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Career concerns, shareholder monitoring and investment efficiency: From the perspective of compensation contract rigidity in Chinese SOEs

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ABSTRACT

This paper presents theoretical analysis of how career concerns and shareholder monitoring affect chief executive officer (CEO) agency costs. We investigate investment efficiency prior to CEO retirement based on a sample of Chinese state-owned enterprises (SOEs) during the 1999–2007 period and find that there is a significant decline in investment efficiency prior to CEO retirement, relative to other periods, and that this decline becomes less significant under stronger shareholder supervision. Our research furthers understanding of the significance of SOE incentive and monitoring mechanisms.

1. Introduction

The debate surrounding China's retirement system has heated up in recent years, particularly regarding the issue of whether the country should introduce a flexible retirement system. Some scholars believe that it would

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be reasonable to raise the retirement age and implement a flexible retirement system to compensate for the rising average life expectancy in China (Li, 2012).[1] In addition to this macroeconomic viewpoint, it is important to investigate the issues involved from a microeconomic perspective, considering, for example, whether a more flexible retirement system could alleviate CEOs' lack of career concern incentives resulting from the mandatory retirement age, reduce agency costs and maintain or improve the performance of Chinese state-owned enterprises (SOEs). These issues are in urgent need of theoretical and empirical evidence.

In theory, career concern incentives have dual effects. On the one hand, early in CEOs' careers, such incentives help to mitigate agency costs between CEOs and shareholders (Fama, 1980; Holmström, 1999). On the other hand, when CEOs are approaching retirement, a lack of career concern incentives can lead to a horizon problem for CEOs and increase agency costs, which can be characterized as a decline in investment efficiency, increased private benefits of control gained through insider trading, excessive remuneration and increased perquisite consumption. Because investment is an important source of corporate value, a decrease in investment efficiency equates to a loss in value. Thus, a change in investment efficiency offers a useful perspective for examining agency costs immediately before CEOs retire.

Many studies have discussed the rigidity of the compensation contracts awarded to CEOs of Chinese SOEs and the consequences thereof (Chen et al., 2005; Xin et al., 2007; Wan and Chen, 2012). Here, we analyze how the lack of career concern incentives influences investment efficiency under the mandatory retirement of SOE CEOs from the perspective of compensation contract rigidity.[2] We also investigate whether shareholder supervision can serve as a substitute to reduce agency costs and increase investment efficiency.

Our theoretical analysis leads to the conclusion that investment efficiency often declines immediately before SOE CEOs retire, although that decline becomes insignificant in the presence of stronger shareholder supervision. Empirical analysis of investment efficiency as CEOs approach retirement in a sample of 256 publicly listed SOEs in the 1999–2007 period produces further support for this conclusion.

The remainder of the paper is organized as follows. We review the literature in Section 2, discuss the background to the study and propose hypotheses in Section 3, outline our research design in Section 4 and display our empirical results and analysis in Section 5. Section 6 concludes the paper.

2. Literature review

2.1. Managerial labor market and career concerns

Managerial labor market mechanisms include the CEO appointment mechanism, compensation and incentive mechanism, and dismissal and exit mechanism. Prior research shows that although the managerial labor market for Chinese SOEs is still controlled to a certain extent (Liu, 2001; Chen, 2003), its efficiency has gradually improved, as indicated by the marketization of compensation, increased pay-performance sensitivity (Zhou, 2003; Zhou and Huang, 2006; Lv and Zhao, 2008; Wu and Wu, 2010; Chen and Li, 2011) and a more efficient appointment and dismissal mechanism (Zhu, 2002; Fang et al., 2007).

In addition, researchers have recently turned their attention to the prescriptive 60-year-old retirement age for SOE CEOs in China. Although it may seem reasonable, this mandatory retirement age can have adverse effects on the performance of SOEs. Thus, it needs to be discussed as a critical problem in the SOE reform process. Previous studies have investigated perquisite consumption immediately before the retirement of SOE CEOs (Wan and Chen, 2012) and find that the imminent retirement of its CEO is associated with lower SOE performance (Zhang, 2010). However, further research is needed to determine how career concern incentives affect the financial decisions of SOEs, particularly with regard to the crucial issue of investment efficiency.

[1] As reported in (Li, 2012), some scholars hold the opinion that as average life expectancy rises in China, raising the retirement age and introducing a flexible retirement system will provide an ideal solution to the retirement age issue. While other scholars propose that China should implement a flexible retirement system, but note that the opinions of individuals and employers should be consulted rather than simply sorting by industries or groups.

[2] Career concern incentives include both external labor market incentives, such as the CEO's positions outside his/her current firm, and internal labor market incentives, such as how fast and by what means the CEO can get promoted inside that firm (Brickley et al., 2006). Because dismissal or demotion can cause negative incentives, career concern incentives can be viewed as opportunities for CEOs to take positions outside the company and to be promoted or remain inside the company.