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## FIRM-SPECIFIC CHARACTERISTICS AND TECHNICAL EFFICIENCY OF ELECTRONICS MANUFACTURING FIRMS IN CHINA

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**ABSTRACT:** *This paper analyses the technical efficiency and total factor productivity (TFP) growth of China's electronics industries from 2006 to 2010 using stochastic production frontier model. The estimates show that the mean technical efficiency scores of electronics firms in Hong Kong and Mainland China are 63% and 90%, respectively. The estimation using the technical inefficiency effects model further reveals that firm specific characteristics, namely the capital structure, profitability, firm size and regional location, are crucial determinants of firms' efficiency. Since firm size has a positive effect on inefficiency, small and medium-sized electronic firms appear to demonstrate a higher level of efficiency than their larger counterparts. In the TFP analysis, Hong Kong firms recorded both higher TFP growth and technological progress compared to their Chinese counterparts. In contrast, Mainland Chinese firms performed better in the context of managerial and scale efficiency.*

**JEL Classification:** *D24, L25, L63.*

**Keywords:** *firm-specific characteristics, stochastic frontier analysis, electronics manufacturing firms, technical efficiency, total factor productivity, China.*

### 1. INTRODUCTION

China has emerged as the world's factory - especially in the production of textiles and clothing, toys, leather products, and electronic appliances - a few decades after its liberalization. The Chinese electronics information industry in particular, has captured a major market share in the world, mostly in the form of original equipment manufacturing (OEM). Not surprisingly, recent figures released by China's Ministry of Industry and Information Technology (MIIT) showed very positive outlook for the industry.<sup>1</sup> In essence, the manufacturing sector contributed close to one-third of the country's GDP from 2006 to 2010.<sup>2</sup> Meanwhile, the export value of mechanical

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and electronics products top US\$933.4 trillion in 2010, representing a 30.9% increase from 2009 (The National Bureau of Statistics of China<sup>3</sup>). Evidently, China has become a major world-class player in the electronics industry in terms of manufacturing volume, accounting for more than 25% of the world's overall manufacture of electronics. Nevertheless, with regards to the export amount, these products only represent about 9% of the world's total export value of electronics. The rapid growth and development of the industry have aroused the interest and attention of researchers especially in the identification of the pivotal factors that have driven the sector over the years.

The main aims of this paper are two folds. First, we want to determine the technical efficiency of the Chinese electronics sector. Secondly, we want to investigate whether firm-specific characteristics such as capital structure, profitability, firm size and regional location affect its efficiency.

We expect to shed some light on the growth and development of electronic industry in China, given the dearth of papers that examine the productive efficiency and competitiveness of this sector. We believe such a study is both interesting and important because manufacturing is one of the key industries in China, in which the electronics industry continues to gain more prominence over the years. The study of productivity and technological progress in the Chinese economy is important as the country has witnessed phenomenal rise in their economic growth since its entry into the World Trade Organization (WTO) in 2001. As our research looks into the productivity and technical efficiency of Chinese manufacturing firms, we believe our paper is timely since the Chinese manufacturing industries is still in the process of catching up in many ways to the more advanced nations like the US and Japan despite its massive economic growth over the last decade or so. Our findings would also be useful for policymakers in terms of policy direction and resource allocations into the electronics manufacturing sector to ensure its long term growth viability in an increasingly open and liberalized Chinese economy.

This paper employs stochastic production frontier analysis (SFA) to estimate the technical efficiency of electronics firms in China, and subsequently investigates whether certain firm-specific features influence firms' efficiency using the technical inefficiency effects model.<sup>4</sup> Being the first study to estimate the technical efficiency of the Chinese electronics firms, we expect to provide some crucial insights on the potential pathway that the Chinese electronics sector can explore to enhance its value-added chain and improve its long-term competitiveness in the world market.

We proceed as follows. Section 2 explains factors that contribute to firm's efficiency and our hypotheses. Section 3 and 4 cover the methodology and data. Section 5 reports the empirical findings. Section 6 concludes.

## **2. FACTORS CONTRIBUTING TO FIRM'S EFFICIENCY AND HYPOTHESIS**

Several factors affect the productive efficiency of firms. In this study, we emphasize the impacts of four firms' characteristics on the employment of production resources. They are firm's capital structure, their profitability, size and regional location.

