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THE CONTRACT MANAGEMENT RESPONSIBILITY SYSTEM IN CHINA

An Institutional Interpretation

DERONG CHEN

Doctor of Philosophy

THE UNIVERSITY OF ASTON IN BIRMINGHAM

January 1993

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SUMMARY

The thesis is about the enterprise reform in China in general, and the Contract Management Responsibility System (the CMRS) in particular. The latter is a new institutional arrangement to deal with the relation between the government and the state-owned enterprise which has always been at the centre of the enterprise reform. The focus of the research is on the process of institutionalization in order to study the problems of the emergence of a free enterprise system in China.

The research is conducted by the four in-depth case studies to reveal how the CMRS is running and what interaction is taking place between the government and the state-owned enterprise under the system. Drawing on the empirical work, the thesis analyzes the features of the CMRS and the characteristics of its implementation process with respect to the structural-institutional paradigm, and the property rights approach. The research shows that to establish a market-type relation between the government and the enterprise is a complicated and dynamic process. It involves the understanding of the two different economic mechanisms, market and planning, and the interactions taken by two parties. It concludes that the CMRS is an unstable system, either going back to the previous system or moving towards a market system, because its dynamic and control dimensions are dysfunctional.

Key words:

economic reform, management autonomy, property rights, entrepreneurship, institutionalization .

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PART I

CHAPTER 1

INTRODUCTION

After a decade of reform, the economic situation in China has been improved enormously (The Economist, November 28th, 1992). This tendency seems to be continuing with tremendous hope. After many generations' efforts, it shows a real opportunity to pursue the country's economic development. The motivation is high and the task is challenging. It is not too difficult to reach certain achievements, but it is hard to build up a fully-fledged new economic system which will be of benefit to the country in the long run. Therefore at this stage it is important to think about how to set up new institutional arrangements based on the existing knowledge and the experiences people have gained all over the world.

This research was initially inspired by the dynamism and complexity of the economic reform in China, and puzzled by the attempt to set up new institutional arrangements by mixing economic and bureaucratic rules together. In comparison with East Europe and the former Soviet Union, China has adopted a more evolutionary approach towards market reform, which is less painful and has achieved a more stable situation. But it is still at the beginning of setting up a new full-fledged economic system, facing tremendous problems and challenges. At present, it would be very valuable to have a better understanding of the

The Contract Management Responsibility System (the CMRS) is one of these new reform programmes, aiming at solving a critical problem that is the relationship between the government and the state-owned industrial enterprise. The system started around 1987, based on the idea of separating management from ownership. It is a typical example of a kind of middle way of combining new and old ideas together which has caused an on-going debate both from practical and theoretical points of view.

Faced with theoretical alternatives, this research aims at putting the subject under the examination of institutional change. This is due to the fact that the reform essentially is a process of changing basic institutional settings from the central planning system towards a market economy. History and recent experiences show that is a long and complicated process with enormous uncertainty. As a standardized advice from the West, a set of institutional changes in five areas should take place in the reform (a World Bank speaker, 1992):

- Price liberalization in terms of relaxing price control and creating markets;
- Macro economic stabilization in terms of setting up macro control instruments,
- Enterprise autonomy in terms of establishing a free enterprise system,
- Social safety in terms of building up a social welfare system,
- External liberalization in terms of opening up a free trading system.

Since these five areas are interconnected towards a whole economic system, to study part of them thoroughly, for example enterprise reform, could make some contributions to the understanding of the whole system.

The CMRS is part of the enterprise reform in China. It can be conceived as an attempt in

setting up new institutions to deal with the relationship between the government and the state-owned enterprise. The basic idea of the system is to establish a kind of contractual relationship between the government and the enterprise, instead of the previous compulsory relationship. As a result the enterprises are supposed to have managerial autonomy.

The CMRS has three main provisions which are (1) the profit sharing scheme between the government and the state-owned enterprise, (2) the total wage bill control scheme for the employees, and (3) the contractual technology investment projects. Since the CMRS was introduced in 1987, it has passed the first contractual period in 1987-1990, and has begun the second period in 1990-1995. As a consequence, this system has diverged the behaviours and performance of the state-owned enterprises in relation with the technology and ownership pattern the companies evolve.

