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CHINESE EXECUTIVE COMPENSATION – DO POLITICAL CONNECTIONS MATTER?

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ABSTRACT

The purpose of this paper is to investigate the impact of varying ownership structure and corporate governance mechanisms on the executive pay levels in Chinese firms. Furthermore, the pay-performance linkage of the Chinese executives' compensation is explored in relation to different ownership structures and corporate governance mechanisms present in the Chinese firms.

The impact of different ownership variables and corporate governance variables on the executive compensation packages is investigated using several statistical regressions. The paper explores if and how a large concentrated ownership either government, institutional, foreign or private can affect the executive compensation packages and if the executive compensation is linked to his/her performance in Chinese firms.

The paper provides evidence that in firms with high levels of government or institutional ownership, the pay-performance sensitivities are weak; executive compensation tend to be high without being justified by firm performance. However, in firms with relatively high levels of foreign or private ownership, the pay-performance sensitivity is stronger and executives are compensated for better firm performance. Also, the paper provides evidence that firms with higher numbers of independent board of director members had better control on their executive compensation mechanisms.

***Keywords:** Corporate governance, Executive compensation, Chinese firms*

INTRODUCTION

The level of CEO compensation has recently sparked an intense debate among politicians and the media in the United States and all over the world. Following the 2008-2009 financial crisis politicians attacked excessive executive pay as scandalous and detrimental to society and thus they demanded that action be taken to curb executive compensation excesses. Despite the widespread media and public attention on CEO compensation packages in the United States and the Western countries, there is little empirical evidence about the CEO compensation

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mechanism in the rapidly emerging Chinese economy. Recently Kato and Long (2006) evaluated the impact of CEO compensation on Chinese firm performance. They found that strong levels of private ownership tend to enhance the link between executive pay and firm performance.

Agency theory suggests that firms with a large controlling shareholder will have a significant impact on CEO compensation packages. Executive compensation plays an important role in corporate governance structure by providing incentives for executives to perform their duties and maximize shareholders' wealth. Agency costs that arise from separation of ownership and control should be low in firms with a large controlling shareholder since the controlling shareholder would have strong incentive to provide a high degree of monitoring management (Shleifer and Vishny, 1997). Thus, performance-based compensation can play a significant role in aligning the interests of CEOs and shareholders would be expected to be a significant part of CEO compensation packages in firms with large controlling shareholders. Agency costs might also arise from conflicts of interest between large and minority shareholders in firms with concentrated ownership. A large majority ownership can expropriate wealth from minority shareholders when corporate governance circumstances are weak within a firm, controlling shareholders can derive substantial private benefits at the expense of minority shareholders (Dyck and Zingales, 2004).

The ownership and corporate structure characteristics of Chinese listed firms on Shanghai and Shenzhen stock exchanges are very distinctive and different from firms in other countries. The majority of firms are former state-owned enterprises where the state continues to be the large shareholder. The implication of the state ownership on firm value for Chinese firms has been investigated in several studies (Wei and Varela, 2003; Paskelian and Bell, 2009). Non-value maximization behavior of firms in the presence of high government ownership is evident from these studies. In firms where the government still has a large presence, executives are often appointed by the government, their effectiveness in maximizing shareholders wealth has been questioned (Fan *et al.*, 2007). More importantly, there are questions whether China's corporate governance mechanisms provide enough protection for investors or provide incentives for managers to promote shareholder wealth (Paskelian and Bell, 2010).

While government control is still predominant in China, Chinese privatized firms offer a wide variety of ownership structures that provides a fertile ground for studying the impact of such ownership structure on CEO compensation. Starting 2001, foreign and private investors have been flocking to China to invest in many of their privatized firms. Also, there is a large institutional ownership present in the Chinese firms, institutional owners such as state governments, governmental agencies, and other legal entities who hold ownership stakes in the privatized firms.

In this paper we study the relationship between ownership structure and CEO compensation in Chinese firms. We also study the relationship between CEO compensation and corporate governance variables. In our empirical analysis, we consider both cash and equity-based components of CEO compensation. Furthermore, we control for a comprehensive set of corporate governance variables including CEO and board characteristics. Our study contributes to the literature in the following ways. The empirical evidence on certain governance structures that provide incentives to managers to increase firm value is mixed. Furthermore, there is little

empirical research done on firms outside of the U.S. as a result of limited data. Moreover, two interesting research questions are whether the different ownership structures and their inter-relations affect the pay-performance characteristics of executive compensation packages and whether corporate governance mechanisms such as independent board and compensation committee are effective in enhancing the executives' pay-performance sensitivities.

