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How do market forces affect executive compensation in Chinese state-owned enterprises?☆

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ABSTRACT

This paper studies how the evolution of market forces affects executive compensation in China's listed state-owned enterprises (SOEs) from 2000–2007. Along with the progress of market reforms we find that the level of executive compensation increases gradually and the relation between compensation and performance becomes more sensitive. However, the effect of market forces on executive compensation in SOEs is limited by CEOs' political connections. Our findings suggest that introducing exogenous market forces alone may not be sufficient to ensure the effectiveness of governance structure in a transition economy.

1. Introduction

Recent studies focus on the evolution of corporate governance in emerging markets and how multiple forces affect the corporate governance structure (Claessens & Fan, 2002; Djankov & Murrell, 2002; Kole & Lehn, 1999). The extant literature implies that market forces resulting from regulatory change might be pivotal exogenous factors promoting spontaneous and vigorous modification to the governance structure in developed markets.[1]

However, the evidence is mixed as to the extent to which market forces can reshape corporate governance in emerging economies under transitional reforms. Some studies, though quite limited, document that market-oriented forces do indeed improve corporate governance in emerging economies (see, e.g., Groves, Hong, McMillan, & Naughton, 1995; Mar & Young, 2001; Pinto, Belka, & Krajewski, 1993). Other evidence casts doubts on the effectiveness of market forces in emerging economies in

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[1] Focusing on a specific industrial sector, evidence from the U.S. shows that the change in business environment resulting from deregulation could lead to a dynamic adjustment in corporate governance (see, e.g., Kole & Lehn, 1999).

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which state ownership still dominates the market, the capital market is undeveloped, and investor protection is poor (see, e.g., Gu, Wang, & Xiao, 2010; Kato & Long, 2006; Kornai & Weibull, 1983; Shleifer & Vishny, 1994). As prior studies only focus on the endogenous determinants of corporate governance such as ownership structure, board characteristics, and managerial power after the adoption of market policies (Bebchuk & Fried, 2003; Firth, Fung, & Rui, 2006; Kato & Long, 2006; Mehran, 1995; Riahi-Belkaoui, 1992; Sun, Tong, & Tong, 2002; Wang & Stammerjohan, 2007), some controversy remains. Our study attempts to provide evidence by examining the exogenous impact of market forces on the evolution of executive compensation in China's state-owned enterprises (SOEs) under progressive market reforms.

We focus on executive compensation in China's SOEs for the following reasons. First, executive incentives are an important market-based governance mechanism to alleviate agency costs (Bebchuk & Fried, 2003; Jensen & Murphy, 1990). In particular, monetary rewards play an increasingly prominent role as explicit incentives in Chinese firms since the implementation of market-wide reforms (Kato & Long, 2006; Shirley & Xu, 2001). By examining the evolution of executive compensation in the progress of market development, we can measure the impact of market forces on the corporate governance structure. Second, China's market-oriented reforms provide a natural setting to observe the dynamic in governance structure when subject to multiple external forces. Although market-oriented reforms have been in motion for some time, China's economy is still dominated by state ownership and is under intense government intervention. Thus, China's setting allows us to observe the effect of non-market forces intertwining with market forces in the adoption of corporate governance during the transition period.

Using data on listed SOEs in China from 2000 to 2007, we investigate the effects of market forces on the level of executive compensation and the pay-performance sensitivity. In terms of a market index developed by Fan and Wang (2009) to measure market forces introduced by the progress of market reforms, we find that the progress of market reforms is positively associated with the level of executive compensation. We also find that executive compensation is more sensitive to market-based performance in regions with stronger market forces. We further examine whether non-market forces such as government intervention and political connections hamper the effects of market forces on executive compensation. We only observe the effects of market forces on pay-performance sensitivity in the subgroup of CEOs without political connections. Thus, our findings support that market forces indeed play a positive role in shaping corporate governance, but its role is constrained by the continued presence of government forces in the business. To ensure the validity of our results, we use the first difference model to control for unobserved firm heterogeneity. We also conduct several robustness tests: (1) we use two different proxies for market forces (foreign direct investment and foreign imports and exports); (2) we use alternative performance measures; and (3) we conduct the tests on a cleaner sample. We find that the main findings remain.

This paper contributes to the corporate governance literature in several ways. First, prior studies provide limited knowledge on the dynamic evolution of corporate governance, especially in the context of a transition economy with multiple exogenous factors (Claessens & Fan, 2002; Djankov & Murrell, 2002; Kole & Lehn, 1999). One of the possible reasons is that it is difficult to identify and proxy various forces. Prior studies investigate executive compensation under a specific policy background and examine changes in the incentive mechanism after the government has deregulated a specific sector (Bryan, Hwang, & Lilien, 2005; Crawford, Ezzell, & Miles, 1995; Hubbard & Palia, 1995; Kole & Lehn, 1999). Our study investigates this question in the context of the progress of market-oriented reforms in China and the disparity of market forces across different regions of China.

Second, we contribute to the executive compensation literature on the role of performance measures in an emerging market (e.g., Conyon & He, 2011; Firth et al., 2006; Kato & Long, 2006; Xiao & Wang, 2011). A large number of studies examine performance measures such as *accounting*-based performance and *market*-based performance in incentive contracts in terms of earnings properties as well as manager incentives and behavior (Bushman & Smith, 2001; Camara, 2001; Murphy, 1999; Natarajan, 1996; Zhang, Cahan, & Allen, 2005). We extend previous research by finding that the significance of the performance measures may be determined by the stage of market development. It also provides empirical evidence on tournament theory which argues that it rises the level of executive compensation since it serves as a sufficiently large prize for promotion tournament.

Our findings have policy implications for improving corporate governance in China's emerging markets. While policy makers attempt to introduce market forces into SOEs by adopting policies such as performance contracts or overseas listings (e.g., Shirley & Xu, 1998), the effect of those policies might be mitigated by factors such as state ownership, access to politically-connected resources, and bureaucratic hierarchy. Hence, introducing an exogenous market force alone is insufficient to create a circumstance that fosters efficient corporate governance.

The remainder of this paper is organized as follows. In the next section, we develop the hypotheses. Section 3 presents the research design. The results are presented and discussed in Section 4. We conduct several robustness tests in Section 5 and conclude the paper in Section 6.

2. Institutional background and hypothesis development

2.1. Multiple forces in the governance of China's SOEs

The governance of China's SOEs is subject to both market and non-market forces in China's emerging economy. Since economic reforms were introduced in 1978, market forces have been introduced gradually and greatly enhanced. One market-based reform involves boosting the growth of non-state entities (such as collective, private, and foreigner-invested enterprises) and encouraging these entities to compete with SOEs. Competition, as well as the price mechanism introduced by economic reforms, is gradually changing the operating and decision-making mechanisms of SOEs.