After five to six years practice, the study of the CMRS is both necessary and possible. This period has provided rich empirical materials for policy makers to make an assessment about its achievements and drawbacks, and for the researchers to study theoretical issues which can be derived from this process. It has been long enough to draw a general picture about the implementation of the system, but not too long to trace the details of the process. Therefore, it is the right time to conduct the research.

As a piece of empirical research, the start point is the necessary to decide the research area and to chose methodology. To answer the first question, this research has several alternatives. This is due to the fact that many forms of management and administrative activities have been covered for the CMRS aims at regulating the relationship between the

government and the enterprise. For the research, the CMRS could be divided into several sub-areas, such as the study of policy-making in terms of regulating macro and micro relations, the study of decision-making in terms of managerial autonomy, the study of entrepreneurship in terms of economic transition, the study of principal and agent relations in terms of information asymmetry, the study of cultural and ideology impacting on the transition etc. By focusing on one aspect, such as a micro level analysis of local events, it is easier to carry out a better organized study and to make a comparison with similar situations. For example, if the research focuses on the decision making process, it could be easier to use well developed research procedure and conduct a comparative study. But the disadvantage of this approach is that it is difficult to get an overview of phenomena, in other words, the knowledge from the research is about a fragmented area of a subject, but not a holistic view of the subject itself. In some cases like the CMRS, a kind of holistic view is highly demanded, because it could have immediate policy implications and a long-term impact on the way of thinking. When the society is facing the challenge of setting up a new system rather than improving certain aspects within an established framework, holistic view and system thinking are especially important. This research is an effort in conducting a holistic study on the CMRS.

The institutional approach is deemed to be suitable for this subject. Apart from reasons which have been mentioned before, this approach provides a holistic view by developing an appropriate framework to investigate the major activities which occur under the subject. First this approach focuses on process in terms of the development of activities and ideas through time. Second it conceives of activities as interaction between participants rather than one party dominated, for example, the interaction between the government and

the enterprise. Third, it considers dynamic role relationships between actors and routinized institutional relationships between roles. For example, the role relationship between the government and the enterprise is changing during the economic reform, but it takes time to be routinized as an institution. Fourth, institutional approach not only takes action into account, but the meaning of action as well. It yields a bigger interpretation power to phenomena. All these issues will be further illustrated in the thesis.

Due to the divergent development of institutional theory, this research focuses on three key aspects: the notion of structure, the notion of property rights, and the notion of institutional change. The notion of structure is conceived as a foundation for institutional approach; the notion of property rights is a tool for analysing economic institutions; and the notion of institutional change is the focus point of this research. A more detailed discussion is given in Chapter 2.

To answer the second question of methodology, the alternatives are either quantitative or qualitative or a mixture. In terms of the purposes and nature of the research defined above, a qualitative method is assumed to be more suitable. The main reason is due to the subject in which not much research has been conducted, especially at a holistic level. As a pioneer study, the research framework and key variables need to be generated from empirical material rather than to be tested from existing knowledge. It makes qualitative research more valuable than quantitative research. In this research, the case method with semi-structured in-depth interviews is adopted. Four companies are chosen for investigation. A more detailed discussion is given in Chapter 3.

Arising from the framework of analysis and the complicated nature of the subject, dealing with the institutional arrangement between macro and micro levels, between owner and administrator, and between principal and agent, several questions about the CMRS are asked in the research:

1. What is the basic feature of the CMRS and how could the nature of the CMRS be defined ?
2. What has been happening in terms of performance and behaviour under the CMRS?
3. How could the cause and the meaning of behaviour be interpreted in terms of economic and other factors ?
4. What are the likely trends of the CMRS in respect to the change from the command economy towards a market economy ?

Four state-owned companies are chosen for investigation with the variation of sector, ownership and size as follows:

- Beijing Electric Power Generator Company (BEPGC)
- Beijing Transformer Company (BTC)
- Beijing Dahua Shirt Company (BDSC)
- Beijing No.1 Leather Shoe Company (BLSC)

The thesis is divided into three parts. Part One is about the theoretical foundation of the thesis, including introduction, literature review and research design in Chapters 1, 2, and 3. Part Two is the empirical part of the research, including background of the CMRS and the practice of the CMRS in Chapters 4, 5, and 6. And Part Three is the analysis of the empirical material in terms of the structural feature of the CMRS in Chapter 7, the

characteristics of interaction process in Chapter 8, the mechanism of the system in Chapter 9 and conclusion in Chapter 10.

