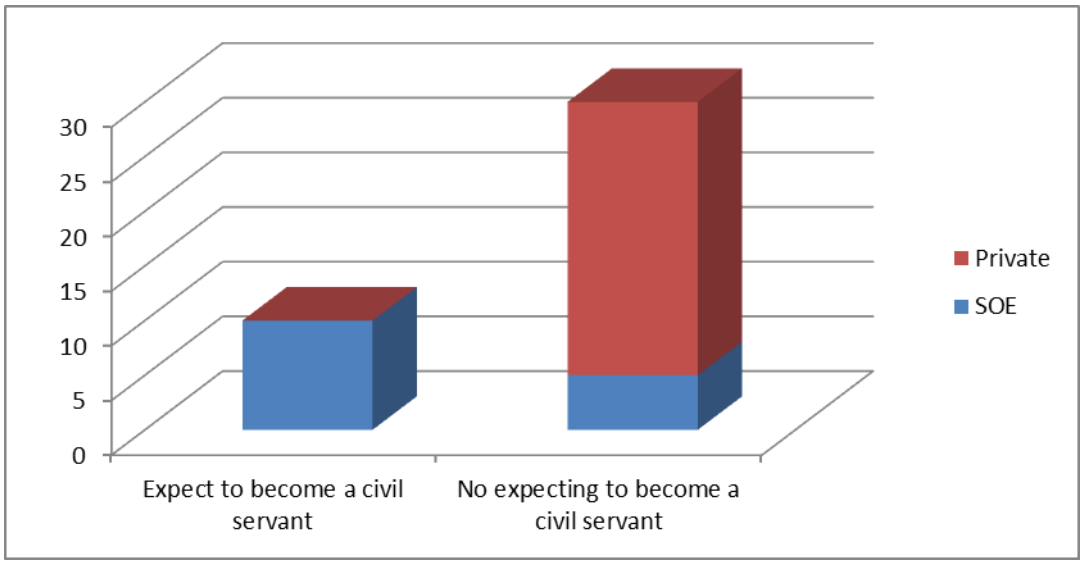

Political level higher than “Chu” (Director)




Other SOEs work experience




Private enterprises work experience




Expectation of working in the government sector

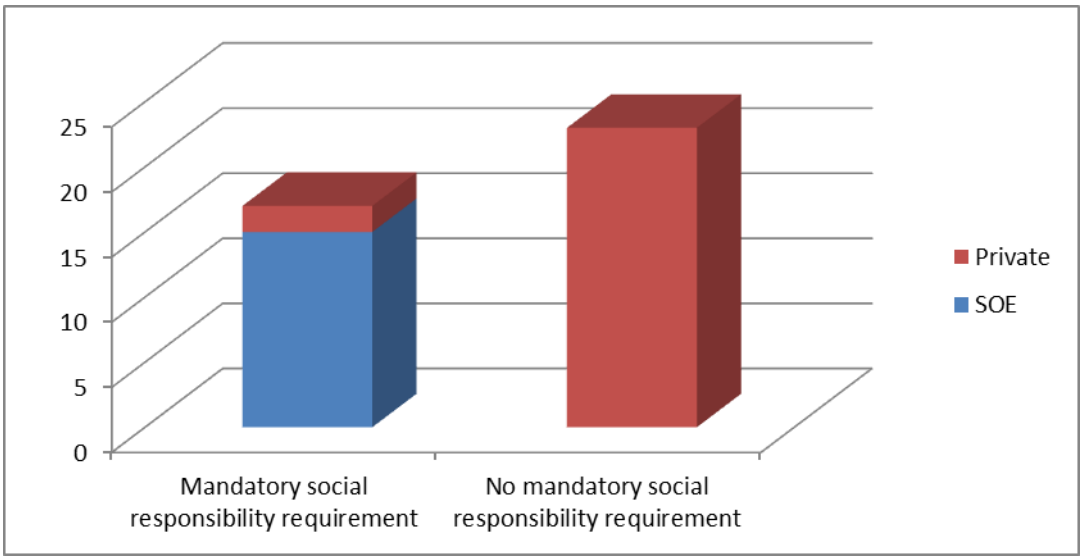



Figure 7.2.3: Distribution of answers to CEO experiences

The third part of our questionnaire is about the monetary payments and welfare of CEOs and their family members. In this part, we carefully deal with monetary payments without confusing the cash/salary with stock/options. In doing so, we ask whether CEOs own any share of the enterprises they are running. As for SOEs, none of their CEOs own any share of the enterprises. This implies that monetary payments only includes cash/salary. Two CEOs from private enterprises also fully own their firms, and 20 CEOs partly own the firms.

In section 5, we already discussed the fact that monetary payments for CEOs of SOEs are much lower than that for CEOs in private enterprises. This is confirmed by our survey. Annual monetary income of all 15 CEOs from SOEs are below 600K (600 thousand Yuan). For the private enterprises, this is totally reversed. 14 CEOs from private enterprises earn more than 1 million Yuan per year in salary. The huge difference in monetary payments raised the question naturally—what are the motivations for CEOs to work in SOEs?

One might argue for the convenience of perquisite consumption in SOEs, yet this is not the case according to our results. Perquisite consumption in SOEs shows no much difference from that in private enterprises. If there is any difference, that is perquisite consumption in private enterprises is even larger than that in SOEs. In our sample, there are ten SOEs and ten private enterprises whose annual perquisite consumption is between 100K and 200K. But there are 10 private SOEs whose annual perquisite consumption is over 1 million. This result contrasts to the traditional belief that perquisite consumption is normal in SOEs and plays an important role of motivating CEOs.

Regarding the welfare, the results are similar. SOEs' famous "high" welfare is not applicable to the comparison at CEO level. Rather, talking about "high" welfare in SOEs, it is more accurate to say that this is particularly aimed at employees, and such welfare includes housing allowance. This situation is already changing. For CEOs, basic welfare is much lower in

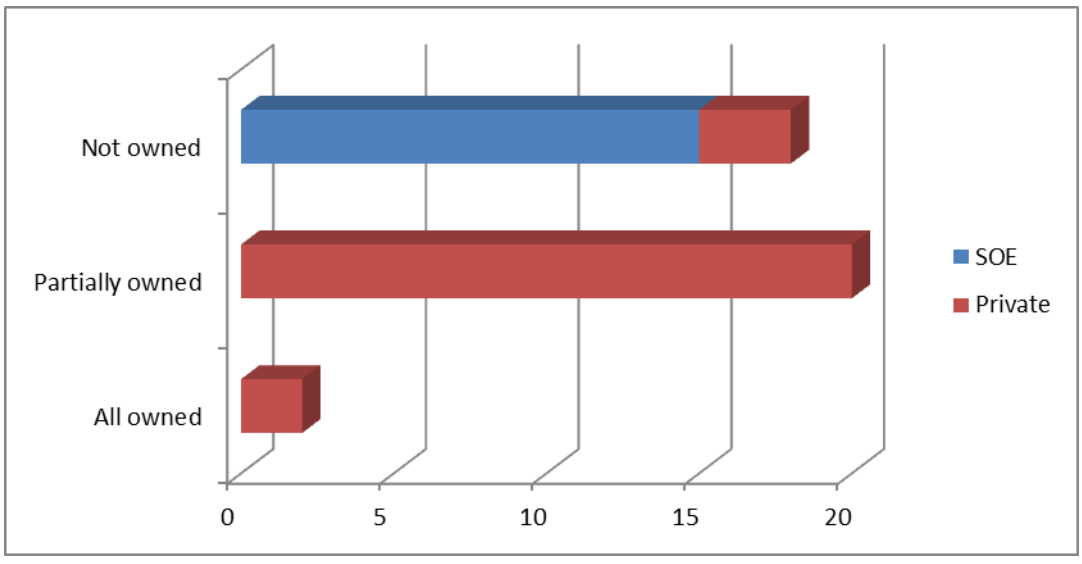
SOEs than that in private enterprises. All 15 SOE samples have the basic welfare lower than 200K per year, while 12 private enterprises have the basic welfare over 1 million. As for the medical care, private enterprises also outperform SOEs. All 15 CEOs from SOEs only enjoy the basic social health insurance and partly covered commercial insurance. Although there are 12 private enterprises that are the same as SOEs, 8 private enterprises offer their CEOs with fully covered commercial insurance and 5 private enterprises offer the family of their CEO with fully covered commercial insurance.

The results obtained in this part of survey show that monetary payments and all monetary-related welfare in SOEs are significantly less than that in private enterprises. This justifies our concern that CEOs are motivated by other things if they choose to work in SOEs. Table 7.2.4 shows the results and Figure 7.2.4 shows the distributions of answers.

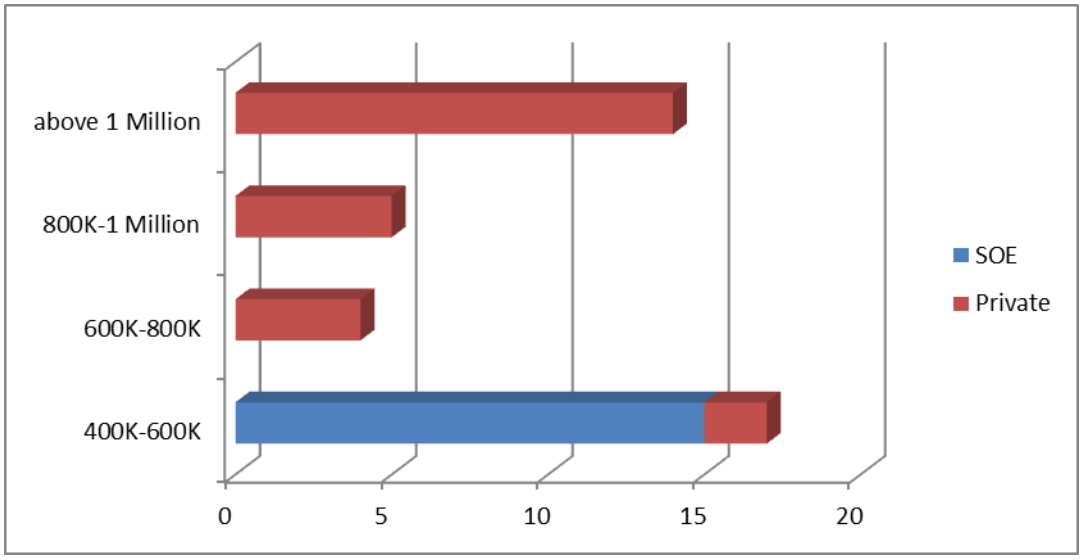
Table 7.2.4: Monetary payments and welfare

| **Survey** | **Option** | **Findings** | **Ownership** | **Distribution of Enterprises with Different Ownership** |
|---|---|---|---|---|
| Owner of the enterprise? | All owned | 2 | SOE | 0 |
| | | | Private | 2 |
| | Partially owned | 20 | SOE | 0 |
| | | | Private | 20 |
| | Not owned | 18 | SOE | 15 |
| | | | Private | 3 |
| Annual monetary income | 400K-600K | 17 | SOE | 15 |
| | | | Private | 2 |
| | 600K-800K | 4 | SOE | 0 |
| | | | Private | 4 |
| | 800K-1 million | 5 | SOE | 0 |
| | | | Private | 5 |
| | above 1 million | 14 | SOE | 0 |
| | | | Private | 14 |
| Annual perquisite consumption | 100K-200K | 20 | SOE | 10 |
| | | | Private | 10 |
| | 200K-400K | 2 | SOE | 1 |
| | | | Private | 1 |
| | 400K-600K | 2 | SOE | 1 |
| | | | Private | 1 |
| | 600K-800K | 1 | SOE | 1 |
| | | | Private | 0 |
| | 800K-1 million | 5 | SOE | 2 |
| | | | Private | 3 |
| | above 1 million | 10 | SOE | 0 |