The remainder of the paper is organized as follows: Section 2 is the literature review of previous studies related to equity offerings. Section 3 covers the empirical hypotheses to be tested in the paper. Section 4 elaborates on the data used in the paper. Section 5 presents the empirical results based on multivariate regression analysis. Finally, section 6 concludes the paper.

LITERATURE REVIEW

The agency problems caused by the separation of ownership and control allow managers to control residual rights which determine the allocation of the firm's resources (Shleifer and Vishny, 1997). As a result, managers may divert resources away from activities which would maximize the firm's value towards activities which would maximize their own self-interests. In countries with low investor protection such as Russia or Eastern European countries, managers expropriate investors directly by cashing out or transfer pricing. In countries with better investor legal protections such as the United States, managers utilize more indirect methods such as perquisite consumption and pursuit of pet projects. Unqualified managers may also engage in activities designed to promote their own job security at relatively high levels of compensation (Shleifer and Vishny, 1997).

In order to reduce the owner/manager agency problems, incentive-based compensation packages are proposed in order to better align the interests of managers with ownership (Jensen and Meckling, 1976; Fama, 1980). Studies suggest that due to the relatively small size of managerial ownership within the corporation, managers do not have incentive to maximize the interests of owners thus causing the owner/manager agency problem to remain (Morck, *et al.*, 1988). Firm owners can try to eliminate the owner/manager agency problems by employing more strict monitoring system independent of the control of management (Fama and Jensen, 1983). Monitoring can be performed by independent board of directors with the power to hire, fire, set compensation, and monitor major firm decisions.

Agency problems are not just limited to the inherent conflicts between owners and managers. Such problems also exist between controlling and minority shareholders (Shleifer and Vishny, 1997; LaPorta, *et al.*, 1999). Controlling shareholders can maximize their own interests at the expense of minority shareholders by using methods such as special dividend payouts proportional to ownership stake, self-dealings where the firm provides privileged services to other firms owned by the same controlling shareholders (Shleifer and Vishny, 1997).

Empirical research examining the pay-performance relationship to mitigate agency problems show mixed results. Jensen and Murphy (1990) find a significant positive relationship between executive compensation and firm performance. Likewise, Firth, *et al.* (2007) found a significant positive relationship between executive pay and firm performance in Chinese firms. Boyd (1994) shows that CEO compensation is negatively related to the degree of board control. Likewise,

Core *et al.*, (1999) show that lower levels of board control lead to greater CEO cash compensation. They conclude that weak governance mechanisms exacerbate management agency problems.

Board size has been found to be a significant factor in explaining firm performance. Studies show a larger board is less effective and results in a relatively lower firm value (Jensen, 1993). Similarly, if the CEO of the firm assumes the role of the chairman of the board of directors, the board will lack independence and will not be able to provide successful management monitoring and control. Similarly, boards dominated by outsiders have a higher independence and stronger control procedures than boards dominated by insiders (Hermalin and Weisbach, 1988). Chen, *et al.* (2006) found that a relatively higher proportion of outside directors served as an effective deterrent to wrongdoing and effectively reduced financial fraud in Chinese privatized firms.

Chinese publicly listed companies have two unique characteristics. First, most firms have highly concentrated ownership with approximately 60% of all shares controlled by the government or government-related agencies (Chen *et al.*, 2006). Second, the corporate governance of Chinese firms follows two-tier board system, where the board is composed of a supervisory board of directors and a hands-on board. The dual-board system is mandated for Chinese publicly listed firms by the China Securities Regulatory Commission (CSRC). The supervisory board portion of the two-tiered approach monitors the company's directors and top management. The hands-on tier is responsible for working with management on a firm's day-to-day operations. Chinese firms' board of director composition has steadily moved towards including more outside independent directors. Prior to 2001, there was no legal independent director requirement for Chinese listed firms. However, starting 2001, CSRC regulations require that each firm be composed of at least one-third independent directors. Furthermore, independent directors must be assigned important board roles on the nominating committee, audit committee, and the remuneration and appraisal committee. However, empirical evidence regarding the effectiveness of the board of directors in Chinese firms is mixed. Xi (2006) finds that the supervisory board is nothing more than a rubber stamp for the Chinese corporate governance system dominated by the government ownership. Xiao et al. (2004) refer to supervisory boards in China as being corporate captives referred to only as an "honored guest", "friendly advisor", or "a censored watchdog". On the other hand, Firth *et al.* (2007) report that supervisory board size and frequency of meetings were positively related to the informativeness of earnings reports to investors. Also, Lai and Tam (2007) show that for publicly listed Chinese firms, a higher percentage of independent directors on the board results in less income smoothing and higher quality accounting information. Kato and Long (2006) find that the adoption of independent directors by Chinese firms resulted in an improvement between the sensitivity of CEO turnover and firm performance.