CHAPTER 2

A REVIEW OF THE INSTITUTIONAL PERSPECTIVE

The research is organized around an institutional perspective which is a big subject, developed in divergent ways. This survey attempts to conduct a comprehensive review of it, but giving weight to institutional change. It aims at mapping out a general picture with sufficient detail of some areas in order to guide the research from both macro and micro points of view. The review starts with the structural paradigm which acts as a base for institutional theory, and then moves to the review of its development in economics and sociology. Finally it concentrates on the issue of institutional change with two related approaches, the property rights school and North's theory of institutions and institutional change.

The author believes the institutional perspective will provide a broad framework to study the process of economic reform in general which is a complex of economic and social phenomena, and to study the CMRS in particular which is part of this reform process. Furthermore, the issue of institutional change is considered specifically relevant to the CMRS, due to its nature of setting up a new relationship between the government and the state-owned enterprise. As a preliminary to the review, it is worth mentioning why the institutional perspective is chosen as a theoretical guidance for this research. Therefore the review is divided into six parts:

(1) The Selection of the Institutional Perspective

- (2) A Generic Paradigm of Structural Analysis
- (3) A Comparative Review of the Institutional Perspective
- (4) A Review of Institutional Change
- (5) The Property Rights Approach
- (6) The North's Approach to Institutional Change.

2.1. The Selection of the Institutional Perspective

The choice of theoretical perspective actually is part of the research process, especially for a subject like the CMRS which has several facets providing many opportunities. Since the CMRS is an attempt to find a new way to deal with the relation between the government and the state-owned enterprise, the system is novel. It differs both from a central planning system and also from a market economy. It is not difficult to study the subject in one way or another, but difficult to get a holistic view in order to have a better understanding of the reform process as a whole. For that, a preliminary assessment about of major alternatives is necessary.

The CMRS was originally based on the idea of separating management from ownership which supposed to be an universal rule in modern industrial society (Chandler, 1977). It implies that there is no need to change ownership structure, but only to find a new governance approach when the state-owned enterprise is supposed to have managerial autonomy. This is exactly what the general provision of the CMRS stands for (Appendix 1). If so, the relation between owners (no matter who they are) and the managers can be conceived as a kind of principal and agent relationship. One party (the principal) delegates work to another (the agent) who performs that work. Because the principal and the agent

are likely to have different objectives and to possess different information, it causes the principal-agent problem (Berle & Means 1932; Jensen & Meckling, 1976). If the subject is viewed in this way without further studying the content of the CMRS, agency theory appears to be relevant to deal with the problems occurred in the system.

However, once studying the real arrangements (or the contract terms) between the government and the enterprise under the CMRS, it is easier to find out that this institutional arrangement is in fact to deal with the property rights structure. The three main provisions of the CMRS are about profits sharing scheme, total wage bill control and investment control schemes (See chapter 4). It is readily interpreted as the right to gain and the right to use according to property rights school (Furubotn and Pejovich, 1972). Obviously it is beyond the scope of agency theory and needs to be examined from other approaches, especially from the property rights points of view.

Furthermore another peculiar feature of the CMRS is the ambiguous of its provisions. In terms of the relationship between the government and the firm, only few things are explicitly defined in the contract, and others are left in practice linked to other schemes. It makes the process of the implementation complicated and dynamic which involves the actions taken by the two parties. This feature opens more possibilities to study the CMRS, so that some might focus on the design of the system, some on the motivation and behaviour of the managers, some on the assessment of the performance etc. The research also can be interpreted either from economic point of view, or connected with ideological and cultural factors. Such divergence arise the question of how to choose research dimensions in order to cope with the complexity of the subject.

This research argues that the CMRS should be conceived as an institutional arrangement to deal with institutional changes which are inevitable for economic reform. The reasons are that the arrangement involves the structural change between macro and micro levels, the change in the roles of the government and the firm, and the change in the rules of governing their relations. To study the institutional feature of the CMRS will provide insights to understand whether or how a new economic system is set up which is absolutely essential for the reform.