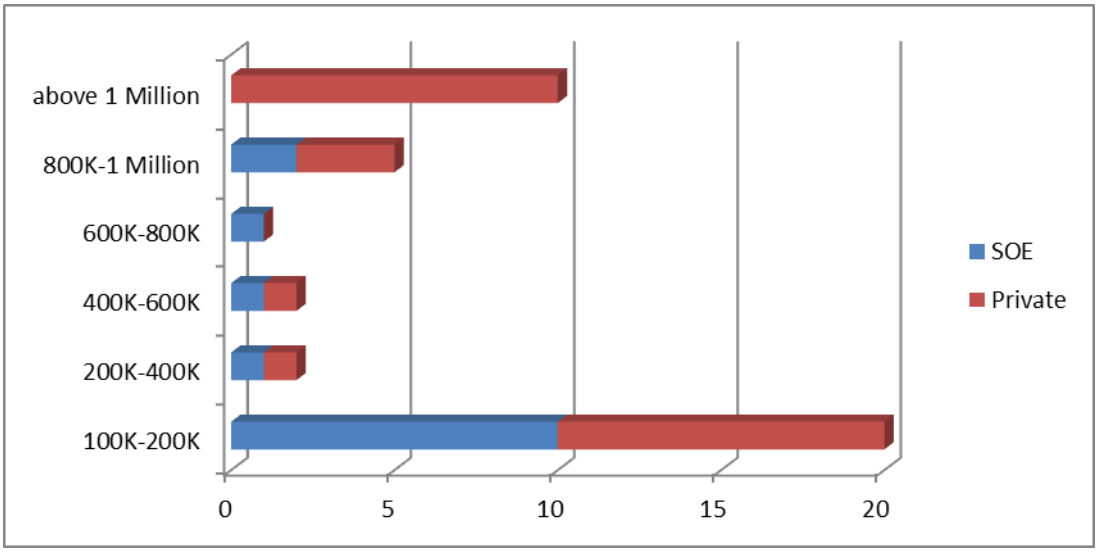
| | | | | |
|---|---|---|---|---|
| | | | Private | 10 |
| Annual basic welfare | 100K-200K | 18 | SOE | 15 |
| | | | Private | 3 |
| | 200K-400K | 4 | SOE | 0 |
| | | | Private | 4 |
| | 400K-600K | 5 | SOE | 0 |
| | | | Private | 5 |
| | 600K-800K | 1 | SOE | 0 |
| | | | Private | 1 |
| | 800K-1 million | 12 | SOE | 0 |
| | | | Private | 12 |
| Other welfare annually | 100K-200K | 22 | SOE | 15 |
| | | | Private | 7 |
| | 200K-400K | 18 | SOE | 0 |
| | | | Private | 18 |
| Medical insurance | Social health insurance & Partly commercial medical insurance | 27 | SOE | 15 |
| | | | Private | 12 |
| | Social health insurance & full commercial medical insurance | 8 | SOE | 0 |
| | | | Private | 8 |
| | Social health insurance & Family full commercial medical insurance | 5 | SOE | 0 |
| | | | Private | 5 |



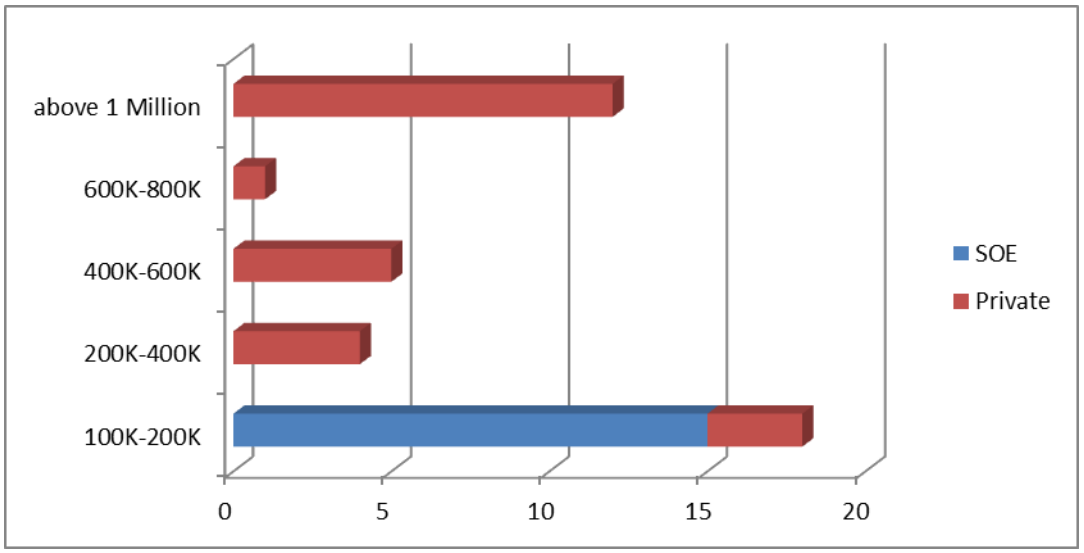

Ownership of the enterprise



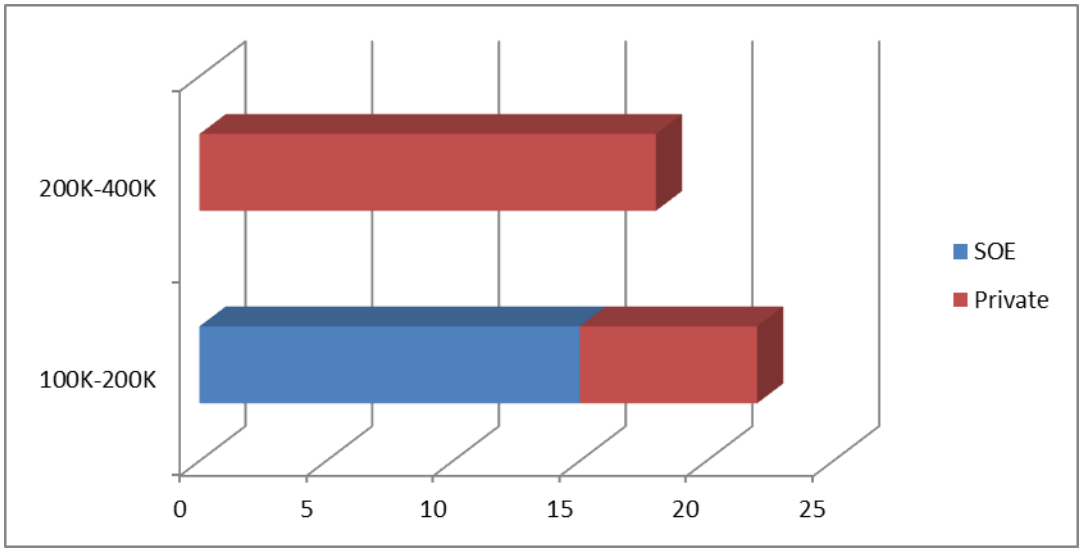

Annual monetary income




Annual perquisite consumption




Annual basic welfare




Annual other welfare

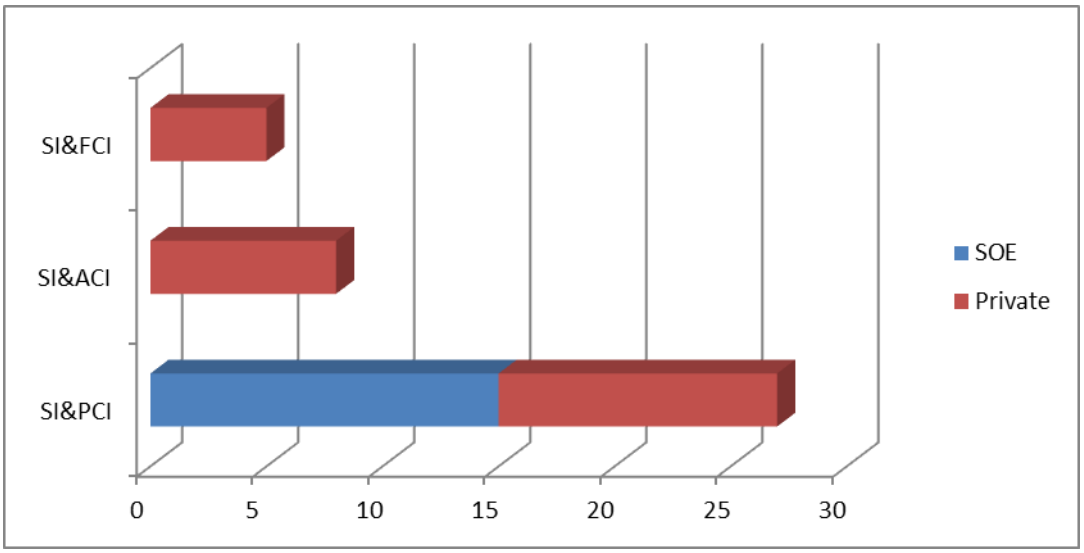



Figure 7.2.4: Distribution of results in monetary payments

Finally, we summarize the results in the last part of our questionnaire. This part asks questions regarding family members, their working status, schooling experience, and time spent with families. For the 40 samples, 32 of them are married. In particular, 13 married CEOs come from SOEs and 19 come from private enterprises. For the rest 8 CEOs who are still single, 2 of them come from SOEs and 6 of them come from private enterprises.

Next, we ask the working status of CEOs' spouses. We find that 2 spouses of CEOs from SOEs are working in the C-SOEs, and five spouses of CEOs from SOEs are working in the L-SOEs. Note that because CEOs from SOEs are relatively aged, some of their spouses already retired. In our survey, there are five such cases. Put these results together, for all the spouses of 13 CEOs from SOEs, most of them are also working in SOEs, unless they are retired. Only 1 of these spouses works in the private sector. This gives us the impression that the whole families of CEOs from SOEs are heavily bonded and connected with political relationships. Of course, there are also 7 spouses of CEOs from private enterprises who also work in L-SOEs. But most of the spouses of CEOs from private enterprises (12 of them) are unemployed, or put differently, they are full-time housewives. This sharp difference also reflects the fact that CEOs in private enterprises earn much higher monetary income so that they can support full time housewife. It also shows that getting involved with political relationships is not only a matter wanted by CEOs from SOEs but also their families.

