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From boardroom to parliament

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Everyone has different motivations for working, . But the primary incentive for slogging it out in the corporate jungle would be money— at least that is what employers believe. This helps explain why companies are often willing to shell out wads of cash to outbid one another in the labour market for top executives.

Yet, one country has shown that strong company profits can be achieved without having to pay top dollar. The CEOs of China’s state-owned enterprises (SEOs) are leading their companies to new heights despite being paid less than their counterparts in the private sector.

The Ministry of Finance in China reported in March 2011 that profits from SOEs have reached 331.65BRMB (52B USD) in the first two months of the year, up 29.4 per cent from the same period of 2010.

It also said that the operating revenues of SOEs in January and February that year came to 5.14 trillion RMB (815.5B USD), up 26.4 per cent.

At the same time, the gulf between the salary of a CEO at a SOE and private enterprise remains wide. China’s highest paid CEO, Yang Yuanqing of Lenovo Group, received an annual salary of 78.72M RMB (12.5M USD) last year. In contrast, the highest paid CEO at an SOE was Han Junliang, who was paid 8.58M RMB (1.4M USD) by Sinovel Wind Group.

What motivates these CEOs when they do not stand to benefit substantially from their companies’ growth?

According to Jerry Cao, an assistant professor of finance at the Lee Kong Chian School of Business, the driving force is the likelihood of a political career as the CEOs try to move up the rungs of the career ladder. Cao was co-author of the paper '*Political Promotion, CEO Incentives, and the Relationship between Pay and Performance*'.

It’s not all about the money

China started the corporatisation and privatisation of its SOEs in 1978 when many decision rights associated with the operation of the firm, such as profit retention and profit-sharing schemes, were shifted from the state level to the firm level.

But the state retained its control over personnel decision with the ultimate authority over the selection, appointment, and dismissal of SOE executives. It is also common practice for the ruling Communist Party to consider these executives in the selection and evaluation process for bureaucratic promotion.

As the CEOs in these companies have limited outside job opportunities, a political appointment which brings with it higher salary and prestige, would make for an attractive career move.

This means that besides carrying out their fiduciary duties, these CEOs are also concerned about assessments from government officials, which might allow them to climb the political ladder, said the researchers.

From the start of the early 1980s, the Chinese central government has mandated that almost all bureaucrats at various levels should be familiar with capitalist ideas. The policy sends a signal to the CEOs that the government values economic performance, providing another reason for these executives to work towards raking in handsome company profits.

And while the pay package of the CEOs at the SOEs is smaller, there has been a gradual introduction of a performance-based system which emphasizes the linkage of pay to economic performance after the establishment of stock exchanges in the early 1990s. This had increased the amount of attention CEOs give to the financial position of their companies.

Since economic development is a significant objective of the government, economic performance should be positively related to the likelihood of a CEO receiving political promotion, the researchers hypothesised.

They conjectured that the extent to which government focused on economic achievements in determining political assignments, the greater the motivation for CEOs to maximise firm value.

The researchers analysed the CEO compensation data of 756 SOEs listed on the Shanghai and Shenzhen stock exchanges from 2005 (when these data began to be disclosed) to 2009. They also tracked the career movement of the CEOs through annual reports, news and online searches.

The data showed that 331 of the CEOs changed their jobs during the time period and the researchers traced the new job positions. Of these, 141 CEOs had a promotion out of which 104 was a political promotion.

In their study, the researchers defined a political promotion as the appointment of an officer of the central government, local government, or the military; a member of the Standing Committee of the National People’s Congress, Chinese People’s Political Consultative Conference, and the Secretary of the Communist Party Committee in the firm or parent company.

The researchers noted: “The relative rarity of non-politically related promotion is consistent with limited outside opportunities that CEOs face in the managerial labor market in China.”

The statistics revealed that the mean *return on assets* and *return on sales* of the SOEs led by those who had a political promotion was 4.27 per cent and 6.04 per cent respectively.

In contrast, the mean values *return on assets* and *return on sales* of the SOEs led by those who did not have any promotion was 1.24 per cent and 2.76 per cent respectively.

“These results suggest that political promotion is at least partially based on economic performance,” said the researchers.

At the same time, these better performing CEOs had a lower pay. Their mean pay is 395,513 RMB (62,750 USD) — much lesser than the 449,135 RMB (71,260 USD) collected by the CEOs who did not receive any promotion.

Motivating the CEO

These findings – the first of its kind in offering empirical evidence – indicates that both explicit (compensation-based) and implicit (political-based) incentives are effective in shaping managerial behaviour, the researchers noted.

It “fills a void” in understanding China’s significant growth in state-related sectors by showing how alternative mechanisms based on political incentives can provide executives with sufficient motivation in an institutional environment with weak corporate governance, and ultimately enhance the performance of the state economy.

Because of the massive size and the advantages that they enjoy, SOEs are often viewed as highly inefficient. However, the finding that CEOs are also focused on making profits show that the 'inefficiency' perception is “not necessarily so”. Cao noted that “SOEs with capable CEOs with political ambitions seem to play a pivotal role in fuelling Chinese growth”.

One policy implication of the findings is that full privatisation does not necessarily have to be the only solution to SOEs going forward in the global economy. “While CEO pay is often not competitive in SOEs compared to private companies, government is smart to use political benefit as another way to incentivize top managers,” he said.

So when political career concerns provide an incentive for CEOs to improve firm performance, minority shareholders may benefit for they often have limited influence over management of the CEOs from SOEs. "In contrast, many SOEs can destroy value for small investors who naively believe their investment of SOEs can yield good returns," Cao concluded.