HYPOTHESIS DEVELOPMENT

The corporate ownership structure in China is very different from the U.S. and other Western countries, the Chinese government and government related agencies have controlling ownership stakes in the majority of the Chinese privatized firms. Most of the listed firms on the two Chinese stock exchanges are privatized former state owned enterprises (SOEs). When the Chinese government privatized the SOEs, it kept a lion's share in most of the privatized companies. As a result, the government has a large controlling ownership in a large number of Chinese listed

firms. Another distinguishing feature of the Chinese firms is the presence of different types of shares. Non-tradable shares are owned by the government or government agencies or legal persons related to the government; those shares cannot be traded without the formal approval of the CSRC. Tradable shares include shares owned by domestic individuals and shares owned by foreign individuals.

According to LaPorta *et al.* (1999), firms controlled by large shareholders can encounter agency problems which pit the controlling shareholder against minority shareholders. The controlling shareholder attempts to maximize his welfare by influencing the decision of management. The benefits that the controlling shareholder extracts at the expense of other investors are referred to as the private benefits of control. The level of such benefits is in large part dependent on how well the interests of outside investors are protected in the firm's country. It should be noted that as a controlling shareholder obtains more private benefits, the outside investors' assessment of firm value declines. Morck and Yeung (2003) argue that decisions in firms with concentrated ownership are made for the benefit of controlling shareholders while at the same time harming the interests of minority shareholders. Large controlling shareholders place great value in the ability to control company management decisions even when the exercise of such control leads to poor firm performance.

In China, the government is the large controlling shareholder in a large number of Chinese firms, thus we hypothesize the following:

> *H1: Firms with higher government ownership will have lower impact on CEO compensation packages and the CEO compensation link with performance will be weak.*

Institutional ownership can benefit minority shareholders by reducing potential agency costs and ensuring that managers act in the best interests of shareholders. Starting 2001, private and Chinese institutional investors were allowed to take large ownership stakes in the Chinese privatized firms. Thus, they can provide effective monitoring of the management and affect key strategic policies in corporations including decisions on CEO compensation packages.

McConaughy (2000) and Block (2008) report that in the US and Germany, respectively, large private controlling shareholders influence the level of CEO compensation. CEOs in such firms may receive larger compensation packages if they maximize the overall shareholders' wealth. Consistent with this argument, we hypothesize the following:

> *H2: Firms with large private institutional ownership will likely have higher impact on CEO compensation packages and the CEO compensation link with performance will be strong.*

Recently, foreign investor activism has gained considerable attention both in financial press and academic circles. Foreign investors with major shareholdings would be expected to have an incentive to monitor the management and other controlling shareholders. Consistent with this view, large foreign owners can state that one of their main objectives is to reduce excessive executive compensation and strengthen the link between executive pay and performance (Brav *et al.*, 2008). Therefore, we hypothesize the following:

> *H3: A large foreign investor presence strengthens the link between CEO compensation and performance.*

Board of directors can play an important role in monitoring corporate decisions and protecting the interests of minority shareholders. One of the most important duties of the board of directors is to monitor decisions on executive compensation packages. Core *et al.* (1999) find that CEO compensation is higher when the proportion of independent directors is lower and board size is larger. Other board characteristics including the number of outside directorships held by directors could also influence their monitoring ability and might have implications for CEO compensation packages. Therefore, we hypothesize that:

> *H4: Firms with more independent directors on their board will likely have higher impact on CEO compensation packages and the CEO compensation link with performance will be strong.*