In addition, one CEO has no children, and he comes from SOE. For the rest 14 CEOs from SOEs, they have one child, which is in line with China's one-child policy that was only abandoned recently. For CEOs from private enterprises, 18 of them have one child while 7 have two children. Because of the age differences, some of these children are still doing university studies while some of them already entered the job market. We record the educations; background of these children and see whether there is any difference between SOEs and private enterprises. The results show no significant difference. Most of CEOs from

either SOEs or private enterprises sent their kids to key primary schools. At the university level, most of children from SOEs family (12 of them) attended key universities (211 universities). As for CEOs from private enterprise, because some of their children are still young, there are only 13 children that have education at university level. For these children, only 6 of them are in the key universities while the rest 7 are in common universities. This result might show the different demand for education at university level of CEOs working in the private sector. In any case, going to the key universities might not be highly demanded by these CEOs. Because most of these CEOs sent their kids to key primary school, similar to CEOs from SOEs, it is reasonable to assume that there is no significant difference of the education level before university between kids from SOEs family and those from private enterprises family. Moreover, it is well known in China that there are back doors for kids to enter the 211 universities. The door opens particularly for kids whose parents have connections with the government or politicians. We believe, therefore, that kids from SOEs family going to the 211 universities is not a result of better education background but a potential welfare of working in SOEs because they have political connections.

For the employment status, not too many children are at this age. For the 13 working children from SOE family, 6 of them are working in SOEs and 7 choose to work in private enterprises. We believe that working decision of children is less affected by parents, thus choosing which type of enterprises to work for is more a decision of children themselves.

The distribution of household income is similar to that of CEOs' income. Note that several CEOs from private enterprises are still not married. Anyway, household income of SOE family is significantly lower than that of private enterprise family.

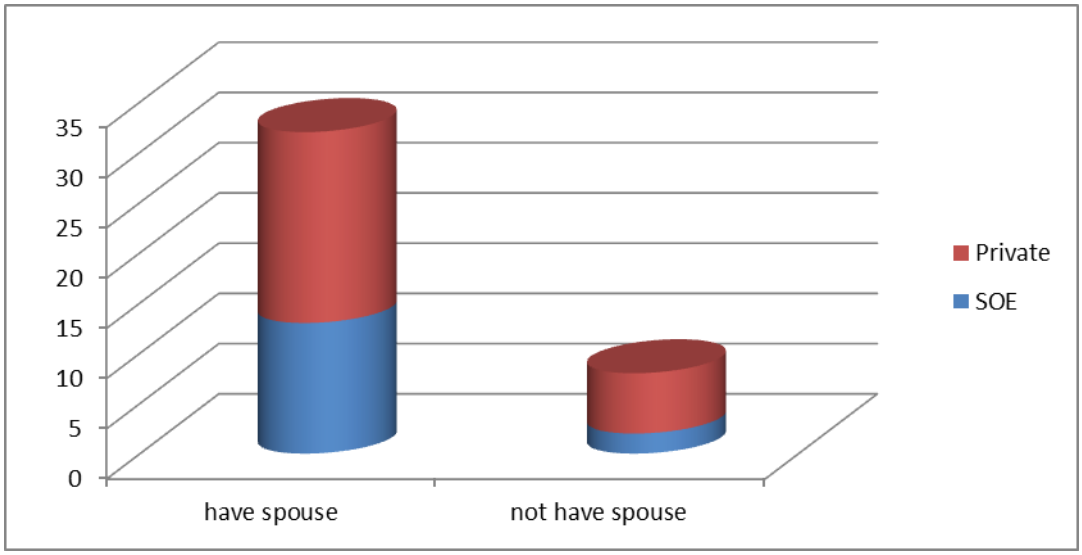
Our last question asks the time CEOs spend with their family. It seems that most of CEOs in our sample are quite busy so that they spend less than 5 hours with their family every week. However, there is also weak evidence that CEOs from SOEs are relatively less busy than those from private enterprises.

Table 7.2.5 shows the results and figure 7.2.5 shows the distribution.

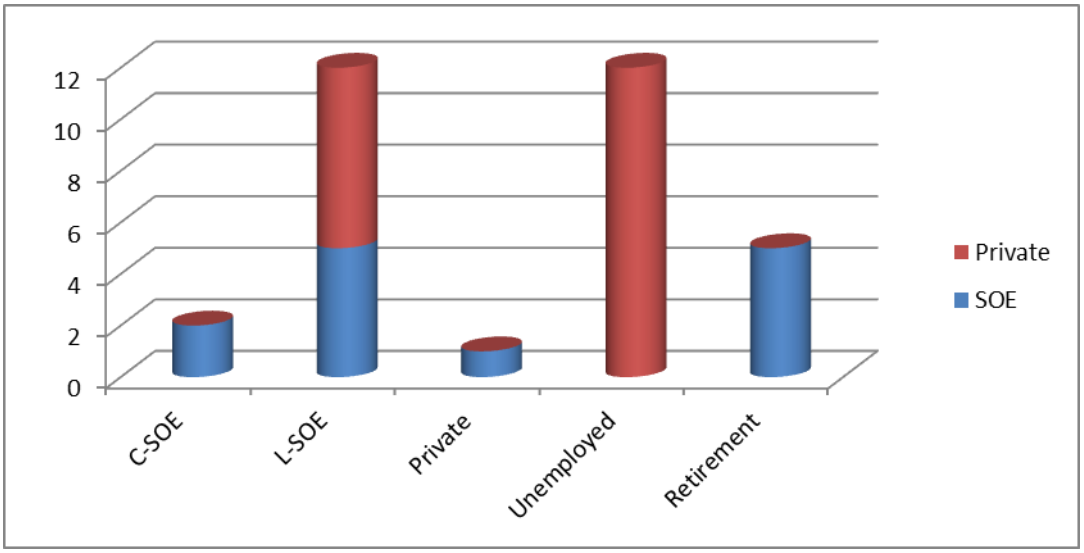
Table 7.2.5: Family status

| **Survey** | **Option** | **Findings** | **Ownership** | **Distribution of Enterprises with Different Ownership** |
|---|---|---|---|---|
| Do you have a spouse? | Yes | 32 | SOE | 13 |
| | | | Private | 19 |
| | No | 8 | SOE | 2 |
| | | | Private | 6 |
| Employment status of your spouse | C-SOE | 2 | SOE | 2 |
| | | | Private | 0 |
| | L-SOE | 12 | SOE | 5 |

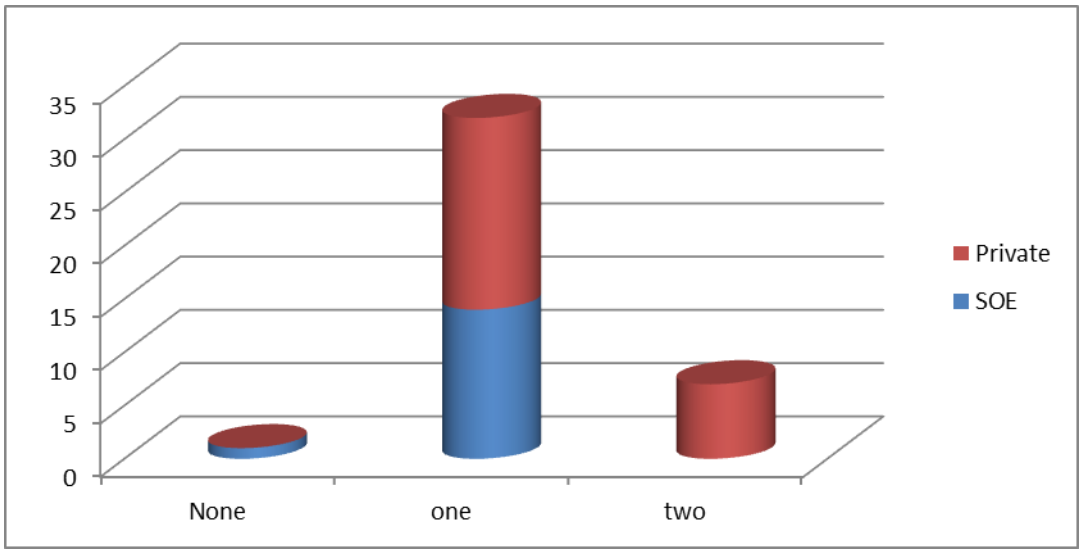
| | | | | |
|---|---|---|---|---|
| | | | Private | 7 |
| | Private Enterprise | 1 | SOE | 1 |
| | | | Private | 0 |
| | Unemployed | 12 | SOE | 0 |
| | | | Private | 12 |
| | retirement | 5 | SOE | 5 |
| | | | Private | 0 |
| How many children do you have | None | 1 | SOE | 1 |
| | | | Private | 0 |
| | one | 32 | SOE | 14 |
| | | | Private | 18 |
| | two | 7 | SOE | 0 |
| | | | Private | 7 |
| Your child's education | key primary and secondary schools | 44 | SOE | 14 |
| | | | Private | 30 |
| | General primary school | 2 | SOE | 0 |
| | | | Private | 2 |
| | key university | 18 | SOE | 12 |
| | | | Private | 6 |
| | General university | 9 | SOE | 2 |
| | | | Private | 7 |
| Employment status of your children | C-SOE | 2 | SOE | 1 |
| | | | Private | 1 |
| | L-SOE | 5 | SOE | 5 |
| | | | Private | 0 |
| | Private Enterprise | 10 | SOE | 7 |
| | | | Private | 3 |
| Household income | 400K-600K | 2 | SOE | 2 |
| | | | Private | 0 |
| | 600K-800K | 19 | SOE | 13 |
| | | | Private | 6 |
| | 800K-1 million | 1 | SOE | 0 |
| | | | Private | 1 |
| | above 1 million | 18 | SOE | 0 |
| | | | Private | 7 |
| How many hours do you spend with your family every week? | Below 5 | 30 | SOE | 8 |
| | | | Private | 22 |
| | 5-10 | 9 | SOE | 6 |
| | | | Private | 3 |
| | 10-20 | 1 | SOE | 1 |
| | | | Private | 0 |