Institutional analysis has been developed in several dimensions: economics, organization theory, political science, public choice, history, and sociology, although sometimes it is difficult to cut off absolute boundaries (Powell and DiMaggio, 1991). This research mainly draws on the sociological and economic dimensions. The main advantage of these two dimensions is to be able to cope with the complexity of the institutional change occurred in the reform, in which both economic and social factors can be taken into account. To deal with the divergent development of institutional theory, the literature review is organized in three parts to cope with the needs of the CMRS: the generic paradigm of structure, the comparative review of institutional perspective, and the property rights approach. The review will start with the introduction of three key notions: structure, institution and property rights.

First the notion of structure is supposed to be the core of institutional analysis. In a broad sense, structural analysis is conceived as a basic inquiry to the scientific enterprise for studying regularities and systematic relationship both in natural and social sciences. "It is

difficult to conceive of any line of scientific inquiry without sooner or later invoking the notion of structure" (Smelser, 1988). In a narrow sense, institutions, institutional change, and institutionalization are regarded as the subjects directly dealing with social structure and order. Obviously the notion of structure is even more relevant for them. Moreover by considering the study of institutional change is still very new both in economic and sociological approaches (North, 1990 and Powell, 1991), the general paradigm of structural analysis will provide insights to the further development of the two disciplines, and also will be very helpful to study a specific process of institutional change such as the CMRS at this stage. Smelser has developed the notion of structure in terms of its generic features and this provides a broad paradigm for structural analysis (Smelser, 1988). By applying this paradigm to the study of institutional change, it enables the investigation to be more fundamental and holistic. To a large extent, this research is an application of this structural paradigm in institutional change.

Second the notion of property rights is considered as a key element of an economic system, and is the core of Neo-institutional Economics (Eggertsson, 1990). The concept of property rights has been widely used in terms of common sense, legal definition or other professional content with diverged meanings. The most general definition of property rights, which runs through Roman Law, the works of Marx and Engels, and current legal and economic studies, is that " the prevailing system of property rights in the community can be described, as the set of economic and social relations defining the position of each individual with respect to the utilization of scarce resources" (Furubotn and Pejovich, 1972). Property rights structure constitutes the basic structure of an economic system and affects the way people behave. "Individuals respond to economic incentives, and the

pattern of incentives present at any time is influenced by the prevailing property rights structure" (Furubotn and Pejovich, 1974). Therefore the change of property rights structure will affect people's behaviour and performance. Neo-institutional Economics aims at developing theories to build up a link between structure of property rights to institutional arrangements, incentive schemes and behavioural patterns in order to explain a wide range of economic activities. Among them, Douglass North and Brian Arthur as economic historians pay more attention to institutional change. This research draws on property rights as a kind of structural elements to study the economic feature of the CMRS and some issues of the institutional change rather than to apply this approach systematically.

Third, the notion of institution represents a distinctive approach to the study of social, economic, and political phenomena. On the one hand, institutional analysis has a long historical standing. Durkheim called sociology "the science of institutions" (Durkheim, 1950). And yet the process of institutionalisation can be seen to have not been drawn a sufficient attention in the contemporary literature. At present the study of institutions is experiencing a renaissance throughout the social sciences (Powell and DiMaggio, 1991). This is because "social, political, and economic institutions have become larger, considerably more complex and resourceful, and *prima facie* more important to collective life" (March and Olsen 1984).

New institutional analysis has been developed in economics, organization theory, political science and public choice, history, and sociology. Among approaches, the concepts of institution and institutionalization have disparate meanings, although there seems to be an underlying similarity in them. As its application, institutional analysis also applies to the

study of state socialism. In opposition to the earlier theories of totalitarianism and modernization, the new institutional analysis presents an orienting framework, especially in analyzing the economic transition towards a market economy (Stark and Nee, 1989). The intention is to understand patterns of institutional regularity which can be taken to explain how the mechanism of the economy operates in reality, why it did not ensure the expected development and efficiency of the socialist economy, and how it is moving towards a market economy. Kornai's work on the features of the planned economies, such as chronic shortage and budgetary constraints is conceived as an early contribution in terms of the institutional approach in economic analysis (Kornai, 1980).

To sum up, the choice of institutional analysis as a theoretical perspective for this research has derived from the primary study of the features of the CMRS. The CMRS is essentially conceived as the problem of institutional change which is also the core of the economic reform. The institutional perspective which is applied to the research is composed of three key notions: the notion of structure, the notion of institution and the notion of property rights. They provide a powerful tool to study the CMRS by taking account of both economic and social factors.