For capital structure, the agency costs hypothesis by Jensen and Meckling (1976) pointed out that higher leverage generates incentives for managers to perform more in the interests of shareholders (thus decreases the propensity to commit moral hazard), which in turn should raise firm's performance. However, it is widely recognized that the effect of leverage on total agency costs is expected to be non-monotonic that when leverage exceeded the optimal capital structure, it may raise the costs of financial distress, liquidation or bankruptcy. As such the agency costs of outside debt may overwhelm the agency costs of outside equity, so further increases in leverage result in higher agency costs overall.<sup>5</sup> The first argument leads to the following hypothesis:

*H<sub>01</sub>: Firm with lower leverage is expected to lower agency costs, increase efficiency and thereby lead to an improvement in firm's performance.*

In the literature, various measures of firm performance have been used in testing the predictions of the agency-cost hypothesis. Demsets and Lehn (1985) used financial ratios from balance sheet and income statements; Cole and Mehran (1998) opted for stock market returns and their volatility; Himmelberg *et al.* (1999) and Zhou (2001) utilized Tobin's q (which mixes market values with accounting values). Elsewhere, Becchetti and Sierra (2003) argued the significance of non-financial data as predictors of firms' successes. The contrasting of opinions is unsurprising given that the empirical evidence on the agency costs hypothesis in the finance literature as a whole is mixed. In view of this, we address this measurement issue by using efficiency levels derived from SFA as the indicator of firms' performances. This is based on the fact that efficiency is a measure that is related to the concept of value maximization, and it is therefore, a reliable barometer on the efficacy of managers raising revenues while also controlling costs.

The effect of firm size on technical efficiency is less obvious, however. Jovanovic (1982)'s model supports that larger firms are more efficient than smaller ones given that larger firms are more diversified, have better technology and managers, superior training support than smaller firms and also have more qualified human capital resources. In addition, larger firms are also likely to benefit from innovation for the reason that large firms incur lesser duplicative attempts and investments which in the case of smaller firms would prove less cost-effective (Wu *et al.*, 2007 and Tabak and Tecles, 2010). On the contrary, Ma (2002) and Aggrey *et al.* (2010) contended that small and medium-sized firms are superior at adjusting to environmental variation than larger firms. In addition, direct involvement of shareholders in productive operations lessens agency expenses in small companies relative to larger ones; the delegation process in the latter is likely to lead to greater incidents of adverse selection and moral hazard. Agell (2004) claimed that workers of small firms are induced by competitive-based incentive plans instead of monetary inducements, which suggests smaller firms are more efficient. Based on these literatures, we form the following hypothesis:

*H<sub>02</sub>: The larger the firm size, the lower the unit cost in terms of the firm's management, lead to higher firm's efficiency than smaller firms.*

In the case of firm profitability, the hypothesis states that efficiency is significantly correlated with expected returns in firms. Efficiency has been found to be directly associated with returns on assets and returns on equity (see Fama and French, 2002; Cheng and Tzeng, 2011). Other evidence advocates like DeYoung *et al.* (2001) state that efficiency is fairly steady over time

and high efficiency would translate to higher potential expected returns. It is therefore reasonable for us to set the third hypothesis as:

$H_{03}$ : Profitable firms are more efficient.

Finally, we believe that regional location is also a determinant of efficiency in the production of electronics components. This argument is in line with many academic papers that cite the theory of “location economies” or “clustering”.<sup>6</sup> The null hypothesis is formulated as follows:

$H_{04}$ : There are similarities in technical efficiency between the electronics firms in Hong Kong and Mainland China.

### 3. METHODOLOGY

From an economic perspective, all firms are assumed to operate on the frontier in which the highest production is attainable with the existing technology and factors of production. Many past studies on production functions also presume that firms are functioning at this frontier apart from a randomly distributed error term. Conversely, there are ample empirical evidences that show firms operating inside the frontier; they are technically inefficient. Consequently, most empirical approaches explicitly let production to take place beneath the frontier. These approaches include stochastic production frontier models developed by Farrell (1957) and later popularized by Aigner, *et al.* (1977) and Meeusen and van den Broeck (1977). In addition, Battese and Coelli (1995) put forward a random effects model for stochastic frontiers to estimate technical efficiencies that have been adjusted to consider for external factors such as geographical factors or infrastructural conditions.

Our paper follows the approach of Battese and Coelli (1995) as we estimate the coefficients of the stochastic production frontier and the inefficiency model concurrently using maximum likelihood approach.<sup>7</sup> If we denote  $Y_{it}$  (in logarithm) to represent revenues deflated by the Producer Price Index (PPI) at constant 2005 prices of the  $i$ th firm at time  $t$ , the stochastic production frontier, which includes a random error term, can be formulated as follows:

$$Y_{it} = f(X_{it}, \beta, t) \text{ with } \varepsilon_{it} = v_{it} + u_{it}, u_{it} \geq 0 \quad (1)$$

where  $i = 1, 2, \dots, m$  represents the electronics firm and  $t = 1, 2, \dots, T$  represents the time trend and proxy for technological progress.  $X_{it}$  is a vector of inputs that comprises of logarithm net fixed asset ( $K$ ) and labor force ( $L$ ) for firm  $i$  at time  $t$  with  $\beta$  as a vector of unknown parameters identified as elasticity. The term  $\hat{\lambda}_{it}$  represents the stochastically composed (random) error term. The random error term is decomposed into two unobservable components, statistical noise ( $v_{it}$ ) and technical inefficiency ( $u_{it}$ ) that are independent of each other. The statistical noise,  $v_{it}$  is a two-sided error term and is assumed to be independently and identically distributed (i.i.d.),  $N(0, \sigma)$ . It captures measurement error and random variation in production due to factors beyond the control of firms such as labor strikes, luck, war as well as the pooled effects of unidentifiable factor inputs in the production function. The one-sided error term  $u_{it}$  captures technical inefficiency in production, which is assumed to be firm-specific, non-negative random variables, independently distributed as non-negative truncations (at zero) of the distribution  $N^+(\delta z_{it}, \sigma)$ . The one-sided inefficiency effect for the panel data model is specified as follows:

$$u_{it} = \delta z_{it} + \omega_{it} \quad (2)$$

where  $z_{it}$  represents a vector of firm-specific factors that determine the technical inefficiency and  $d$  is a vector of coefficients to be identified in the inefficiency model. In this study, the firm-specific factors contributing to inefficiency include capital structure, profitability, size of firm, and regional differences of electronics firms as discussed in Section 2. The term  $w_{it}$  denotes the truncations of the distribution  $N(0, s)$ .

The technical efficiency scores of firm  $i$  at time  $t$  are defined as the ratio of the actual output for the  $i$ th firm relative to the corresponding frontier function (the maximum achievable output), i.e.,  $TE_{it} = \exp(-u_{it}) = \exp(\delta z_{it} + \omega_{it})$ . This technical efficiency measure takes a value between zero and one, with one signifying the firm being totally productive efficient and the actual output attaining its highest achievable amount; a technical efficiency of less than one signifies the existence of technical inefficiency on the component of the firm, i.e., the firm could have produced more output given the inputs being employed.

The production technology is assumed to be described by the transcendental logarithmic form, translog, as suggested by Christensen *et al.* (1973), which provides a second-order Taylor-series approximation to any twice-differentiable production function. Formally, our estimated empirical model is a translog production function of  $f(X_{it}, \beta, t)$  as follows:

$$\begin{aligned} \ln(Y_{it}) = & \beta_0 + \beta_K \ln(K_{it}) + \beta_L \ln(L_{it}) + 0.5\beta_{KK} \ln(K_{it})^2 + 0.5\beta_{LL} \ln(L_{it})^2 + \beta_{KL} \ln(K_{it})\ln(L_{it}) \\ & + \beta_t t + 0.5\beta_{tt} t^2 + \beta_{Kt} \ln(K_{it})t + \beta_{Lt} \ln(L_{it})t + v_{it} - u_{it} \end{aligned} \quad (3)$$

where  $Y$  is real revenue,  $K$  is real net value of fixed assets,  $L$  is labor and subscripts  $i$  and  $t$  indicate the  $i$ th firm at  $t$ th year. The time variable  $t$  is included as a regressor in order to capture neutral technical progress in production. This indicates that some of the shifts in the production frontier are allowed to occur independently of changes of the inputs. In addition, this model is chosen due to its adequate and flexible functional form, which is confirmed by the likelihood ratio (LR) test conducted in the Section 5.<sup>8</sup>

Equation (4) shows the inefficiency-effects model that we use to examine the factors affecting technical inefficiency.

$$u_{it} = \delta_0 + \delta_{LEV} LEV_{it} + \delta_{ROA} ROA_{it} + \delta_{SIZE} SIZE_{it} + \delta_T T + \delta_{REG} REG_{it} + \omega_{it} \quad (4)$$

where  $LEV$  is leverage of the firm,  $ROA$  is Return on Assets,  $SIZE$  is size of firm,  $T$  is time trend,  $REG$  is regional location dummy variable. The expected sign of the  $LEV$ 's coefficient is positive and the expected sign of  $ROA$ 's,  $SIZE$ 's and  $REG$ 's coefficients are negative as discussed in Section 2.

Following Kumbhakar and Lovell (2000), total factor productivity change (TFPC) is decomposed into three sources: technical change (TC), technical efficiency change (TEC) and scale change (SC). Technological progress represents the fractional derivative of the production function with respect to time, scale component as the elasticity contribution to the TFP growth (TFP change) and the TEC as the derivative of technical efficiency with respect to time. Thus, TC, TEC and SC, respectively, can be measured as follows:

$$TC = \frac{\partial \ln f(x_i, t)}{\partial t} = \hat{\beta} + \hat{\beta}_t t + \hat{\beta}_K \ln(K_{it}) + \hat{\beta}_L \ln(L_{it}) \quad (5)$$

$$TEC = \frac{d \ln TE}{dt} = \frac{TE_{t+1} - TE_t}{TE_t} \quad (6)$$

$$SC = (e - 1) \sum_j \left( \frac{e_j}{e} \right) \dot{x}_j \quad (7)$$

where  $e_j, j = 1, 2, \dots, J$  are elasticities of output with respect to input  $j$ ,  $e = \sum_j e_j$  and  $\dot{x}_j$  represents the growth rate of input  $x_j$ .