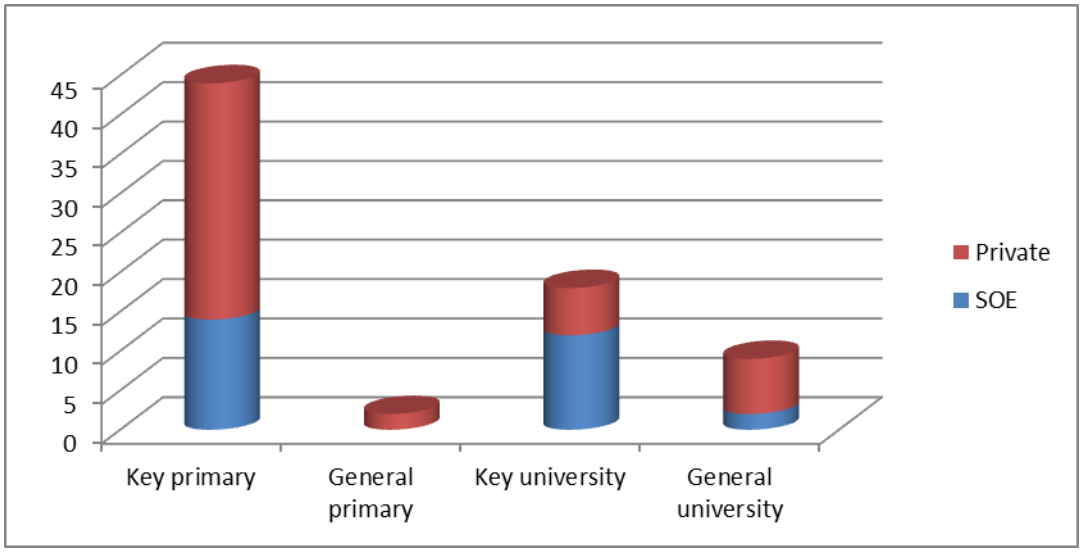

Marriage status



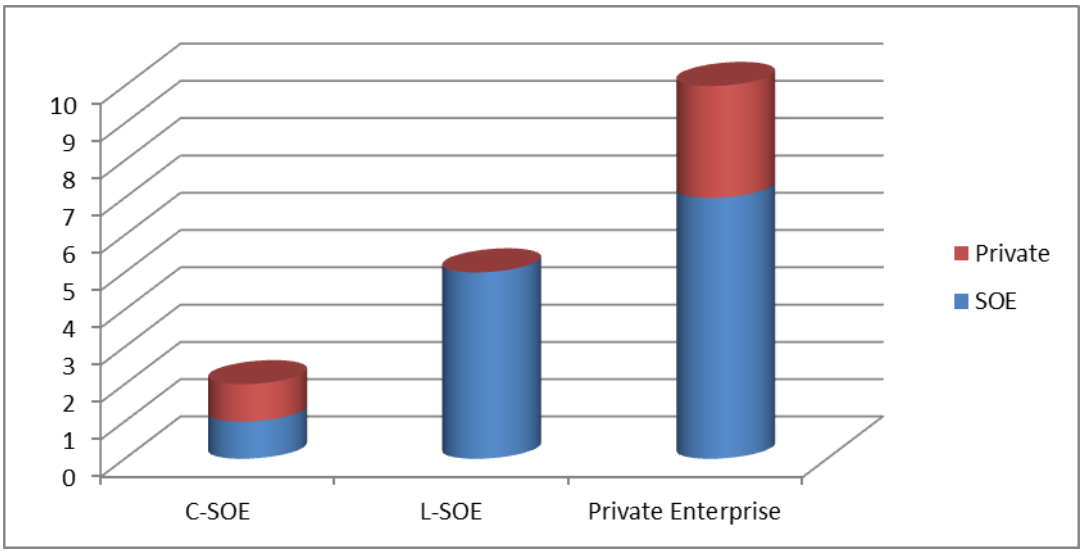

Working status of spouse



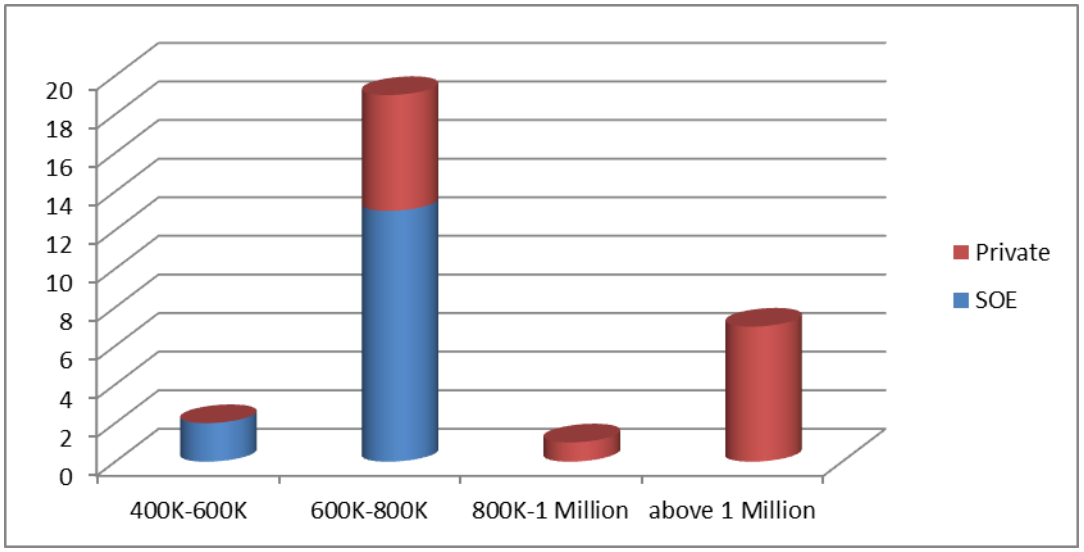

Number of children



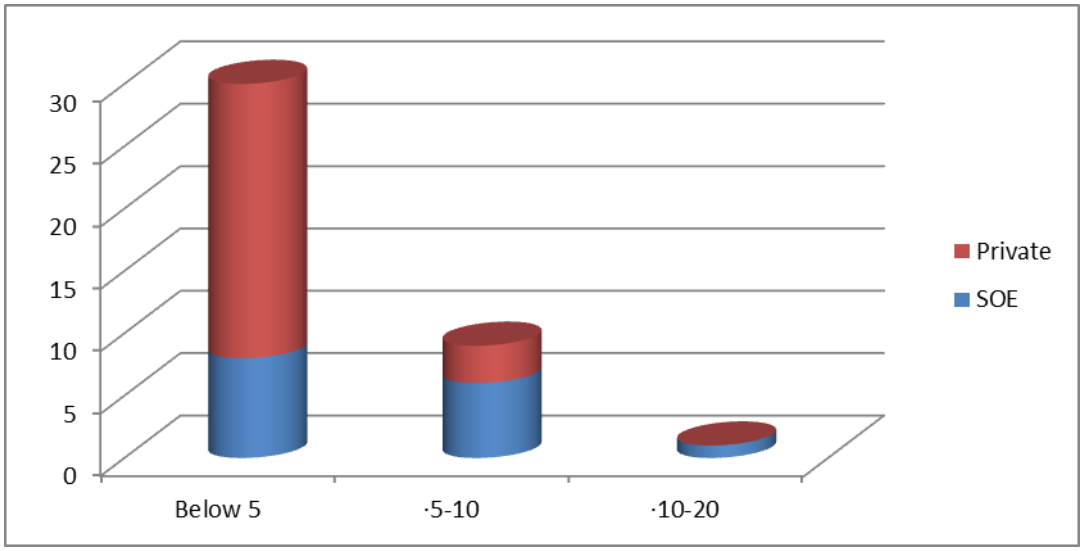

Educational background of children




Children's working status: they are working in C-SOE, L-SOE, or Private enterprises




Household income




Hours spent with family

Figure 7.2.5 distribution of results in family part of the survey

### 7.3. More sample analysis

The summarized statistics above already show some patterns that CEOs from SOEs are paid much less in monetary salary than those from private enterprises. And there are clear evidences that CEOs from SOEs are more motivated by political promotion rather than monetary payments. Political promotion and connections give these CEOs potential welfare such as sending their kids to key schools and having other discretionary power. This welfare cannot be measured in monetary terms. Another evidence is that most CEOs from SOEs have expectations of working in the government again after they leave the business. This shows that working in SOEs is mainly viewed as a springboard for political promotion and potential benefit from getting higher political titles.

Our comparison of SOEs and private enterprises is done at a comparable level in a sense that the two types of firms belong to the same industry and the asset sizes of private enterprises are as large as possible to approximate SOEs. In this subsection, we show more industry-level and firm-level evidences.

Evidence 1: there is a clear pattern in SOEs that the lower the CEO's monetary payments, the stronger the expectation of the CEO to work in the government after they leave the SOE.

This evidence shows that CEOs of SOEs concern more about political career and less about monetary payments. Nominal monetary payments has limited impact on these CEOs' incentives to act and behave. Instead, political concern is both substantial in the short run and persistent in the long run.

Evidence 2: controlling for firm performance, compared with private enterprises, the lower the CEOs' monetary income and their family income, the more likely their kids are in key primary school and key universities (top 211 universities in China).

As going to key primary school and key universities are viewed as a benefit from political connections, evidence 2 shows that political promotion may serve as complimentary compensation to monetary payments. For private enterprises, their CEOs enjoy decent monetary payments, and therefore they are more likely to send their kids to private schools or abroad. It is worth to mention here that good private schools are generally much more expensive than public schools that have equivalent education quality. Here education quality of a key primary school is measured by the probability of its students entering key universities, and education quality of a university is measured by the ranking of universities a-la international standard, e.g., a standard reported by Peking University. Therefore, as CEOs from SOEs earn much less than those from private enterprises, both at individual level and household level, they are less likely to be able to send their kids to outstanding private schools. Instead, they send their kids to public schools that have no worse education quality, a choice that is only applicable to those who have political connections. This shows that there are benefits from political promotion that are complimentary to monetary payments.

Evidence 3: the larger the SOE's asset size, the stronger the expectation of the CEO to work in the government after they leave the SOE. The return on assets, nevertheless, has no such effect.

For a long period of time, as introduced in section 5, the top goal for SOEs is asset expanding rather than profit making. Evidence 3 shows that working for SOEs with a larger asset size is more likely to be political promoted, hence CEOs in large SOEs have stronger incentives to work in the government in the future. The profitability, measured by return on assets or return on equity, has no such effect because these two measures of firm performance are less connected with probability of CEOs being promoted. This result shows clearly that the top concern of CEOs of SOEs is political promotion, and their behaviors are guided by this concern. Their investment strategies and operation standard all serve for this target.

Evidence 4: compared with local SOEs, CEOs in central SOEs have stronger expectation of working in the government.

This evidence is straightforward to understand. Central SOEs are more close to the political center and have better opportunities to contact with officials in the higher level governments and agencies, particularly the State Council. In this way, CEOs working in central SOEs have advantages of getting promotion opportunities, and they are more likely to be affected by the ground environment of having a political career. In fact, central SOEs normally have higher political orders than local SOEs. Political promotion for their CEOs has certain patterns. Although these patterns might be related to the findings in this study, we do not discuss them in details here.

Evidence 5: CEOs working in SOEs that belong to industries of finance and manufacturing have stronger expectations of working in the government than those working in SOEs that belong to industries of mining and real estate.