The characteristics of compensation committee have considerable impact on the effectiveness of the CEO compensation committee. Williamson (1985) argues that managers are likely to write their own pay contract with one hand and sign them with the other in firms without compensation committees. Main and Johnston (1993) point out that a compensation committee is expected to exert an influence on top executive pay, which should be set in the interests of shareholders. The role of the compensation committee is to design an appropriate executive pay package and align the interests of management and shareholders. The presence of independent directors is specifically crucial in the compensation committees. The presence of compensation committee is relatively new practice in China. It is widely argued that most boards and committees in Chinese firms lack independence because of government ownership. Following Newman and Mozes (1999) who found that the sensitivity of executive pay to performance is lower when at least one member on the compensation committee is an insider, we hypothesize that:

> *H5: Firms with more independent board members in their compensation committees will have higher control on the executive compensation packages and the CEO compensation link with performance will be stronger.*

DATA DESCRIPTION

The sample of firms used in this study is comprised of all the Chinese firms present in the CSMAR database during the period 2003-2008. In our sample, we excluded financial sector firms (banks, insurance companies, etc.) since their cash policies and accounting procedures differ from those of other industrial sectors. The sample consists of 469 firms over a 5 year time span. The executive compensation data is taken from the Sinofin Information Services; the data consists of executive cash compensation that includes salary, cash bonuses and equity compensation.

The descriptive variables in the table 1 are calculated as follows: total compensation of the top three executives of the firm in Renminbi (RMB) calculated as the sum of the highest-paid three executives divided by three. The total compensation of the top three directors of the firm in RMB calculated as the sum of the highest-paid three directors divided by three. Total executive pay is the total annual salary for all directors, supervisors and high level executives. Average executive pay is the total annual executive pay divided by the number of executives, supervisors and directors. Government ownership is the percentage of the shares owned by the Chinese government. Institutional ownership is the percentage of shares owned by other government agencies, state agencies and municipalities. Foreign ownership is the percentage of shares owned

Table 1
Descriptive Statistics

	Mean	*Median*	*Standard Deviation*
Panel A: Executive Compensation			
Total Compensation Executives	105,365.34	124,369.14	103.514.27
Total Compensation Directors	109,256.41	132,325.14	114,365.59
Total Executive Pay	987,368.214	1,362,321.84	841,236.36
Average Executive Pay	94,635.18	92,314.48	84,279.31
Panel B: Ownership Variables			
Government	51.36	42.29	41.57
Institution	11.57	7.13	21.63
Foreign Ownership	6.32	8.25	3.15
Private Ownership	11.36	7.54	5.12
Panel C: Board Characteristics			
Board of Directors Size	9.54	6.15	4.15
Board of Supervisors Size	5.28	2.24	1.87
Independent Directors	1.25	2.00	1.33
Number of Executives, Directors and Supervisors	12.52	6.11	3.14
Percentage of Independent directors in the Compensation Committee	38.46	68.28	49.82
Panel D: Firm Specific Variables			
Number of Employees	3,448.25	5,655.47	9,485.36
Market Capitalization (1000 RMB)	1,259,587.36	8,958,245.36	5,365,458.36
Sales (1000 RMB)	1,367,254.74	10,365,365.44	6,142,368.85
Total Assets (1000 RMB)	4,585,696.12	9,545,284.41	3,125,347.48
ROA	0.042	0.051	0.44
Market to Book Value	4.69	7.85	2.15
Annual Stock Return	0.143	0.09	0.584
Sales Growth	0.08	0.14	0.09

by foreign investors. Private ownership is a dummy variable equal to one if the firm is controlled by private individuals. The Board characteristic variables are: the size of the board of directors, the size of the board of supervisors, the total number of directors, supervisors and executives, the number of independent directors in the board and the percentage of the independent directors present in the compensation committee. Profitability variables include total sales, firm value measured as the total market value of the firm, the return on asset ratio (ROA), Market to Book ratio, the average annual stock return, the standard deviation of the annual stock returns, sales growth and total assets and the number of employees of the firm.

The sample used in the paper is fairly balanced between government and non-government firms with high government ownership firms representing 42% of our sample (median value). Other government related ownership represents about 7% of our sample (median value). Foreign ownership is about 8% while Local Chinese ownership is about 7.5% of the sample respectively. The average (median) CEO total compensation in our sample is 92,314.48 RMB.