#### 4. DESCRIPTION OF DATA USED

The panel data is provided by Economic Databases for Emerging and Developed markets (CEIC). Due to the deficiency of data, the balanced panel data of 350 observations in total for a sample of 70 Chinese electronics manufacturing firms over the period 2006 to 2010 are used to measure the co-efficients of the stochastic frontier production function explained above. Gross total output,  $Y$ , is the total revenue of firm; capital,  $K$ , the net value of fixed assets;  $L$ , is the total number of employees. Number of employees is used in lieu of man hours owing to the inaccessibility of the data. All monetary variables are controlled for inflationary effects by deflating a PPI deflator and hence these variables are in 2005 Chinese Yuan price (RMB). The deflator is provided by OECD Stat ([www.stats.oecd.org](http://www.stats.oecd.org)). The leverage of the firm (LEV) is measured as the ratio of total debts to total assets and the return on assets (ROA) defined by the ratio of total returns to total assets. Firm size and regional location of a firm are denoted by dummy variables. The binary variable for size, SIZE, is denoted as:  $SIZE_i = -1$  if the number of full-time employees of the  $i$ th firm is less than 50 (small firm),  $SIZE_i = 0$  if the number of full-time employees of the firm is in the range of 51 and 150 (medium firm) and  $SIZE_i = 1$  if the number of full-time employees of the firm is more than 150 (large firm). The regional location (REG) variable takes the value 1 if a firm is located in the Mainland China and 0 for a firm located in Hong Kong. The descriptive statistics for the electronics firms in our sample are presented in Table 1. The substantial diversity in size between the sample firms is exhibited by the values of the standard deviations of the variables for output and capital, which are greater than twice of their respective averages. It is also observed that the mean and median are not equal, implying that the variables may not be normally distributed; this could be a problem if ordinary least squares (OLS) regression is employed.

**Table 1**  
Summary statistics for electronics firms in China

<i>Variables</i>	<i>Mean</i>	<i>Median</i>	<i>Standard Deviation</i>	<i>Minimum</i>	<i>Maximum</i>
Y	55,269	15,011	104,836	71	905,364
K	9,414	2,799	20,295	40	159,740
L	9,891	4,357	17,854	5	126,687
LEV	0.5195	0.4895	0.2964	0.0720	4.2510
ROA	1.2120	2.5180	13.4837	-120.4800	27.3200
SIZE	0.9143	1.0000	0.3686	-1.0000	1.0000
REG	0.5428	1.0000	1.0000	0.0000	1.0000

Note: 350 observations.

## 5. RESULTS AND DISCUSSION

### 5.1. Results from the Stochastic Production Frontier Estimations

The Stochastic Frontier Analysis Program (FRONTIER 4.1), developed by Coelli (1996), was used to estimate the model specified in Eq. 3.<sup>9</sup> The coefficients of the model thus obtained are presented in Table 2.

**Table 2**  
Panel Estimation of Stochastic Frontier Production Function for Chinese Electronic Firms

Variable	Parameter	Coefficient	Standard error	t-ratio
<i>Production function</i>				
Intercept	$\beta_0$	2.1080*	0.0927	22.7280
ln(K)	$\beta_K$	0.3712*	0.0380	9.7773
ln(L)	$\beta_L$	0.5740*	0.0382	15.0204
0.5ln(K) <sup>2</sup>	$\beta_{KK}$	0.1337*	0.0487	2.7454
0.5ln(L) <sup>2</sup>	$\beta_{LL}$	0.1107*	0.0206	5.3719
ln(K)ln(L)	$\beta_{KL}$	-0.1187*	0.0275	-4.3159
t	$\beta_t$	0.3319*	0.0563	5.9001
0.5(t) <sup>2</sup>	$\beta_{tt}$	0.0243	0.0556	0.4369
ln(K)t	$\beta_{Kt}$	-0.0655*	0.0241	-2.7216
ln(L)t	$\beta_{Lt}$	0.0634*	0.0162	3.9248
<i>Variance parameters</i>				
Sigma-squared	$\sigma^2$	0.6733*	0.0501	13.4320
Gamma	$\gamma$	0.9999*	0.0000	10318935
Log-likelihood function	LR	-394.4706		

Note: The asterisk \* indicates that coefficients are statistical significant at the 1% level of significance

At the first glance, the parameter of gamma ( $\gamma$ ) is 0.9999 and rejected at 1% level significance level. This indicates that the deviation from the frontier is due entirely to inefficiency. The large value of  $\gamma$  also confirms that the estimates from the maximum likelihood are superior to those of the OLS approach in modeling the production function of the Chinese electronics firms. As the technical inefficiency effects have significant impact on the output (i.e. there are differences in efficiency among the firms), the use of a frontier analysis is validated. The significant and positive value of variance parameters ( $\sigma^2$ ), on the other hand, also confirms that some proportions of the total variability in productions are interrelated with technical inefficiency, which signifies that the observed output diverged from frontier output due to factors that are perhaps within the control of the firms. Meanwhile, all the other estimated parameters (i.e., all the  $b_K$  and  $b_L$ ) are not only statistically significant but also have the positive signs, which are expected in production functions.