Due to the limitation of our survey data, the comparison in evidence 5 is done with the four industries of finance, manufacturing, mining, and real estate. However, the general pattern already exists here. Political promotions for CEOs of SOEs are most commonly observed for industries such as finance and manufacturing. Therefore, in line with this fact, that CEOs of SOEs in these two industries have better prospects of getting politically promoted is easy to understand. This result also confirms that CEOs of SOE really concern with political promotion, and if they have such concern, they act to fight for it.

The conclusions based on our survey results are clear. The CEOs working in SOE are largely motivated by the political promotion. They have limited concern about the monetary payment in their career. Instead, the political concern is substantial in both the short run and long run. Political promotion is so important to these CEOs, not just because these CEOs simply like politics, but also because political promotion can serve as a substitutable and complimentary compensation to monetary payment to these CEOs, and in most case, political promotion can give them more benefits than monetary payment. Kids studying in key primary schools or key universities are one of such examples showing that money is not enough. Higher political rank enables these CEOs to send their kids to these key schools more easily, and such benefit cannot be obtained by just monetary payment. Therefore, we not only show that political promotion is important, but we also show why it is important.

The survey also shows that CEOs working in central SOE have stronger concern about the political promotion that those working in local SOE, and those working in financial and manufacturing industries have stronger concern than those working in other industries. The first result is in line with our expectation, as central SOE are surrounded by the heavier political atmosphere, and political environment does affect one's objectives. The second result is also consistent with our expectation, where political promotion happens most frequently in SOEs that belong to financial and manufacturing industries.

# Chapter 8. Summary and Conclusions

## 8.1 Summary of the thesis

This thesis studies the role of political promotion in CEO remuneration design in China's SOEs. The design of CEO remunerations is commonly believed to be crucial to providing incentives for the executives to perform in the way that is desired by shareholders. According to existing researches, a good design of remuneration can provide efficient incentives for CEOs so that they maximize the shareholders' wealth and the firms' values, thus alleviating the moral hazard problem.

The incentive pay theory, pioneered by Jensen and Murphy (1990), extends this argument further. They show that if CEO remuneration is correlated to firm performance, such as stocks and options, the value of which is tied with firm value, then CEO will exert high effort to improve firm performance in order to increase their remuneration. By contrast, if there is no

such incentive pay in CEO remuneration plan, CEO will have no incentives to improve firm performance. The theory is straightforward, and can be successfully applied to empirical tests in the US and other countries.

However, when Jensen and Murphy (1990)' theory is applied to China's SOEs, the findings in this thesis do not support the theory's predictions. Because SOEs rarely pay their CEOs with stocks, and even if they do, these stocks are not allowed to be sold in the second market, the performance of these SOEs should be poor according to theory's prediction. The baseline model regression shows that when the return of the firm increases 1000 yuan, the salary of CEOs of SOEs only increases by 0.963 yuan, which is far lower than that in the US where SOEs pays less to CEOs than non SOEs. However, as the regression in section 4 shows, the coefficient $\beta_1$ is significant in the following equation:

$$compensation_{i.t} = \alpha + \beta_1 performance_{i.t} + \beta_2 controls$$

where performance is measured by return on assets. For SOEs, $\beta_1$ = 0.963 while for non-SOE, $\beta_1$ = 0.692. This result shows that CEO remunerations in SOEs is more sensitive to firm performance than that in non-SOE. This result is surprising, because it is widely acknowledged that there is not too much remuneration to CEOs of SOEs that are incentive pay in forms of stocks or options. This raises the question why $\beta_1$ is significant? In addition, the results in Table 4.1.2 contrast the statistics in Table 3.3.3. In Table 4.1.2, the coefficient before ROA for SOEs is larger than that for non-SOEs, while in Table 3.3.3, SOEs pays less to CEOs than non SOEs. One potential explanation is that assets in SOEs are state owned, and asset expansion or maintaining asset value is the prior target for them. For non-SOEs, maximizing shareholders' wealth is the prior target. Therefore, increasing ROA has political motivation in SOEs.

To verify the above argument, we use ROE as the alternative measure of firm performance. The result in Table 4.1.3 shows that CEO remuneration is not sensitive to ROE in SOEs but sensitive in non-SOE. The above two results show that the CEO pays in SOEs is not sensitive to firm performance in terms of ROE, or the sensitiveness is too small to provide adequate incentives in terms of ROA, confirming that monetary payments cannot be the most important incentive to these CEOs.

Traditionally it is believed that non-SOEs care more about profit and have better incentive compatible compensation packages for their CEOs. Thus, corporate governance theory would predict that CEO compensations in SOEs are less sensitive to the firm performance than that in non-SOEs. The findings in this thesis show otherwise. In fact, we notice that classic CEO remuneration theory assumes that CEOs pursue monetary payments. If this assumption holds good, together with our regression results, we should be able to observe two facts. First, CEOs of SOEs get higher monetary payments than those in non-SOEs as the sensitivity of remuneration to firm performance is larger in the former; Second, if the CEOs of SOEs cannot get enough monetary payments that is equivalent to firm performance, these CEOs would quit the job. However, neither of the above two phenomenon can be observed. The average monetary payment to CEOs of SOEs is only 76% of that in non-SOEs, and we

seldom see CEOs voluntarily quit the job. The second fact is more evident particularly when we consider the two "salary limit" act respectively in 2009 and 2014 where no CEOs left the office after the salary limit. Instead, we do observe that these CEOs work even harder. This fact tells us that, CEOs of SOEs must care something else.

It is based on our regression results and our causal observations that we conjecture that political promotion might play an important role here. Particularly, the nature of SOEs in China is quite specific that they are more like profit making supervisors rather than enterprises in the traditional sense. Most CEOs in China's SOEs have political titles and ranks— in other words, they are managers of the SOEs as well as public servants in the government. More importantly, most of their salary is determined according to their political ranks. The higher the rank, the larger the monetary salary. In addition, the SOEs are also ranked, which affects the rank of their CEOs. The rank of SOEs is determined by many variables, such as industry, location and importance in the industry. The most important determinant is, however, the size of the firm. Generally, the larger is the firm size, the higher rank is the firm, and hence the higher political rank of its CEO. This potential link explains the question raised before: why $\beta_1$ is significant? The significant relationship between ROA and monetary payments in SOEs cannot be explained by traditional corporate governance theory but by the unique exogenous payment structure of SOEs in China. All in all, political rank and political promotion are the key variables here.

Therefore, this thesis provides an alternative explanation of the above regression results. The high sensitivity of remunerations to firm performance in China's SOEs is not driven by a more efficient incentive pay design, but by the fact that the firm size affects both political promotion (hence payment) and firm performance. We first use case studies to strengthen our causal observations. Based on the two case studies, we formally propose the hypothesis that political promotion is the key motivation for CEOs of SOEs to improve firm performance.

The case studies clearly show that even if the monetary payments to the CEO was fixed for a long time, the asset and the profit of the SOE rose steadily, both of the ROA and ROE rose steadily, and there is a stable and improving firm performance. The monetary remuneration does not provide sufficient incentives (if any) to CEOs to exert such effort. The improvement of firm performance was more evident when the CEOs are about to be politically promoted.

The two case studies focus on the role of political promotion in motivating CEOs of SOEs. The stories behind the two cases are in line with the overall background of SOE. Note that the quantitative analysis in section 4 shows that CEO in China's SOEs are not motivated by monetary payments. However, since there is evidence that they have incentives to improve firm performance, this incentive must come from somewhere else. The case studies focus on the event that happened near the time when the CEO got promoted. Such qualitative analysis serves as the reason for the hypothesis of the importance of political promotion.

To further test this hypothesis, this thesis uses survey analysis. We carefully design a survey questionnaire and distribute it to 100 CEOs working in SOEs or private enterprises. We

received 54 responses, in which only 40 are complete and consistent. We used these 40 survey results to illustrate and test our hypothesis. In the design of the survey, the target is clear: we set up questions in an implicit way to investigate CEOs' potential interest in political promotion. That is, we do not directly ask CEOs their interest in political promotion, as this is a very sensitive question. Instead, we ask their interest in the benefit that can solely come from political promotion, and we compare the answers between CEOs from SOEs and non-SOEs. This part helps to identify the effect of political promotion in affecting CEOs' behavior. In the second part, we ask CEOs' monetary payments and their firms' performance. This part serves as the robustness check for our regression results in section 4. In the third part, knowing that certain behaviors can be observed if the CEO is interested in political promotion, we investigate whether CEOs of SOEs have such behaviors. All the above three parts consist the survey and help to test our hypothesis that political promotion is the key motivation for CEOs of SOEs to improve firm performance.

The survey finds out that (i) there is a clear pattern in SOEs that the lower the CEO's monetary payments, the stronger the expectation of the CEOs to work in the government after they leave the SOEs; (ii) controlling for firm performance, compared with private enterprises, the lower the CEO monetary income and their family income, the more likely their kids are in key primary school and key universities (top universities in China); (iii) the larger the SOE's asset size, the stronger the expectation of the CEO to work in the government after they leave the SOE. The Return on assets, nevertheless, has no such effect; (iv) compared with local SOEs, CEOs in central SOEs have stronger expectation of working in the government; and (v) CEOs working in SOEs that belong to industries of finance and manufacturing have stronger expectations of working in the government than those working in SOEs that belong to industries of mining and real estate.

Evidence (i) shows that CEOs of SOEs concern more about political career and less about monetary payments. Nominal monetary payment has limited impact on these CEOs' behavior. Instead, political concern is both substantial in the short run and persistent in the long run. In the evidence (ii), we use the opportunities and abilities to send kids in the key primary school or key universities as the proxy for the benefits of political promotion. Evidence (ii) shows that political promotion serves as a complimentary compensation to monetary payment. Evidence (iii) shows that CEOs working for SOEs with larger asset sizes is more likely to be political promoted, hence CEO in large SOE have stronger incentives to work in the government in the future. Evidence (iv) shows another factor that affects CEOs' interest in political promotion, that is, the distance to the political center. Finally, evidence (v) investigates whether our results are robust across industries. All the above findings support our hypothesis that political promotion is the key and usually the only concern of CEOs working in SOEs.

Therefore, as the completion of the research design shows at the beginning, this thesis consists of three parts. It first tests the Jensen and Murphy (1990)'s theory with China's SOEs data and finds that the theory is not valid. It then uses two case studies to propose the hypothetical explanation that CEOs in China's SOEs care more about political promotion

rather than monetary payments. Finally, it uses survey studies to formally test the hypothesis and finds out that political promotion is in fact the strongest and nearly the only concern of these CEOs.

