The Influence of Intra-temporal Duality on Agency Cost and Agency Efficiency: Future Government Bureaucrats and Existing CEOs

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Abstract. China’s economic is changing from planned economy to market economy and partial privatization of state-owned enterprises (SOEs) is also a common problem which many emerging countries will face in the transition period. We find that both agency cost and agency efficiency of SOEs are higher than non-SOEs. We also find the main reason of higher agency efficiency of China’s SOEs is that CEOs want to be government bureaucrats so they work hard-political consideration.

Introduction

During the economic reforms of the 1980s, China’s economic was rapidly developed. There is many interesting phenomenon in the development process of Chinese enterprises. China’s economic is changing from planned economy to market economy and partial privatization of state-owned enterprises (SOEs) is also a common problem which many emerging countries will face in the transition period. Thereby, a lot of researches are focused on this problem. We find that both agency cost and agency efficiency of SOEs are higher than non-SOEs. In order to explain these results, we have discussed it with many people who have worked in SOEs as well as professors. All of us totally agree that higher agency cost is due to low level of salary which cannot meet CEOs’ requirements. Therefore, they use their authorities to realize more on-the-job consumption. The main reason of higher agency efficiency is that CEOs hope to become a government bureaucrat so they work hard. In other words, they consider more about their political future.

In China, many hard-working CEOs of SOEs was promoted to be political leaders. For example, Jia Qinglin, Chairman of Chinese People's Political Consultative Conference, used to be CEO of China National Machinery & Equipment Import & Export Corporation; Zhou Yongkang, Secretary of the Central Political and Legal Commission, used to be CEO of PetroChina Company Limited; Liu Qing, Beijing Party Secretary, used to be CEO of WuHan Iron and Steel (Group) Corp; Wu Yi, Chinese Vice Premier, used to be Deputy manager of Sinopec Beijing Yanshan Chemical Corporatin which is the biggest Petrochemical company in Beijing. Recently, Guo Shengkun, board chairman of Aluminum Corporation of China Limited (CHALCO), was promoted to be Party Secretary of Guangxi province and Zhu Yanfeng, CEO of China FAW Group Corporation (FAW) was promoted to be Vice Governor of Jilin province. Guo Shengkun worked in non-ferrous metals industry in long period. Guo Shengkun was CEO of CHALCO when it was established in February 2001 and in the end of that year CHALCO went public on New York and Hong Kong Stock Exchange separately. Also in that year, output value of CHALCO jumped to six in the ranking of global non-ferrous metal industry. To the end of 2003, the profit of CHALCO was 4.3 billion Yuan and it became one of global top 500. Zhu Yanfeng was CEO of FAW when he was thirty-eight years old. Due to his hard work, the profit of FAW increased from 150 million Yuan in 1998 to 3.5 billion Yuan in 2006. Because of these successful former examples, CEOs of SOEs have enough motivation to believe that if they work hard they will obtain better political development. In other words, they will be from a CEO to a government bureaucrat. China is a high level corruption country and government bureaucrats always use their authorities to earn huge additional income.

In conclusion, we find the main reason of higher agency efficiency of China’s SOEs is that CEOs
want to be government bureaucrats so they work hard-political consideration. It is an interesting problem to research. On the one hand, you can find enough samples in China. On the other hand, the research will make contribution to corporate governance and agency-principle problem. Most importantly, it is not unique to China and it is an important and common issue that many counties, especially emerging counties, should solve recently. The purpose of this paper is to illustrate agency cost and agency efficiency of SOEs in China and explain the reasons of this phenomenon combined with China institutional background-political consideration.

**Literature Review**

Managers (agent) had opportunities to make decision in accordance with their own benefit because of the separation of security ownership and control (Fama, 1980). Jensen and Meckling (1976) defined an agency relationship as a contract under which one or more persons (the principal(s)) engaged another person (the agent) to perform some service on their behalf which involved delegation some decision making authority to the agent. They defined agency cost as the sum of the monitoring expenditures by the principal, the bonding expenditures by the agent, the residual loss.

As for the measurement of agency cost, Antonio S. Mello and John E. Parsons (1992) measured it by the different income of capital structure (with debt and not). Ang et al (2000) used two alternative measures of agency cost. The first was direct agency cost, calculated as the difference in dollar expenses between a firm with a certain ownership and management structure and the no-agency-cost base case firm. This measure captured excessive expenses including perk consumption. This first measure of agency cost was calculated as the ratio of operating expense to annual sales. Their second measure of agency cost was a proxy for the loss in revenues attributable to inefficient asset utilization, which could result from poor investment decisions (e.g., investing in negative net-present-value assets) or from management’s shirking (e.g., exerting too little effort to help generate revenues). This second measure of agency cost was calculated as the ratio of annual sales to total assets, an efficiency ratio. They could then measure agency cost as the difference in the efficiency ratio, or, equivalently, the dollar revenues lost, between a firm whose manager was the sole equity owner and a firm whose manager owned less than 100 percent of equity.