### 5.2. Factors Contributing to Technical Inefficiencies and Hypotheses Testing: The Technical Inefficiency Model

Table 3 presents the estimation of technical inefficiency effects model which is triangulated by the maximum likelihood estimates for the translog stochastic frontier production function in Table 2. The results reveal that most of the parameters estimated are significant with the expected



signs. Not surprisingly, the leverage coefficient is negative, which indicates that leverage is negatively related to technical inefficiency for all electronics firms in China. As such, the null hypothesis  $H_{01}$  is rejected, which is in line with the agency cost hypothesis in that leverage positively affects a firm's efficiency until it reaches the optimal capital structure. This is consistent with the findings of Jensen and Meckling (1976), Myers (2001) and Berger and Bonaccorsi (2006), which stated that leverage can reduce the agency costs of equity by raising a manager's share of ownership in the firm. In addition, leverage can also mitigate manager-shareholder conflict and it may be used as a disciplinary device to reduce managerial cash flow waste through the threat of liquidation.<sup>10</sup> As discussed above, the effect of leverage on total agency costs is expected to be non-monotonic. Under certain extreme condition where bankruptcy and distress become more likely, the agency costs of outside debt would overwhelm the agency costs of outside equity, thus any additional increase in leverage would result in a higher total agency costs (Berger and Bonaccorsi, 2006). Our paper, however, does not find evidence to support this.

**Table 3**  
**Inefficiency model for Chinese Electronic Firms**

<i>Variable</i>	<i>Parameter</i>	<i>Coefficient</i>	<i>Standard error</i>	<i>t-ratio</i>
Intercept	$\delta_0$	1.4543*	0.2890	5.0324
Leverage of the firm	$\delta_{LEV}$	-0.8879*	0.1968	-4.5121
Return on Assets	$\delta_{ROA}$	-0.0417*	0.0044	-9.3941
Size	$\delta_{SIZE}$	1.7402*	0.2789	6.2392
Trend	$\delta_T$	0.3427*	0.0704	4.8663
Region	$\delta_{REG}$	-0.6165*	0.1086	-5.6788

*Note:* The asterisk \* indicates that the coefficient is statistical significant at the 1% level.

As expected, the coefficient representing a firm's ROA is negative, which suggests that profitable firms are more efficient than less profitable firms. This is consistent with the arguments of Fama and French (2002) and Cheng and Tzeng (2011) that firm's profitability is positively related to efficiency as more profitable firms in general are better managed and hence are expected to be more efficient. This finding rejects the null hypothesis  $H_{03}$ .

In the case of firm's size on inefficiency, we find that small and medium-sized electronics firms are much more scale efficient than large electronics firms in China. This undermines the argument of scale economies and is inconsistent with Jovanovic (1982)'s model although is in line with most of the recent studies that found small and medium-sized firms having more flexible organizational structure and their decision-making process, therefore are better equipped to response to market changes. This allows them to undertake tactical actions to grasp opportunities in emerging market, and to generate a niche market position that enable them to be highly efficient (Ma, 2002). In addition, direct involvement of shareholders in business operation reduces agency conflicts in small firms relative to big firms; the latter suffer from organizational moral hazard and adverse selection issues. The executives in smaller firms in contrast may be shareholders; thus, they are more motivated to maximize their earnings and to be more loyal. Furthermore, in China, firms of different sizes are subjected to different degrees of accessibility to bank loans and support from the local governments. All of the above are

sources that enable small firms to be more efficient. Conversely, large firms with hierarchical structure are highly bureaucratized with forms and procedures often taking priority instead of the ultimate results and profits. This hinders them from responding to changing market preferences, which explains why some of these firms continue to produce homogeneous bulk-produced products rather than exploring more personalized and stylized goods that are demanded by customers. These arguments may be the reasons why it is harder for big firms to maintain high efficiency levels, which is in line with our findings that reject the null hypothesis  $H_{02}$ .

Finally, the negative regional coefficient reveals significant dissimilarities in technical efficiency scores between electronics firms in Hong Kong and those in Mainland China - Mainland Chinese firms are more efficient than their counterparts in Hong Kong in the production of electronic components (see Table 3). This finding rejects the null hypothesis  $H_{04}$ .

Interestingly, we found the coefficient for the time trend variable in our technical efficiency effects model to be positive and significant, which suggests that the technical efficiency of electronics firms in China tended to deteriorate throughout the phase studied and thus undermine the arguments of learning economics. A possible explanation for this finding is the growing competition and congestion in the product and input markets. Finally, it may also be attributed to the global financial crisis that affected the global economy thus negatively impacting businesses and demand.<sup>11</sup> This could result in lower resources invested to improve production technologies and production processes. The fact that the global financial crisis began in 2008, which coincided with the second half of our period of analysis, supports the explanation for the positive coefficient of the time trend, i.e., falling technical efficiencies over time by the firms in the study.