The board size in the Chinese firms varies over a wide range. The mean value is about 9.5 while the median value is about 6, and a standard deviation of 4.15%. Our sample contains boards with wide range of sizes. We also notice that the board of supervisors is smaller in size in Chinese firms than the board of directors, the average size being about 5 members. The board of supervisors is responsible in monitoring the board of directors and the top level management in the Chinese firms, while the board of directors is responsible for working with management on a firm's day-to-day operations. We also notice that the number of independent board members is not very high. The average number of independent members is about 2 (median value).

EMPIRICAL ANALYSIS

To investigate the relationship between corporate governance variables such as government, institutional, foreign and private ownership controls and the pay-performance sensitivity of the CEO compensation packages, we use the following regression model:

$$LN(Compensation_{it}) = \alpha + \sum_{k=1}^{n} \phi_k Ownership_{it} + \sum_{l=1}^{m} \gamma_l Governance_{it} + \sum_{p=1}^{q} \delta_p ControlVariables_{it}$$

Where the dependent variable, Ln ($compensation_{it}$) is the log of CEO compensation which is measured by cash compensation (the sum of base salary and bonus). For our estimation, we use pooled OLS with robust standard errors when the dependent variable is the cash salary compensation and a pooled Tobit when the dependent variable is the total compensation includes bonus and equity compensation. We also include a year-specific dummy variable that varies across time to control for the effects of exogenous economic factors on CEO compensation during the sample period. An industry-specific dummy is also included to control for industry effects that influence the CEO compensation.

Following prior studies, two different measures of firm performance is used as control variables: market-based performance measure that is stock return, and accounting-based performance measure that is ROA. Agency theory suggests that a close link between CEO compensation and firm performance would help align the interests of shareholders with those of CEO and therefore give incentives to the CEO to perform better. As for corporate governance variables, we use board size, percentage of independent directors and percentage of independent directors in the compensation committee. We also include a dummy variable that is equal to 1 if the CEO of the company is also the chairman of the board of directors. Finally, we also include some firm-specific control variables such as firm size measured by the log of sales, the firm's growth opportunities measured by the sales growth. We control for the volatility of the stock return using the standard deviation of returns as control variable. Following Hartzell and Starks (2003), we use lagged explanatory variables to reduce the potential endogeneity problems in the regression models.

The results of Table 2 show that the coefficient estimate for government ownership control is positive and significant suggesting that firms with high government ownership might offer greater pay packages to the CEOs but despite their increasing ownership, they do not seem to provide monitoring for the CEO compensation by putting a check on it. Our finding is similar to

Kato and Long (2005) who find that high government ownership usually is associated with inflated CEO compensation packages. We observe that CEO pay is reduced when the firm is controlled by a private shareholder or a foreign shareholder has significant ownership stake in the firm. This evidence is consistent with the hypothesis that private ownership and foreign ownership increase the monitoring and the commitment of a CEO to the firm and thus the CEO would be less likely to leave the firm for another firm and more prone to accept a lower pay. On the other hand, CEOs in firms with high government ownership will be less secure about their job continuity and would want to earn more salary to compensate for any future layoffs. Institutional ownership has a positive and significant impact on the level of CEO compensation. Our results suggest that despite their relatively high ownership in Chinese firms, institutional investors such as other government agencies and state governments do not seem to provide effective monitoring of CEO compensation.

Table 2
Ownership, Corporate Governance and Compensation Regressions

	Executive Compensation	*Executive Compensation*	*Executive Compensation*
Intercept	0.069	0.051	0.185
Government Ownership	0.147**		0.112***
Institutional Ownership	0.015**		0.037*
Foreign	-0.035***		-0.018**
Private	-0.072**		-0.037
Board of Directors Size	0.171***		0.017
Independent Board	-0.116***		-0.153**
Compensation Committee	-0.236***		-0.184***
Log Sales		0.184*	0.234
Log Total Assets		0.364	0.187
Market to Book Value		0.682**	0.017*
Sales growth		0.153*	0.024*
ROA		0.031	0.125
Annual Stock Return		0.0648*	0.027**
Log Market Capitalization		0.027*	0.394
Log Employees		0.481	0.841

*, ** and *** are significant at 10%, 5% and 1% respectively.