### 8.2 Contribution to the literature and practice

The contribution of this thesis to both the literature and the practice are important. As for the literature, most of related previous studies rush into the test of whether incentive pay can promote higher efforts of CEO and therefore improve the firm performances, without questioning what incentives these CEOs have. Monetary payment is presumed to be the only thing that CEOs care about, and therefore most of these studies are using different samples but asking the same question: is monetary payment to CEOs related with firm performances, and does such incentive pay provide enough motivation for CEOs to exert effort and improve the firm performances. Seldom do we find studies that test whether CEOs do care about monetary payment in the first place. The pursuing of a "quite life" is one example given by Mullainathan and Bertrand (2003). In fact, both theoretical and empirical researchers have identified other incentives that motivate CEO's effort, either in a desired manner or undesired manner. Empire building (Baumol, 1959; Willianson 1964), and on-the-job consumption (Meckling 1979) are some of the typical examples. For CEOs working in China's SOE, this thesis shows that the pursuing for political promotion is another, and in fact the most important incentive. This result is mainly due to the particular institutional design of China's SOEs where their CEOs have political titles and ranks.

Therefore, we add to the literature by particularly considering the unique institutional structure of China's SOE and investigating the role of political promotion that it plays to motivate CEO behavior. The study also shed light on the understanding of the political culture in China's SOE. For a long time, political control of China's SOEs has been prized even at the expense of efficiency. It is well acknowledged that, working as a CEO in China's SOEs is not to earn decent money, but to wait for the opportunities to be promoted in the political hierarchy. For instance, when central government owned enterprises were established, their chief directors or CEOs were assigned with political title of "Fu Bu", and other levels of political titles were extended down. This setting is in fact a clear career path for people who work in SOE. Realizing this, our findings can change the empirical studies of optimal incentive pay in corporate governance significantly.

For the practice, this study also makes significant contribution. For the case of China, the finding that there is no evidence of incentive pay in China's SOE is not surprising. But most of these studies conclude that to improve the performance of China's SOE, the reform should consider changing the fixed monetary payment to their CEOs to performance related monetary payment. Nevertheless, this thesis' findings show that, even if SOE use monetary payment as the instrument for incentive pay, it is not going to work. This is because these CEOs care political promotion far more than monetary payment.

We are not making the argument that political promotion is a wrong incentive for CEO. Instead,

we are trying to remind the government, given that they are aware of the emergence of revitalization of SOE, the first thing they should consider is to reward CEOs using the things they really care about. For the reform of corporate governance in SOE to improve firm performance, the way that makes at least some sense to be effective should be connecting the political promotion with firm performance. Such incentive pay uses political promotion rather than monetary payment as the instrument, and we do observe many cases where political promotion as the incentive pay does work. This is not to say that we recommend that all SOE should use political promotion to motivate their CEOs in a more obvious way. What we are arguing here is that, given the institutional design of SOE in China, political promotion is far more effective than monetary payment in providing incentives. If the reform of China's SOE has the goal of using monetary payment as the incentive mechanism, then the CEOs in these enterprises should not have political rank, and their recruitment should be market-based. Otherwise, government appointed CEOs care about political promotion rather than monetary payment.

### 8.3 Conclusions

China's SOEs have historically been a vital instrument for provision of social services and an instrument of state policy. Chinese workers' lives and interactions with the government were generally mediated by SOEs for which they worked. Indeed, one's work affiliation (*danwei*) was more than a job; it was an integral part of one's identity. Aside from the material aspects of one's life, political "participation" was also structured through the *danwei*. More importantly, working in SOEs is a sort of "permanent" job, and the welfare for workers in SOEs has been viewed as much better than that in THE private sector. From the very beginning, SOEs in China is tied closely with politics. Working in SOEs is a career of political promotion. This is true not only for CEOs but also for regular employees. They earn titles, get promoted with higher political ranks, and enjoy the corresponding benefits. In this aspect, SOEs in China are not profit-orientated. They should not be viewed as firms in the economic sense.

Ambivalence about control is new to the Chinese political culture. For a long time, political control of China's SOEs has been prized even at the expense of efficiency. SOEs are in the midst of transition from centralized state management to firms and companies that are in line with traditional firm theories. In order for SOEs to function as effective enterprises, as the Chinese government has been continuously arguing and trying to do, no political control is demanded, and if there is any, the government should only control the asset but not people that are running SOEs. However, it is questionable whether or not policymakers are truly willing to surrender SOEs as state instruments.

With this understanding, we already know that traditional firm theories regarding corporate governance or CEO remunerations are not applicable to China's SOEs. This research tests Jensen and Murphy (1990)'s theory using updated data for all the Chinese firms listed in China's A-share market and confirms the above argument. We find that monetary payments to these CEOs is significantly lower than those CEOs from private enterprises. No options and incentive pay can be found for SOEs, and no significant difference of monetary welfare such

as perquisite consumption, medical care, and other forms of welfare can be identified between SOEs and private enterprises. This raises the question naturally that why CEOs work in SOEs and what are their incentives to exert effort?

We review the literature and find no satisfactory answers to this question. The literatures provide various evidences on the determinants of CEO pay and their effects on CEO incentive mechanism. Nevertheless, these studies treat CEO pay as one variable and neglected the fact that CEO pay is composed by various parts. Even though some research examined the different effects of cash and salary payments and long-term incentives of stocks and options, they fail to consider the interactions between the two parts. More importantly, besides various forms of monetary payments, political promotion is the additional part in the remuneration package to CEOs of SOEs, which is not addressed carefully in previous literature. Instead, political promotions are neglected. This thesis formally addresses the role of political promotion, and it conjectures that SOEs are politically connected. We notice that CEOs of SOEs are normally appointed by the government rather than hired in the open labor market. Moreover, these CEOs normally have political titles. Therefore, political promotion could play an important role of motivating CEOs.

Due to lack of data, we first use two case studies to formally propose this hypothesis that political promotion is the much more important concern for CEOs in China's SOEs. The two case studies, through analyzing firm performance around the time when their CEOs get promoted, shows that these CEOs indeed are motivated by political promotion. To test this hypothesis, we further use survey. The survey compares SOEs and private enterprises in terms of monetary payments and political concern. The survey results find that (i) there is a clear pattern in SOEs that the lower the CEO's monetary payments, the stronger the expectation of the CEOs to work in the government after they leave the SOEs; (ii) controlling for firm performance, compared with private enterprises, the lower the CEO monetary income and their family income, the more likely their kids are in key primary school and key universities (top 211 universities in China); (iii) the larger the SOE's asset size, the stronger the expectation of the CEO to work in the government after they leave the SOEs. The return on assets, nevertheless, has no such effect; (iv) compared with local SOEs, CEOs in central SOEs have stronger expectations of working in the government; and (v) CEOs working in SOEs that belong to industries of finance and manufacturing have stronger expectations of working in the government than those working in SOEs that belong to industries of mining and real estate. All the above findings support the hypothesis that political promotion is the key and usually the only concern of CEOs working in SOEs.

The conclusion is straightforward. Incentive pay in monetary terms is not the best and the most efficient way for CEOs in China's SOEs to improve firm performance. These CEOs either do not care that much about monetary payments, or want something else. In this study, we hypothesis that political pay is the dominating motivation for CEOs of SOEs, and we use case studies and surveys to test this hypothesis. To improve firm performance, political incentives are more important to consider in the design CEO remuneration.

There is room for future work. The first direction is to investigate the efficiency of political promotion in motivating CEOs. This is related to welfare analysis. It is well known that SOEs are under reform currently in China, and one aspect of such reform is about de-politics (get unrelated to politics) of SOEs. China is pushing SOEs to market-based competition. Reform on incentive pay proposes that shares held by CEOs should play the role of providing incentives for them to improve firm performance. Since our study shows that these CEOs do not care about monetary payments but what they actually pursue is politics, more studies are needed in the future to quantify the comparative efficiency of the reform. These strands of studies need to answer the question: should we motivate CEOs by means of political promotion as before, or by means of new incentive pays in monetary terms?

The second direction is to investigate whether political promotion is also the dominating concern of CEOs from SOE in other countries. Noticeably, many developing and developed countries also have state owned enterprises. Some of these SOEs have political background; some have strong influence on politicians' decision making; while some are purely state-held but marketized enterprises. It is worthwhile to investigate whether hypothesis proposed in our current paper is applicable to other countries, and if it is or is not, what determines it. These findings help us to understand the nature of SOEs.

In addition, it needs more work to justify the situations in which one CEO is politically promoted. Our current definition and measurement of political promotion is that a CEO is promoted, either to operate another SOE with higher political ranks (or larger asset sizes), or to work directly in the government as a governor that has equal or higher political ranks. As the SOE reform in China proceeds, political promotion might have different forms. It is important to accurately measure political promotion when one wants to apply the findings in this paper to more complicated models and empirical estimations.

To sum up, political promotion is important for CEOs in China's SOEs. These CEOs behave in ways to get the best opportunities to be politically promoted. This, to a large extend, explains why SOE are pursuing asset size expansion, and why their performance improves suddenly when their CEOs are about to be promoted. In the design of remunerations for these CEOs, political promotion should be the top concern.

**Appendix: Survey Questionnaire**

# CEO Survey

**Background of the enterprise**

| | |
|---|---|
| Ownership（single）： | SOE（ ）/Private（ ） |
| SOE type（single）： | Central government SOE（ ）/Local government SOE（ ） |
| Industry（multiple）： | Manufacture（ ）/Service（ ）/Finance（ ）/Real Estate（ ） |
| Second-tier Industry（multiple）： | Energy（ ）/Mining（ ）/Equipment（ ）/other manufacturing（ ）/Financial Services（ ）/IT（ ） |
| Region（multiple）： | North China（ ）/Middle China（ ）/East China（ ）/South China（ ）/Southwest（ ）/Northwest（ ）/Northeast（ ） |

**Accounting**

| | | |
|---|---|---|
| Accounting | Asset size： | Billion Yuan |
| | ROA： | % |
| | ROE： | % |
| | Net profit： | Billion Yuan |
| | Tax paid annually： | Million Yuan |
| | Number of employees： | |
| | Average salary of employees： | Yuan |

**CEO CV**

| | |
|---|---|
| Gender： | Male（ ）/Female（ ） |
| Age： | 30-40（ ）/40-50（ ）/50-60（ ） |
| Current position： | Owner and CEO（ ）/CEO（ ）/other chief manager（ ） |
| Civil work experience： | Yes（ ）/No（ ） |
| Political level higher than Chu： | Yes（ ）/No（ ） |
| Experience of working in other SOE： | Yes（ ）/No（ ） |
| Working in private enterprise： | Yes（ ）/No（ ） |
| Expected ability of work in the government ： | Yes（ ）/No（ ） |
| Social responsibility of your enterprise： | Yes（ ）/No（ ） |

**CEO income**

| | |
|---|---|
| Ownership of your enterprise： | Full（ ）/part（ ）/no（ ） |
| Salary after tax： | 100-200K（ ）/200-400K（ ）/400-600K（ ）/600-800K（ ）/800K-1 million（ ）/above 1 million（ ） |
| Perquisite consumption： | 100-200K（ ）/200-400K（ ）/400-600K（ ）/600-800K（ ）/800K-1 million（ ）/above 1 million（ ） |

| | |
|---|---|
| Basic bonus and allowance： | 100-200K（ ）/200-400K（ ）/400-600K（ ）/600-800K（ ）/800K-1 million（ ）/above 1 million（ ） |
| Other allowance： | 100-200K（ ）/200-400K（ ）/400-600K（ ）/600-800K（ ）/800K-1 million（ ）/above 1 million（ ） |
| Medical care | Basic（ ）/Basic + partly commercial（ ）/Basic + fully commercial（ ）/Basic + family fully commercial（ ） |