**Table 4**  
**Total Factor Productivity Growths and its Decomposition for Electronics Firms in Hong Kong and Mainland of China**

Year	Hong Kong				
	TES	TFPC	TC	TEC	SC
2007	67.6442	12.0287 (0.3219)	15.8366 (0.0246)	-1.8349 (0.1675)	-1.9730 (0.2182)
2008	61.1744	-3.3322 (0.4153)	15.4804 (0.0257)	-15.6571 (0.2795)	-3.1555 (0.3389)
2009	56.8272	5.0363 (0.3225)	15.4350 (0.0274)	-17.5455 (0.4731)	7.1468 (0.1757)
2010	58.4761	19.1665 (0.3271)	15.4811 (0.0286)	6.3515 (0.2489)	-2.6661 (0.2401)
Average	62.5723	8.2248 (0.1688)	15.5583 (0.0258)	-7.1715 (0.1651)	-0.1620 (0.1464)
Year	Mainland of China				
	TES	TFPC	TC	TEC	SC
2007	93.3167	5.9048 (0.3249)	2.4197 (0.0640)	-0.0805 (0.2756)	3.5656 (0.1993)
2008	88.9570	-0.9118 (0.3590)	2.2864 (0.0627)	-4.6167 (0.3119)	1.4186 (0.1474)
2009	88.8664	7.2377 (0.3862)	2.0988 (0.0644)	-0.7494 (0.3286)	5.8883 (0.1750)
2010	87.8019	9.8468 (0.5767)	2.0328 (0.0712)	-0.1560 (0.1607)	7.9701 (0.5269)
Average	90.2903	5.5194 (0.1487)	2.2094 (0.0643)	-1.4006 (0.0548)	4.7106 (0.1576)

Note: Figures in parenthesis are the standard deviations

### **5.3. Technical Efficiency Measurements of the Sector and the Total Factor Productivity (TFP) Analysis**

Table 4 presents the annual estimates of technical efficiency scores (TES) (column 1 in Table 4) and the TFPC. The latter can be decomposed into technical change (technological change, TC), technical efficiency change (TEC) and scale efficiency change (SC) (see Table 4 under columns 2, 3, 4 and 5) for electronics firms in Hong Kong and Mainland China.<sup>12</sup>

Table 4 shows that the annual technical efficiency scores for both Hong Kong and mainland China electronics firms from 2007 to 2010. It appears that Mainland Chinese electronics firms are significantly more efficient compared to their Hong Kong counterparts in terms of production. The mean technical efficiency score for mainland China is 90.29% while Hong Kong's average is 62.57%. In essence, this means that, on average, Mainland Chinese electronics firm are producing 90% of their potential levels while Hong Kong firms do around 63% of their potential production levels.

Meanwhile, as reported in Table 4 (under TFPC), the TFP for both Hong Kong and Mainland Chinese firms recorded positive growth from 2007 to 2010. However, in 2008, TFP declined by 3.33% in Hong Kong and 0.91% in Mainland China. From the three sources of TFP growth, we observe that the negative growth of TFP in Hong Kong and Mainland China was due almost exclusively to technical efficiency changes. This deterioration in technical efficiency can be attributable to a few factors, among others, poor management, inefficient level of production, variations in economic growth including the global financial crisis of 2008, which comprise of various public policy issues, crisis appreciation of the Chinese Yuan (RMB), upsurge of salaries and finally, environmental issues in the 2000s could have all accounted for the drop in technical efficiency.

As observed, the contribution of technical progress (under TC) to positive overall TFP growth was higher in the case of Hong Kong (15.5%) compared to Mainland China (2.2%). But, the contribution of the scale efficiency (scale change, SC) component to the overall TFP growth was significant only in 2009 for Hong Kong while this was the case for Mainland China in 2009 and 2010. The overall negative scale efficiency change in the case of Hong Kong (-0.16) as opposed to the positive one in the case of Mainland China (4.71) indicates the existence of scale economies in the latter's firms. Table 4 also reveals that on average there is high volatility in technical efficiency changes (TEC) as compared to technological progress (TC) and scale efficiency change (SC) in the case of Hong Kong. This indicates it is the technical efficiency in firms that distinguishes the high productive firms from the low productive ones. In contrasts, Mainland Chinese firms recorded significant volatility in scale efficiency change (SC) thus it is the firm size that explains the cross-firm differences in productivity.

### **5.4. Elasticity and Scale Components**

Table 5 shows that all the elasticity of output with respect to capital and labor have the expected positive signs, which indicate an increase in inputs increases the output level. Interestingly, labor input appears to be more crucial than capital input as the elasticity of output with respect to labor is greater than the elasticity of output with respect to capital for all firms irrespective of their region. This implies that these electronics firms are labor-oriented. On the other hand, it is

also worth noting that as the firm size became larger the elasticities of output, both with respect to capital and labor, increase. From the results, we also observed that the output of large firms is driven more by labor compared to smaller and medium firms, both of which had greater elasticity of capital than of labor.

