CHAPTER 4
HYPOTHESIS DEVELOPMENT

4.1. Different incentives between GA and corporate state-share holders

To develop the hypotheses on the governance roles of different types of state-share holders, it is necessary to detail the incentive differences between GA and corporate state-share holders. GA shareholders are purely government agencies and bear the highest degree of government interference, which can be definitely detrimental to firm performance based on the political perspective. On the other hand, corporate state-share holders bear less degree of government interference because China’s government has been introducing business autonomy to them since 1986.13 A regulation issued in 1986, Factory Director Regulations, first attempted to cede some autonomy to SOE managers but the degree of autonomy that the manager actually enjoyed was unclear: important matters required the approval of the “competent authorities” and “administrative organs”, and he/she was required to carry out the decisions made by such authorities.

To define further the SOE’s sphere of autonomy, Chinese government introduced a set of fourteen rights to SOE managers through the SOE Law and Autonomous Management Rights Regulations promulgated in 1988 and 1992 respectively. These rights concern an SOE manager’s right to decide on:

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13 See chapter 2 of World Bank (1997) for details.
1) production;  8) disposing of assets;
2) prices of products;  9) operating jointly or merging with other units;
3) sale of products;  10) hiring and firing workers;
4) selection of suppliers;  11) personnel management decisions;
5) foreign trade;  12) distribution of wages and bonuses;
6) investments;  13) organizational structure; and
7) use of retained earnings;  14) the refusal of unregulated government collections.

To further protect SOE autonomy, government departments that violate SOE autonomy are subject to disciplinary actions, and anyone who obstructs a factory director or management personnel in the execution of their duties shall be penalized by the public security authorities and may be subject to criminal prosecution.14

To safeguard the state’s interests and give incentives for good performance, a performance-based bonus payment scheme for SOE managers was introduced in the Autonomous Management Rights Regulations.15 World Bank (1997) provides an example of incentive contract (see Appendix D in this thesis) between Shanghai SAMB and the First Department Store (Group) Company (FDS): the reward system for the SOE manager involves a base salary plus incentive pay based on a number of assessment indicators. Of the base salary, 80 percent is paid in advance, with remainder payable at the end of the year. The remaining 20 percent is paid in full if the manager meets all assessment indicators. If the manager fails to fulfil the indicators, all or a percentage is forfeited. If the manager beats all indicators, an

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14 However, the implementation of the fourteen autonomous management rights has been highly uneven (World Bank (1996)). For example, 97% SOE managers have the production autonomy but only 19% managers have even refused unregulated government collections. Investigating the implementation of the 14 rights is beyond the scope of this thesis.

15 See World Bank (1997) for some other means to safeguard the State’s interests and give incentives for good performance.
additional bonus up to the year’s base salary will be granted. Further, another reward can be granted if an outstanding contribution is made. Prior literature finds that introducing decision autonomy and incentive contracts has increased SOEs’ productivity (Groves et al. (1994) and Groves et al. (1995)). Corporate state-share holders are mainly wholly state-owned enterprises and thus they have the similar autonomy and incentive contracts, which is the main distinction from GA shareholders.

4.2. Types of state-share holders and firm performance

The inefficiency of state shareholdings mainly arises from government intervention that does not usually allow management autonomy and incentive contracts. Thus, China’s listed companies with GA shareholders, subject to direct government intervention, may under-perform companies with corporate state-share holders or companies without any state-owned shares that have less government intervention. However, compared with the GA shareholders, corporate state-share holders have one more layer of principal-agency relationship in the government shareholding hierarchy (see the right-lower corner of Appendix A), which may result in more serious agency costs. If the benefits from the autonomy of management and incentive contracts dominate the “one more layer” agency costs for corporate state-share holders, firms with corporate state-share holders will out-perform those

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16 It should be aware of that firms with GA shareholders could have closer connections (guanxi) to politicians than firms without GA shareholders, which makes firms with GA shareholders do business easier in Chinese special “guanxi” business environment. However, Xin and Pearce (1996) find that private firms have more government connections compared with SOEs. Thus, the benefit of “guanxi” for GA shareholders is still not clear.

17 Insider control could be the most serious governance problem for corporate state-share holders (Aoki and Kim (1995)). The result of introducing autonomous management rights is that managers (and other insiders) end up with de facto control over SOEs, leading to many agency problems: asset-stripping, poor investment decisions, decapitalization through excessive wage increases, and increases in other private benefits (World Bank (1997)).
with GA shareholders. To test this prediction, I formulate the following hypothesis (stated in alternative form):

**H1a:** the performance of firms with GA shareholders is lower than that of other types of firms (including firms with corporate state-share holders and firms without state-owned shares).

While corporate state-share holders have more autonomy and act more like market-oriented private owners (such as non-state legal person shareholders) than GA shareholders, they still bear higher degree of government intervention than non-state owners,\(^\text{18}\) and could be less efficient. Thus, I hypothesize the following (stated in alternative form):

**H1b:** the performance of firms with corporate state-share holders is lower than that of firms without state-owned shares.