The results of Table 2 show that the relationship between board size and CEO compensation is positive and significant. This finding supports the argument that larger boards can have problems in providing coordination, communication and monitoring the management, which can lead to higher CEO compensation without merit. For our sample of Chinese firms larger boards seem to be less effective in providing monitoring for CEO compensation packages. Larger boards are inherently more diverse, with members representing different type of ownerships which may become hard to provide a positive monitoring mechanism for the Chinese firms. The coefficient of the compensation committee variable is negative and significant which suggests that firms with more independent members on their compensation committees provide better monitoring and control of their managers and the CEO pay is better linked to performance.

Firm performance, measured by stock return, does have some impact on CEO compensation. This finding is similar to the results from prior studies reporting positive and significant impact of stock return on CEO compensation for UK and US firms (Ozkan, 2011; and Hartzell and Starks, 2003). We also observe that the coefficient estimate for Market to Book ratio, that combines accounting-based and market-based measure of firm performance, which is a measure of growth opportunities, is positive and highly significant. Similarly, the coefficient for sales growth is positive and weakly significant. Finally, we find that firm size, measured by log of sales, has a positive and but weak significant impact on CEO compensation. Overall, our findings are consistent with the literature where better performing firms provide higher compensation packages to their CEOs. Overall, the results provide strong support to all of the above hypotheses except hypothesis 2. The case of institutional ownership in China is different than in other countries. Chinese institutional ownership is comprised of state governments and government related agencies which do not have the same monitoring incentives as the institutional investors in the U.S. and other market economies.

Table 3
Ownership, Corporate Governance and Compensation Tobit Regressions

	Executive Compensation	*Executive Compensation*	*Executive Compensation*
Intercept	18.36	18.18	19.17
Government Ownership	0.527***		0.187***
Institutional Ownership	0.023**		0.128*
Foreign	-0.184***		-0.027**
Private	-0.123**		-0.365
Board of Directors Size	0.271**		0.128
Independent Board	-0.128**		-0.138**
Compensation Committee	-0.315***		-0.259***
Log Sales		0.214*	0.410
Log Total Assets		0.547	0.271
Market to Book Value		0.428**	0.036*
Sales growth		0.108*	0.037*
ROA		0.374	0.274
Annual Stock Return		0.290*	0.041**
Log Market Capitalization		0.117*	0.137
Log Employees		0.384	0.412

*, ** and *** are significant at 10%, 5% and 1% respectively.

Table 3 presents the estimates of Tobit models for CEO compensation. We observe similar results as with our OLS regression analysis. Overall, the results suggest that firms with high government ownership offer a higher remuneration to their CEOs than non-government owned firms. We also find evidence that firms where foreign or private ownership is high, CEOs receive a lower compensation. We also find that institutional investors, far from monitoring and help reducing the CEO pay, have a positive effect on executive compensation. Our results indicate that the CEO pay-performance sensitivities are higher when the board size is small and when the compensation committee is composed of independent members. The results of table 3 reconfirm all the hypotheses except hypothesis 2.

In Table 4 we consider the interaction of ownership and stock return variables to investigate whether different ownership concentrations and governance characteristics can play a significant monitoring role in determining CEO compensation in Chinese firms.

Table 4
Ownership, Stock Returns and Compensation Interactions OLS Analysis

	Executive Compensation	*Executive Compensation*	*Executive Compensation*
Intercept	2.781*	3.84**	3.27*
Government Ownership	0.384**		0.181*
Institutional Ownership			0.187
Foreign		0.058	0.036
Private		0.013	0.041
Board of Directors Size			0.113*
Compensation Committee			-0.314***
Gov*Return	-0.184		-0.625
Inst*Return	-0.574		0.821
Foreign*Return		0.271***	0.058**
Private*Return		0.117***	0.013**
BoardSize*Return	-0.245***		-0.841*
Board Indp*Return	0.368***		0.115**
CompComm*Return	0.452***		0.028**

*, ** and *** are significant at 10%, 5% and 1% respectively.

The coefficient for the interaction term between government ownership and stock returns in table 4 is not significant, which indicates that government ownership does not provide active monitoring of the CEOs and the pay packages are not related to the CEO's performance. Our results indicate that even though firms with high government ownership provide higher CEO compensation packages, however this high compensation is not related to the firm performance and achievement of better results of the CEO, rather it seems that the higher compensation of the CEOS in high government ownership firms have other motives than the performance based compensation. This result is consistent with our hypothesis 1.