**CEO family background**

| | |
|---|---|
| Marriage： | Yes（ ）/No（ ） |
| Spouse working status： | Central SOE（ ）/Local SOE（ ）/Private enterprise（ ）/unemployed（ ）/retired（ ） |
| Number of children： | none（ ）/1（ ）/2（ ）/3（ ）/ over 3（ ） |
| Children education： | key primary school( )/regular primary school（ ）/211 universities（ ）/other universities（ ） |
| Children's working status： | Central SOE（ ）/Local SOE（ ）/private enterprise（ ）/not applicable（ ） |
| Family income： | 100-200K（ ）/200-400K（ ）/400-600K（ ）/600-800K（ ）/800K-1 million（ ）/above 1 million（ ） |
| Time spent with family per week： | Less than 5 hours（ ）/5-10 hours（ ）/10-20 hours（ ）/over 20 hours（ ） |

## References:


1. Aggarwal, R. K., & Samwick, A. A. (1999). Executive compensation, strategic competition, and relative performance evaluation: Theory and evidence. The Journal of Finance, 54(6).
2. Acharya, V., Gabarro, M., and Volpin, P. (2011). Competition for managers, corporate governance and incentive compensation. *Corporate Governance and Incentive Compensation (March 16, 2010). AFA*.
3. Adithipyangkul, P., Alon, I., and Zhang, T. (2011). Executive perks: Compensation and corporate performance in China. *Asia Pacific Journal of Management, 28*(2), 401-425.
4. Aggarwal, R. K., and Samwick, A. A. (1999). Executive compensation, strategic competition, and relative performance evaluation: Theory and evidence. *The Journal of Finance, 54*(6).
5. Amzaleg, Y., Azar, O. H., Ben-Zion, U., & Rosenfeld, A. (2014). CEO control, corporate performance and pay-performance sensitivity. Journal of Economic Behavior & Organization, 106, 166-174.
6. Armstrong, C. S., Ittner, C. D., and Larcker, D. F. (2012). Corporate governance, compensation consultants, and CEO pay levels. *Review of Accounting Studies, 17*(2), 322-351.
7. Babenko, I. (2009). Share Repurchases and Pay‐Performance Sensitivity of Employee Compensation Contracts. The Journal of Finance, 64(1), 117-150.
8. Arrow, K., and Solow, R. (1993). *Report of the NOAA panel on contingent valuation*.
9. Bebchuk, L. A., and Fried, J. M. (2004). *Pay Without Performance* (Vol. 278). Harvard University Press, Cambridge, MA.
10. Bebchuk, L. A., Fried, J. M., and Walker, D. I. (2002). Managerial power and rent extraction in the design of executive compensation. No. w9068. *National Bureau of Economic Research*.
11. Bertrand, M., and Mullainathan, S. (2003). Enjoying the Quiet Life? Corporate Governance and Managerial Preferences. *Journal of Political Economy, 111*(5), 1043-1075.
12. Bertrand, M., and Mullainathan, S. (2001). Are CEOs rewarded for luck? The ones without principals are. *The Quarterly Journal of Economics, 116*(3), 901-932.
13. Bo, H. (2009). *Political appointment of managers in China. Working paper.* University of London.
14. Boeker, W. (1992). Power and managerial dismissal: Scapegoating at the top. *Administrative Science Quarterly*, 400-421.
15. Brick, I. E., Palmon, O., & Wald, J. K. (2012). Too much pay-performance sensitivity?. Review of Economics and Statistics, 94(1), 287-303.
16. Brown, R., Gao, N., Lee, E., and Stathopoulos, K. (2012). What are friends for? CEO networks, pay and corporate governance. *Corporate Governance* (pp. 287-307): Springer Berlin Herdelberg.
17. Buck, T., Liu, X., & Skovoroda, R. (2008). Top executive pay and firm performance in China. Journal of International Business Studies, 39(5), 833-850.
18. Buck, T., Bruce, A., Main, B. G., & Udueni, H. (2003). Long Term Incentive Plans, Executive Pay and UK Company Performance*. Journal of Management Studies, 40(7), 1709-1727.
19. Cao, J., Lemmon, M. L., Pan, X., & Tian, G. G. (2009, November). Political Promotion, CEO Compensation and Their Effect on Firm Performance. In AFA 2011 Denver Meetings Paper.
20. Cao, J., Lemmon, M., Pan, X., Qian, M., and Tian, G. (2011). Political promotion, CEO incentives, and the relationship between pay and performance. *CEO Incentives, and the Relationship between Pay and Performance (August 21, 2011)*.
21. Capezio, A., Shields, J., and O'Donnell, M. (2011). Too Good to be True: Board Structural Independence as a Moderator of CEO Pay‐for‐Firm‐Performance. *Journal of Management Studies, 48*(3), 487-513.
22. Chang, H., Choy, H. L., & Wan, K. M. (2012). Effect of the Sarbanes–Oxley act on CEOs' stock ownership and pay-performance sensitivity. Review of Quantitative Finance and Accounting, 38(2), 177-207.
23. Chen, G., Firth, M., and Rui, O. (2006). Have China's enterprise reforms led to improved efficiency and profitability? *Emerging Markets Review, 7*(1), 82-109.
24. Chen, H., Jeter, D., & Yang, Y. W. (2015). Pay-performance sensitivity before and after SOX. Journal of Accounting and Public Policy, 34(1), 52-73.
25. Chen, H., & Leng, F. (2004). Pay-performance sensitivity in a heterogeneous managerial labor market. Journal of management accounting research, 16(1), 19-33.

26. Chen, S., Lin, B., Lu, R., & Zhang, T. (2015). Controlling shareholders' incentives and executive pay-for-performance sensitivity: Evidence from the Split share structure reform in China. Journal of International Financial Markets, Institutions and Money, 34, 147-160.
27. Chizema, A., Liu, X., Lu, J., and Gao, L., (2015), Politically connected boards and top executive pay in Chinese listed firms, *STRATEGIC MANAGEMENT JOURNAL*, 36-6, 890-906
28. Cichello, M. S. (2005). The impact of firm size on pay–performance sensitivities. Journal of Corporate Finance, 11(4), 609-627.
29. Ciscel, D. H., and Carroll, T. M. (1980). The determinants of executive salaries: An econometric survey. *The Review of Economics and Statistics*, *62*(1), 7-13.
30. Conyon, M. J., and He, L. (2011). Executive compensation and corporate governance in China. *Journal of Corporate Finance*, *17*(4), 1158-1175.
31. Conyon, M. J., and He, L. (2012). CEO Compensation and Corporate Governance in China. *Corporate Governance: An International Review*, *20*(6), 575-592.
32. Conyon, M. J., and Murphy, K. J. (2000). The prince and the pauper? CEO pay in the United States and United Kingdom. *The Economic Journal*, *110*(467), 640-671.
33. Conyon, M.J., He, L., and Zhou, X., (2015), Star CEOs or Political Connections? Evidence from China's Publicly Traded Firms, *JOURNAL OF BUSINESS FINANCE & ACCOUNTING*, 42-3~4, 412-443.
34. Conyon, M. J., and He, L. (2016). Executive Compensation and Corporate Fraud in China, *JOURNAL OF BUSINESS ETHICS*, 134-4, 669-691.
35. Cooper, M. J., Gulen, H., & Rau, P. R. (2014). Performance for pay? The relation between CEO incentive compensation and future stock price performance. The Relation Between CEO Incentive Compensation and Future Stock Price Performance (October 1, 2014).
36. Cordeiro, J., He, J. R., Conyon, M., and Shaw, T., (2016), Chinese executive compensation: the role of asymmetric performance benchmarks, *EUROPEAN JOURNAL OF FINANCE*, 22-4~6, 484-505
37. Cornett, M. M., Marcus, A. J., & Tehranian, H. (2008). Corporate governance and pay-for-performance: The impact of earnings management. Journal of Financial Economics, 87(2), 357-373.
38. Coughlan, A. T., and Schmidt, R. M. (1985). Executive compensation, management turnover, and firm performance: An empirical investigation. *Journal of accounting and economics*, 7(1), 43-66.
39. Crawford, A. J., Ezzell, J. R., and Miles, J. A. (1995). Bank CEO pay-performance relations and the effects of deregulation. *Journal of Business*, 231-256.
40. Davis, G. F. (1991). Agents without principles? The spread of the poison pill through the inter-corporate network. *Administrative Science Quarterly*, 583-613.
41. Dicks, D. L. (2012). Executive compensation and the role for corporate governance regulation. *Review of Financial Studies*, *25*(6), 1971-2004.
42. Duffhues, P., & Kabir, R. (2008). Is the pay–performance relationship always positive?: Evidence from the Netherlands. Journal of multinational financial management, 18(1), 45-60.
43. Dutta, S. (2008). Managerial expertise, private information, and pay-performance sensitivity. Management Science, 54(3), 429-442.
44. Edwards, J. S., Eggert, W., and Weichenrieder, A. J. (2009). Corporate governance and pay for performance: evidence from Germany. *Economics of Governance*, *10*(1), 1-26.
45. Festinger, L. (1954). A theory of social comparison processes. *Human relations*, *7*(2), 117-140.
46. Firth, M., Fung, P. M., and Rui, O. M. (2006). Corporate performance and CEO compensation in China. *Journal of Corporate Finance*, *12*(4), 693-714.
47. Forth J, Bryson A, Stokes L. Are firms paying more for performance?[M]. National Institute of Economic and Social Research, 2014.
48. Gabaix, X., & Landier, A. (2006). Why has CEO pay increased so much? (No. w12365). National Bureau of Economic Research.
49. Garen, J. E. (1994). Executive compensation and principal-agent theory. *Journal of Political Economy*, 1175-1199.
50. Hao, X., (2015). Top Executive Remuneration, Political Promotion Incentive and Bank Risks. Journal of Finance and Economics, (6), 94-106.
51. Hass, L. H., Johan, S., and Schweizer, D. (2016), Is Corporate Governance in China Related to Performance Persistence? *JOURNAL OF BUSINESS ETHICS*, 134-4, 575-592
52. Haubrich, J. G. (1994). Risk aversion, performance pay, and the principal-agent problem. *Journal of Political Economy*, 258-276.