As mentioned before, the percentage of state-owned shares held by GAs should be a more accurate proxy for the role of government shareholdings. From the political perspective, a negative relation between the percentage of state-owned shares held by GAs and firm performance is predicted. This prediction is tested by the following hypothesis (stated in alternative form):

**H1c:** there is a negative association between firm performance and the voting rights of GA shareholders.

\(^{18}\) Firms without any state-owned shares are not necessarily independent of government intervention (Clarke (2003)).
The first two hypotheses investigate the effect of the type of state-share holders on firm performance based on their different incentives. The type of state-share holders might also be treated as a surrogate for the degree of governmental interference: GA shareholders bear higher degree of governmental interference than corporate state-share holders. The third hypothesis then further develops the first two hypotheses and implements a continuous variable, the percentage of state-owned shares held by GAs, to proxy for the degree of governmental interference, which can lend support to the inefficiency of state-owned shares. Overall, these three hypotheses predict that governmental interference is detrimental to firm performance.

4.3. Types of state-share holders and management turnover

A direct test for the governance role of shareholders is measuring the sensitivity of top management turnover to poor firm performance. The negative relationship between top management turnover and firm performance has been found worldwide.\textsuperscript{19} Although the corporate governance system for China’s listed companies is ineffective, I predict a significant negative relationship between top management turnover and firm performance in China for two reasons. First, non-state shareholders have strong incentives to replace poor top management. Although the government maintains the right to appoint or remove top management, non-state-share holders can lobby government (usually the Party Organization Department of Chinese Communist) to replace poor management. Second, although state-share holders have less incentive to monitor managers than non-state shareholders, they

could replace poor managers to maintain their reputations. This negative relationship is tested by the following hypothesis (stated in alternative form):\(^\text{20}\)

\textbf{H2a: there is a negative association between top management turnover and prior year firm performance.}

The sensitivity of this negative relation will vary between state and non-state shareholders, which is caused by different degrees of agency problems (the managerial perspective). State-share holders have less incentive to replace poor managers because of the “absence of principal” problem discussed in Chapter 2.\(^\text{21}\) Thus top management turnover in firms with state-share holders should be less sensitive to poor firm performance than in firms without state-share holders. It will be tested with the following alternative hypothesis:

\textbf{H2b: the sensitivity of top management turnover to poor firm performance in firms with state-owned shares is weaker than that in firms without state-owned shares.}

However, different types of state-share holders may have different incentives to monitor top management even though all of them are state-share holders. Compared with corporate state-share holders, GA shareholders have less incentive to monitor managers for two reasons. The first is that they are politicians rather than business persons and therefore have less incentive based on the managerial view.

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\(^{20}\) This study is not the first to test the association. Using survey data for non-listed SOEs, Groves et al. (1995) show that management turnover is negatively related to performance in the years 1980 through 1989. In concurrent work, Firth, Fung, and Rui (2002) report a negative association between chairperson turnover and prior firm accounting performance in China’s listed companies from years 1998 to 2000.

\(^{21}\) I have not differentiated different types of state-share holders in this hypothesis. The “absent of principal” problem is for both GA and corporate state-share holders.
The second reason is that there is no active labour market for professional managers in China (World Bank (1997)). Most of the top management are assigned by Chinese government or the GA shareholders. Managers have incentives to bribe politicians to remain in control even when firm performance is poor. However, the incentives of corporate state-share holders are different from those of GA shareholders. They have more incentives to maximize the firm’s value for two reasons. One is that corporate state-share holders have incentive contract with government authorities (see Appendix D for an example), which may drive corporate state-share holders to monitor top management of listed companies through their voting rights on the board. The other is that there is a political concern for corporate state-share holders. In China, managers of state-owned enterprises have opportunities to be promoted to a government position if SOEs under their control improve their performance. Thus corporate state-share holders have incentives to monitor the decision-making process and make it more efficient. Although final decisions about top management are still made by the government, corporate state-share holders can exert pressure to replace poorly performing managers. Thus, if the monitoring incentives of corporate state-share holders dominate the “one-more-layer” agency problem discussed in section 4.2 for hypothesis H1b, the top management turnover in firms with corporate state-share holders should be more sensitive to poor firm performance than that in firms with GA shareholders. The prediction can be tested by the following hypothesis (stated in alternative form).

22 For example, the chairman (Shulin Li) of Jilin Chemical Industrial Company Limited, a listed company in New York, Hong Kong, and Shenzhen, was promoted to a position in Jilin provincial people's congresses on March 10, 1998.
H2c: the sensitivity of top management turnover to poor firm performance in firms with GA shareholders is weaker than that in firms with corporate state-share holders and firms without state-owned shares.

Again, compared with non-state shareholders, corporate state-share holders are still state-share holders and thus could exert less effort in monitoring top management turnover. Thus, I hypothesize the following (stated in alternative hypothesis):

H2d: the sensitivity of top management turnover to poor firm performance in firms with corporate state-share holders is weaker than that in firms without state-owned shares.