The sum of the input elasticities for Mainland Chinese firms (1.0681) suggests that the electronics firms in Mainland China were operating with almost constant returns to scale (efficient). In contrast, the sum of the coefficients of labor and capital for Hong Kong electronics firms is 0.4732, indicating suboptimal production levels (decreasing returns to scale). Finally, the results also revealed the larger electronics firms in the sample achieved economies of scale but the small and medium ones did not have minimum efficient scale, especially in the case of small firms.

**Table 5**  
**Elasticity and Return-to-scale of the Stochastic Frontier Production Function Model for Chinese Electronics Firms**

Variable	Region		Firm Size		
	Hong Kong	Mainland China	Small	Medium	Large
Capital elasticity	0.1471	0.4317	0.1368	0.3749	0.3923
Labor elasticity	0.3261	0.6365	0.3423	0.4657	0.7408
Returns-to-scale	0.4732	1.0681	0.4790	0.8406	1.1331

**5.5. Diagnostics Checking**

To ensure the robustness of the results, we first employ the generalized likelihood ratio statistic to test for the relevance of inefficiency effects, functional form and technical change hypotheses (Coelli, 1996). The results of the formal hypotheses tests under this procedure are presented in Table 6. The first null hypothesis,  $H_0: \gamma = \delta_0 = \delta_{LEV} = \delta_{ROA} = \delta_{SIZE} = \delta_T = \delta_{REG} = 0$ , relates to the statistical (and economic) relevance of firms' inefficiency. In order to explicitly test for the presence of technical inefficiency in a specific production process, one needs to test the null of the joint significance of the coefficients in Eq. (3), which is, based on the variance parameter

of  $\gamma = \frac{\sigma_v}{\sigma}$ ,  $\sigma^2 = \sigma_v^2 + \sigma_u^2$ . We find that the null hypothesis (of no inefficiency effects) is strongly rejected at 1% significance level thus we conclude that there are technical inefficiency effects in the models and the traditional average response function is an inadequate representation of our models.<sup>13</sup>

The second hypothesis stated that  $H_0: \delta_{LEV} = \delta_{ROA} = \delta_{SIZE} = \delta_T = \delta_{REG} = 0$  which is also strongly rejected at the 1% level of significance thus confirming that joint inefficiencies exist and they are related to the variables specified in the technical inefficiency effect model. Therefore, the variables specified in the models play a significant role in explaining the observed inefficiency among the electronics firms in China. Subsequently, we test the Cobb-Douglas specification. The null hypothesis,  $H_0: \beta_{KK} = \beta_{LL} = \beta_{KL} = \beta_{Kt} = \beta_{Lt} = \beta_t = \beta_{tt} = 0$ , is decisively rejected at the 1% significance level, which indicates that the logarithmic transcendental (translog) production function is adequate.

**Table 6**  
**Generalized Likelihood Tests of the Stochastic Frontier Production Function Model and**  
**Technical Inefficiency Model for Chinese Electronic Firms**

<i>Null Hypothesis</i>	<i>LR</i>	<i>Critical Value</i>	<i>Decision</i>
$H_0: \gamma = \delta_0 = \delta_{LEV} = \delta_{ROA} = \delta_{SIZE} = \delta_T = \delta_{REG} = 0$	-458.37	22.53	Reject $H_0$
$H_0: \delta_{LEV} = \delta_{ROA} = \delta_{SIZE} = \delta_T = \delta_{REG} = 0$	-456.78	20.09	Reject $H_0$
$H_0: \beta_{KK} = \beta_{LL} = \beta_{KL} = \beta_{Kt} = \beta_{Lt} = \beta_t = \beta_{tt} = 0$	-460.86	18.48	Reject $H_0$
$H_0: \beta_{Kt} = \beta_{Lt} = 0$	-407.24	9.21	Reject $H_0$
$H_0: \beta_{Kt} = \beta_{Lt} = \beta_t = \beta_{tt} = 0$	-402.62	13.28	Reject $H_0$

*Note:* LR is the likelihood-ratio test statistic. The critical values are at 1% significance level and are obtained from Table 1 of Kodde& Palm (1986) for joint restriction. Log-likelihood function for General model is -393.68

The fourth hypothesis tested for the existence of the Hicks-neutral technical change. The computed LR statistic exceeds the critical value at 1% significance level thus the translog function without Hicks-neutral technical change is the best fit for the data. The last hypothesis is to test the null hypothesis that there is zero technical change among the electronics firms in China,  $H_0: \beta_{Kt} = \beta_{Lt} = \beta_t = \beta_{tt} = 0$ . The null hypothesis is rejected at the 1% level, which indicates the existence of technological change over the sample period in the China electronics firms.

All the tests indicated and confirmed that the appropriate specification is the translog frontier with a non-neutral technical change; it also has variables in the inefficiency component of the model as presented in Table 2.