Manohar Singh and Wallace N. Davidson (2003) measured agency cost using data from American large companies by sales on total assets and operating expense ratio consulting Ang. In this paper, I use operating expense-to-annual sales ratio as the proxy for agency cost and use annual sales-to-total assets ratio as the proxy for agency efficiency.

Anget al (2000) suggested that the factors which had impact on agency cost and agency efficiency included ownership structure, external monitoring by banks, firm’s age, industry and size. In this paper, I use ownership share of the largest shareholder as the proxy of ownership structure, the firm’s debt-to-asset ratio as the proxy of external monitoring by banks and the natural logarithm of sales as the proxy of firm’s size.

Joseph P.H. Fan, T.J. Wong and Tianyu Zhang (2007) found that firms with politically connected CEOs underperformed those without politically connected CEOs by almost 18% based on three-year post-IPO stock returns and had poorer three-year post-IPO earnings growth, sales growth, and changed in returns on sales. The negative effect of the CEO’s political ties also showed up in the first-day stock return. They focused on former government bureaucrats and existing CEOs. I am interested in existing CEOs and future government bureaucrats. In this paper, I hope to find the behavior characteristics of CEOs because they want to be promoted as government bureaucrats and illustrate these behavior characteristics how to influence agency cost and agency efficiency of SOEs.

**Research Design**

**Variable Design**

Dependent variables (AC) = OperatingExpense/AnnualSales

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Dependent variables (AE) = AnnualSales/TotalAssets

Independent variable (Property) is the property of firm’s actual control entity including state-owned enterprises and non-state-owned enterprises. We obtain the data from CSMAR database directly. Independent variable is a dummy variable.

Control variables include the ownership share of the largest shareholder (OS), the firm’s debt-to-asset ratio (D/A), firm’s age (Age), industry (Ind) and the natural logarithm of sales (logSale).

Data Resource

CSMAR Annual Financial Report Database and Shareholder Research Database of Listed Companies in China provided by GTA Information Technology Co. Ltd.

The sample is A-share listed companies in Shanghai and Shenzhen Stock Exchange from 2012 to 2016. We have eliminated the financial companies (industry code is I) and ST, *ST companies (these companies have been punished by China Securities Regulatory Commission during this period).

Methodology

We mainly use Multivariate Regression Analysis and Event Study.

Stage 1. Primarily, we investigate the correlation between the property of firm’s actual control entity and agency cost and agency efficiency. There is a relationship between them or they don’t have significant relationships. In addition, we hope to find the differences between SOEs and non-SOEs in agency cost and agency efficiency.

![Correlations Table]

**Correlation** is significant at the 0.05 level (2-tailed).

**Correlation** is significant at the 0.01 level (2-tailed).

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<thead>
<tr>
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<th>AE</th>
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<th>PROPERTY</th>
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<tr>
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<td>AC</td>
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T-Test

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Primarily conclusion: there is a correlation between the properties of firm’s actual control entity and agency cost and agency efficiency. Moreover, both agency cost and agency efficiency of SOEs is higher than those of non-SOEs.

**Stage 2.** Adding control variables, we further research whether primarily conclusion of the first stage is still right or not.

\[
AC = \alpha + \beta_{\text{Property}} + \beta_{1}\text{OS} + \beta_{2}\text{D}/\text{A} + \beta_{3}\text{Age} + \beta_{4}\text{Ind} + \beta_{5}\log\text{Sale} + \varepsilon
\]

\[
AE = \alpha + \beta_{1}\text{Property} + \beta_{2}\text{OS} + \beta_{3}\text{D}/\text{A} + \beta_{4}\text{Age} + \beta_{5}\text{Ind} + \beta_{6}\log\text{Sale} + \varepsilon
\]

**Stage 3.** We investigate the characteristics of agency cost and agency efficiency of SOEs in the perspective of future government bureaucrats. We plan to manually collect CEO data from financial reports, Internet and other available resources. For each CEO who has been promoted to be a government bureaucrat, we make a file of CEOs and SOEs. In addition, the file typically contains information on CEOs’ name, age, gender, education, background, promotion time, existing position and information on SOEs’ operating expense, sales, assets, ownership structure, debt-to-asset ratio, age and industry and so on.

**Conclusion**

We set the promotion time is \(t + 1\), and compare the differences of agency cost and agency efficiency in \(t\) and \(t - 1\) separately. If agency efficiency in \(t\) is significant higher than that in \(t - 1\), that is to say CEOs’ hard word is due to their political consideration. This is an event study and the length of window is two years.

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\begin{align*}
&[\quad \text{t}_1 - \quad \text{t}_0 \quad \text{t}_1] \\
&\text{t}_0 < \text{t}_1 < \text{t}_0 + 2
\end{align*}
\]

We divide the SOEs into two groups: SOEs with CEOs who have been promoted to be government bureaucrats and SOEs without CEOs who have been promoted to be government bureaucrats. We compare the agency cost and agency efficiency of these two groups. We find that agency efficiency of SOEs with CEOs who have been promoted to be government bureaucrats is
significant higher than that of SOEs without CEOs who have been promoted to be government bureaucrats, that is to say CEOs’ hard word is due to their political consideration.

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