Similarly, we find that the interaction term between the institutional investors and stock returns is not significant. Therefore, we can affirm that ownership by states or government related agencies does not provide the positive monitoring effect on their CEO and the high compensation of those CEOs is not the results of their high performance. This result contradicts our second hypothesis, where we state that higher institutional ownership increases monitoring control and enhances pay-performance sensitivity of CEOs. The nature of the institutional owners in China is completely different from the institutional owners elsewhere; in China, institutional owners are state and other government agencies. Therefore, the contradictory results to hypothesis 2 makes a lot of sense since any type of government ownership does not provide the required monitoring and control of CEOs.

Concerning foreign and private investors, the results of table 4 are highly significant. Both coefficients of the interaction terms between foreign and private investors with the stock returns are positive and significant. Foreign and private investors provide higher pay packages when

the CEO of the company performs better, this result is consistent with Kato and Long (2006) where they also find the positive monitoring and control provided by the presence of foreign or private investors in Chinese firms. Unlike the high pay of CEOs in high government owned firms, the CEOs in firms with significant private ownership and foreign ownership do need to achieve better results in order to receive higher compensation.

The corporate governance variables interactions terms with return also provide some very interesting results. The board size with returns is negative and significant which means that the size of the board is not linked to the stock performance. This result is similar to our earlier reported result about the board impact on monitoring and control of managers, larger boards due to their diversity tend to be less effective in monitoring the managers. However, we find positive and significant coefficients for both board independence and compensation committee variables with returns, which confirm our previous results. When the board is composed of more independent members or when the compensation committee includes more independent members, the monitoring and control of management is stronger and the pay-performance sensitivity is stronger.

Table 5
Ownership, Stock Returns and Compensation Interactions Tobit Analysis

	Executive Compensation	*Executive Compensation*	*Executive Compensation*
Intercept	4.28**	5.12**	4.86*
Government Ownership	0.523***		0.221*
Institutional Ownership			0.328
Foreign		0.129	0.084
Private		0.117	0.095
Board of Directors Size			0.175
Compensation Committee			-0.236***
Gov*Return	0.217		-0.269
Inst*Return			0.458
Foreign*Return		0.374***	0.084**
Private*Return		0.238***	0.038**
BoardSize*Return	-0.147**		-0.158*
Board Indp*Return	0.236***		0.354**
CompComm*Return	0.184***		0.247**

*, ** and *** are significant at 10%, 5% and 1% respectively.

Table 5 presents the estimates of Tobit models for CEO compensation and the interaction terms between ownership, board size and stock returns. We observe similar results as with our OLS regression analysis as in table 4.

Overall, we find that the pay package of Chinese CEOs seems more sensitive to firm performance if the firm has significant private or foreign ownership. CEO compensation does not depend on stock price performance in firms with high government ownership or in firms with institutional ownership. This finding suggests that there is a sort of over compensation that government offers to their executives which is not necessarily based on those executives performance. We also find that the independence of the board is

CONCLUSIONS

In this paper, we analyze the role of controlling government, institutional investors, private and foreign shareholders and their interaction, in determining CEO compensation packages. We also look at the characteristics of the board of governors and their role in controlling and monitoring managers and setting their compensation packages. Given the prevalence of concentrated ownership structures in China where the Chinese government owns large, and often controlling, equity stakes in listed firms, it is important to improve our understanding of how CEO incentives and compensation packages differ from those in the United States and other western countries where most listed firms are widely-held and concentrated ownership by single shareholders is relatively rare.

Our results show that Chinese firms with high government or institutional ownership provide high CEO compensation packages, but the high compensation is not based on the performance of those CEOs but rather it has other reasons. We also find that firms with significant private or foreign ownership tend to compensate their CEOs based on their performance, unlike the firms with high government ownership. We also provide strong evidence on the effect of board independence on executive pay-performance for Chinese listed firms. We find that independent boards are more effective in providing monitoring and control, although the size of such independent boards are not very high in Chinese listed firms. We also find that, when monitoring and control are effectively managed, the CEO's compensation is related more to market performance of the firm rather than accounting performance.

Overall, our results suggest than independent directors on board are more likely to be a good governance mechanism in setting optimal executive compensation. Also, our results suggest that private and foreign ownership provide positive monitoring and control in Chinese firms, unlike the government or institutional ownership.

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