## 6. CONCLUSIONS

This paper applied a translog stochastic frontier with inefficiency effects to a panel of China firm-level data. The results revealed that the average technical efficiency of Hong Kong and Mainland Chinese firms were 63% and 90%, respectively thus implying that firms in these two regions produce 63% and 90% of their potential output levels. The inefficiency effects model also revealed a decrease of efficiency over time; it also identifies several other factors that explained firm performance differences. Further, we also observed that small and medium-sized firms are more efficient than large firms while the issue of location is also a significant factor for efficiency. In the context of the latter, firms located in Mainland China are generally more efficient than those located in Hong Kong. Finally, we observe that profitable firms tend to outperform their less-profitable counterparts in terms of efficiency. This finding supports the agency cost hypothesis but does not support the interest-tax shield hypothesis. These results not only shed some light on the relationship between China's electronic production and capital structure, they also revealed some insights into the decision-making process in firms.

This paper is the first to use SFA to examine the issues of productivity growth, technical change, and other economic measures of electronics firms in China. The SFA approach allows the relaxation of the assumption that electronics firms are successful profit maximizers and measures the output function and presents estimates of each firm's inefficiency in relation to the estimated function. In terms of the TFP results, the figures revealed that the negative TFP growth across firms is mostly due to technical efficiency changes both in the case of Hong Kong and Mainland China. Therefore, managerial inefficiency appeared to be a major

shortcoming in productivity issues. Technological progress appeared to be the catalyst of the TFP growth in Hong Kong but scale efficiency changes is the main driver for TFP growth in the case of Mainland Chinese firms. To elevate and sustain a high TFP growth, the relevant policymakers should adopt development plans that promote competition and intensify better use of technology in the electronics industry, the latter especially for Mainland China. The 12<sup>th</sup> Five-Year Plan (2011-2015) by the Chinese government has several provisions which look into the realization of these issues. In this respect, the Chinese authorities invested heavily in science (and technology) research and development while also further strengthening its existing intellectual property laws. Others like financial and fiscal policies would also include research funding for high-technology industries are also part of the government's plans for the area of technology. We believe that such policies are timely especially in light of the fact that our TFP results show that the Chinese firms' technological progress was significantly lower than their Hong Kong counterparts. The private sector, meanwhile, can contribute by developing various incentive systems to upgrade their managerial efficiency.

The returns-to-scale analysis for the electronics firms in China reveal that firms in Mainland China exhibit increasing returns to scale while firms in Hong Kong decreasing returns. The elasticity of output with respect to the inputs revealed that the output of all firms are driven more by labor than capital. In addition, as firms become larger, the elasticity of their outputs with respect to capital and labor also increases. This indicates that there are still significant economies of scale in the sector that have yet to be realized.

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### NOTES

1. For example, the sales turnover for China's electronics and information industries saw a 20% increase in 2011, totaling US\$1.48 trillion. A total of 1.13 billion cellular phones and 320 million computers were produced in that year with some 600,000 new jobs being created by the electronics and information industries alone in 2011 ([http://www.chinadaily.com.cn/bizchina/2012-02/28/content\\_14708139.htm](http://www.chinadaily.com.cn/bizchina/2012-02/28/content_14708139.htm)).
2. The proportion of manufacturing (value added) to China's overall GDP from 2006 to 2010 are 32.9%, 32.9%, 32.7%, 32.3% and 32.5% respectively (The World Bank's world development indicators database).
3. From the Statistical Communiqué of the People's Republic of China on the 2010 National Economic and Social Development ([http://www.stats.gov.cn/english/StatisticalCommuniqu/201102/t20110228\\_61451.html](http://www.stats.gov.cn/english/StatisticalCommuniqu/201102/t20110228_61451.html)).
4. See Battese & Coelli (1995).
5. See Jensen (1986) on the discussion of how the use of debt versus equity in raising capital can pose different degrees of agency cost to firms.
6. See Porter (1990, 1998), Krugman (1991) on "clustering" theory. This theory in essence, is a basically similar to what Alfred Marshall (1920) calls "external economies of scale".
7. A complete review of stochastic frontier models can be obtained from Coelli *et al.* (2005) and Kumbhakar and Lovell (2000).
8. Sharma *et al.* (2007) supported translog model by given four reasons: (1) it provides a local second order approximation to an arbitrary functional form and so gives for some generality; (2) CES and Cobb-Douglas production functions are also special cases of the translog and so the translog includes these frequently

- employed specifications; (3) it allows for non-constant returns to scale as well as for technical change to be both neutral and factor augmenting; and (4) partial elasticities of substitution among inputs are allowed to vary and elasticity of scale can vary with output and input proportions.
9. The authors would like to thank Tim Coelli for providing Frontier 4.1.
  10. See also Jensen's (1986) free cash flow theory on this subject.
  11. For example, China's exports of mechanical and electronics products saw a step decline in 2009, recording a contraction of 13.4% compare to the exports of mechanical and electronics for 2008 ([http://www.stats.gov.cn/english/StatisticalCommuniqu/201002/t20100226\\_61447.html](http://www.stats.gov.cn/english/StatisticalCommuniqu/201002/t20100226_61447.html)).
  12. The detailed results are available upon request.
  13. Coelli, *et al.* (1998) indicate that if  $g = 0$ , the divergence from the Frontier are exclusively due to noise.

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