53. He, L., Wan, H., and Zhou, X. (2015), How are political connections valued in China? Evidence from market reaction to CEO succession, *INTERNATIONAL REVIEW OF FINANCIAL ANALYSIS*, 36, 141-152
54. Himmelberg, C., and Hubbard, R. (2000). Incentive pay and the market for CEOs: An analysis of pay-for-performance sensitivity. Paper presented at the Tuck-JFE Contemporary Corporate Governance Conference.
55. Hou, W., Lee, E., Stathopoulos, K., and Tong, Z. (2010). Does Ownership Reform Influence Executive Pay in China? *Available at SSRN*.
56. Hu, Y. (2015). Social Responsibility and Executive Pay Performance Sensitivity in State-Owned Enterprises in China. Available at SSRN 2565147.
57. Hubbard, R. G., and Palia, D. (1995). Executive pay and performance evidence from the US banking industry. *Journal of Financial Economics, 39*(1), 105-130.
58. Jensen, M. C. (1993). The modern industrial revolution, exit, and the failure of internal control systems. *The Journal of Finance, 48*(3), 831-880.
59. Jensen, M. C., and Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics, 3*(4), 305-360.
60. Jensen, M. C., and Murphy, K. J. (1990). Performance pay and top-management incentives. *The Journal of Political Economy, 98*(2), 225-264.
61. Jensen, M. C., and Murphy, K. J. (2010). CEO incentives—It's not how much you pay, but how*. *Journal of Applied Corporate Finance, 22*(1), 64-76.
62. Jia-nan, Z. H. O. U., & HUANG, D. S. (2007). Pay Performance Sensitivity and Risk: The Impact of Managerial Overconfidence [J]. Journal of Systems & Management, 3, 007.
63. John, T. A., & John, K. (1993). Top management compensation and capital structure. The Journal of Finance, 48(3), 949-974.
64. John, K., & Qian, Y. (2003). Incentive features in CEO compensation in the banking industry. Economic Policy Review, 9(1).
65. Kato, T., & Kubo, K. (2006). CEO compensation and firm performance in Japan: Evidence from new panel data on individual CEO pay. Journal of the Japanese and International Economies, 20(1), 1-19.
66. Ke, B., Petroni, K., & Safieddine, A. (1999). Ownership concentration and sensitivity of executive pay to accounting performance measures: Evidence from publicly and privately-held insurance companies. Journal of Accounting and Economics, 28(2), 185-209.
67. Knetsch, J. L., and Sinden, J. A. (1984). Willingness to pay and compensation demanded: Experimental evidence of an unexpected disparity in measures of value. *The Quarterly Journal of Economics, 99*(3), 507-521.
68. Lazear, E. P., and Rosen, S. (1981). Rank-order tournaments as optimum labor contracts. *The Journal of Political Economy, 89*(5), 841-864.
69. Liang, H., Renneboog, L., and Sun, S., (2015), The political determinants of executive compensation: Evidence from an emerging economy, *EMERGING MARKETS REVIEW*, 25, 69-91.
70. Lin, T. (2007). Economic logic of political promotion: Prefectural mayors of China. Public Management Research, 5, 45-68.
71. Lippert, R. L., & Moore, W. T. (1994). Compensation Contracts of Chief Executive Officers: Determinants of Pay‐Performance Sensitivity. Journal of Financial Research, 17(3), 321-332.
72. Liu, Q., Xiao, X., (2015). Promotion Incentive and Compensation Incentive for Executives of State-owned Enterprises: Based on Perspective of Double Identity. Technology Economics, (02), 93-100.
73. Liu, Q., and Lu, Z. J. (2007). Corporate governance and earnings management in the Chinese listed companies: A tunneling perspective. *Journal of Corporate Finance, 13*(5), 881-906.
74. Luo, Y. (2013). Executive compensation and corporate governance in emerging markets: The theoretical framework and recent developments. *Available at SSRN 2245223*.
75. Luo Y. CEO power, ownership structure and pay performance in Chinese banking[J]. Journal of Economics and Business, 2015.
76. aughy, D. L. (2000). Family CEOs vs. nonfamily CEOs in the family‐controlled firm: An examination of the level and sensitivity of pay to performance. *Family Business Review, 13*(2), 121-131.
77. McGuire, J. W., Chiu, J. S., and Elbing, A. O. (1962). Executive incomes, sales and profits. *The American Economic Review*, 753-761.
78. Mishra, C. S., McConaughy, D. L., & Gobeli, D. H. (2000). Effectiveness of CEO pay-for-performance. Review of Financial Economics, 9(1), 1-13.

79. Mishra, C. S., and Nielsen, J. F. (1999). The association between bank performance, board independence, and CEO pay-performance sensitivity. *Managerial Finance, 25*(10), 22-33.
80. Murphy, K. J., and Zabojnik, J. (2004). CEO pay and appointments: A market-based explanation for recent trends. *The American Economic Review, 94*(2), 192-196.
81. Perry, T., and Zenner, M. (2001). Pay for performance? Government regulation and the structure of compensation contracts. *Journal of Financial Economics, 62*(3), 453-488.
82. Pi, J., (2009). Local Duplicative Investments under Political Promotion Incentives. Finance and Economics, (9), 65-72.
83. Qian, Y. (1996). Enterprise reform in China: Agency problem and political control. *Economics of Transition, 4*(2), 427-447.
84. Schipani, C., and Liu, J. (2002). Corporate governance in China: then and now.
85. Sok‐Hyon K., Praveen K., and Hyunkoo L. (2006). Agency and corporate investment: The role of executive compensation and corporate governance. *The Journal of Business, 79*(3), 1127-1147.
86. Tosi Jr., H. L., and Gomez-Mejia, L. R. (1989). The decoupling of CEO pay and performance: An agency theory perspective. *Administrative Science Quarterly*, 169-189.
87. Tosi, H. L., Werner, S., Katz, J. P., & Gomez-Mejia, L. R. (2000). How much does performance matter? A meta-analysis of CEO pay studies. Journal of Management, 26(2), 301-339.
88. Vafeas, N. (1999). Board meeting frequency and firm performance. *Journal of Financial Economics, 53*(1), 113-142.
89. Zhou, L. A. (2004). The incentive and cooperation of government officials in the political tournaments: An interpretation of the prolonged local protectionism and duplicative investments in China . *Economic Research Journal, 6*, 33-40.
90. Fu and Li,. (2012). The sensitivity of CEO pays to corporate performance after "the Measure". *Finance and Accounting Monthly, 29*（002）.
91. Hu, Guan, Li,. (2008). *Empirical Research on the Top Manager's Incentive and Performance of Listed Enterprises After the Reforms of Split Share Structure*. *Journal of Liaoning University of Petroleum & Chemical Technology* (01), 96-98.
92. Lei, Li, and Jin. (2010). Stock split Reform, CEO compensation and Accounting performance sensitivity. *China accounting Review* (01), 17-30.
93. Li Y., Qin Y.H. and Huang J. C. (2010). Perks, Employee's Salary and Firm Performance. *Finance & Trade Economics.* (07), 60-68.
94. Liu, R., (2007). Performance Based Incentives, Same Industrial Structure and Local Protection: An Explanation under the Framework of Benefits of Political Control Rights. South China Journal of Economics, (6), 61-72
95. Lv C. J. and Zhao Y. H., (2008). Research on the Compensation Effect of SOEs' Managers: Based on the Mangeral Power. Management World. *11*(99), 109.
96. Quan X. F., Wu S. N. and Wen F.(2010). Management power, the private benefits and compensation control empirical evidence from Chinese listed SOEs, Economic Research Journal. (11).
97. Ren G. Q., Fu Y. R. and Zhang Y. M.(2011). The Relationship of Bank Executive Pay and Corporate Performance After Salary Limit . Chinese & Foreign Entrepreneurs. *7*.
98. Schaefer, S. (1998). The Dependence of pay—Performance Sensitivity on the Size of the Firm. Review of Economics and Statistics, 80(3), 436-443.
99. Shen Y. F. and Li P. G. (2010). Empirical Research on the Impact of "Pay Ceiling Order" on the CEO Compensation and Pay-for-Luck Phenomenon, China Industrial Economics. *11*, 130-139.
100. Sheng Y. M. (2000). An Economics Analysis of Corruption. Economic Research Journal. *5*(5), 56-57.
101. Wang, Z., Fu, G., Huang, D., and Wang, J., (2014). The relationship between CEO political promotion and perquisite consumption in SOE. Management World, (5), 157-171.
102. Wang C. B., Zhu X. Y., Liu J. Y. and Wu M. Y. (2012). The Renation between Manageral Salary, Firm Performance and Salary Limitation. Statistics and Decision. 20, 161-164.
103. Wei G. (2000). Incentives for Top-Management and Performance of Listed Companies. Economic Research Journal. *3*(12), 32-39.
104. Wei, X., (2012),FDI, Political promotion and environment pollution. Shandong University of Finance and Economics, Master Thesis.
105. Werner, S., Tosi, H. L., & Gomez‐Mejia, L. (2005). Organizational governance and employee pay: How ownership structure affects the firm's compensation strategy. Strategic Management Journal, 26(4), 377-384.
106. Wu, T., (2015). Respond to political promotion in SOE. Jinan University, Master thesis.

107. Xiaoqiang, Z., & Pan, T. (2007). Management Team Pay-performance Sensitivity, Internal Cash Flow and Investment Behavior: a Test of Free Cash Flow and Asymmetric Information Theory [J]. Accounting Research, 10, 012.
108. Xu, X.,(2012). Corporate governance effect of promotion and remuneration: the impact of property right. Economic Science, (2), 102-116.
109. Yi Z. H., Yu S. Y. and Jiang F. X. (2011). Busy Board: Dedication or Inefficient. Finance and Trade Economics. 12.
110. Zabojnik, J. (1996). Pay-performance sensitivity and production uncertainty. Economics Letters, 53(3), 291-296.
111. Zhang B. H. (2012). Analysis of Characteristics of Executive Pay and Corporate Performance Correlation after the Share Reform of Listed Companies in China. Journal of Changchun University of Technology (Social Sciences Edition) 24(2), 13-15.
112. Zhang Q. F. and Ding S. L. (2011). Empirical Analysis of the Impact of Split-share Structure Reform on the Executive Compensation. Economic Management Journal. 03, 142-149.
113. Zhang Q. F., Ding S. L., Wang J. Q. and Dai J. J. (2010). An Empirical Analysis of the Impact of Split-share Structure Reform on the executive compensation. Proceedings of International Conference on Engineering and Business Management（EBM2010). Chengdu, China.
114. Zhang, W., Cahan, S. F., & Allen, A. C. (2005). Insider Trading and Pay‐Performance Sensitivity: An Empirical Analysis. Journal of Business Finance & Accounting, 32(9‐10), 1887-1919.
115. Zhang X. N. (2002). An Analysis of Operator Reward, Employee Ownership and Firm Performance. World Economy, *10*, 57-64.
116. Zhen, C., & Ming, Z. (2008). Performance index, Performance risk and Pay-performance sensitivity [J]. Accounting Research, 2, 008.
117. Zheng, Z., Li, D., Xu, R., Lin, R., and Zhao, X., (2012). Political promotion in SOE and showcase projects: a case study of company A in province N. Management World, (10), 146-156