2.2. The Generic Paradigm of Structural Analysis

As given before, the notion of structure is a basic scientific inquiry in social science. A structural paradigm can provide a powerful framework to lead to institutional investigation. Smelser has identified six separable ingredients for the paradigm (Smelser, 1988):

(1) The notion of structure implies the specification of *basic units of analysis* which makes up parts or elements in research. In much of personality and social psychology, the

basic structure studied is at the level of individual personality (or self), and the basic elements are subparts of that: needs, feelings, aptitudes, attitudes, defenses, and the like. The basic units of analysis in the sociological study of structure have two kinds of considerations: the dynamic role relationship and stable group relationship. For the former, certain relational characteristics that arise from the location and interaction among individual persons, are perceived as role relationships (e.g. parent-child). The complex patterning of role relationships constitutes into institutional form (market structure, family structure, educational structure), and into stratified relations among persons along lines of wealth, power, and prestige. For the latter, relational characteristics also can be perceived as group relationships involving common interaction, membership, feelings of belonging, and identification as such by those outside the group. Political parties, voluntary associations, and social classes are examples.

(2) The notion of structure also implies the basic units have some kind of special or nonrandom *relationship* to one another. For example, applied in the idea of a market structure is the notion that producers, distributors, wholesalers, retailers, and customers stand in a definite, systematic relationship with one another in the production-consumption cycle.

(3) Closely related to this notion is the implication that interactions among the basic elements of analysis are *repetitive* in space and time. It is difficult to conceive of the notion of structure without including this notion of repetition. In fact, it is the dynamic or process side of the more statically conceived element of relationship. Viewed in this way, structure and process are two expressions of the same thing: Structure is a kind of generalization based on observations of repeated processes of interaction among the basic units of analysis, and process is the behavioral manifestation and evidence for structure.

(4) The relationship within a structure are different from relationships with units that are considered to lie outside the structure. It implies the notion of *boundaries*. For instance, the notion of the self or the personality, while it typically allows for interaction with objects, ideas, and persons outside the self, contains some notion of boundaries between the self and what is outside. The sociological concepts of interaction in institutional structure, as well as group structure carry the same implication of boundary. If there were no differences between interactions within a structure and interactions without, the concept of structure would disappear altogether, because there would be no basis for identifying it as such. The idea of a structure, in a word, implies the idea of a qualitatively different nonstructure.

(5) This notion of difference-from-outside gives rise to the further notion of *structure-in-situation* or *structure-in-environment*, and also to the notion of the degree to which the structure is closed from or open to influences or interactions with units or forces outside the structure. For example, family structure is seen as existing in an environment which includes a system of property, a legal system, and an occupational system. For them, the family is not customarily considered as a part, but changes in that environment may affect family structure profoundly. It may also be asked whether the external environment itself has some structure --- that is, is regular and repetitive in its impact on the structure in question --- and, if so, what are the implications for that structure.

(6) Finally many account of structure include some reference to the *reasons* for, or *causes* of structure, that is, why it hangs together and continues to differentiate itself from its environment. Some interpretations are drawn from the ideas of adaptation, maintenance of social integration, and coercion. These accounts of the fundamental bases of social structure constitute the bases of the major theoretical differences and paradigmatic conflicts

in social science.

To sum up, a structural paradigm derived from the six ingredients can be described as such:

- to decide basic units of analysis which can be either role relationships or group relationship;
- to find out some kind of special or nonrandom relationship from basic units of analysis;
- to observe repeated processes of relationship or interaction among the basic units of analysis;
- to delimit boundaries between the self and what is outsider of the basic units of analysis;
- to ask influences or interaction with units or forces outside the boundaries;
- to seek the reasons for or causes of relationship among basic units of analysis.

The structural paradigm provides a general analytical framework to study institutional change. The advantage of the paradigm is able to get a holistic view of change in terms of basic structural elements. Especially for studying a new field, it can avoid missing important aspects which might happen when applying specialized theoretical perspectives in the first place. For further searching specific features of the subject, the structural paradigm could be considered as a first step leading to more specialized theoretical perspectives. Viewed in this way, the CMRS as a new subject needs to be first examined under the paradigm, and then to move to other perspectives.

2.3. A Comparative Review of the Institutional Perspective

As mentioned before, the institutional perspective has been developed in many variants that it is often easier to gain agreement about what it is not than what it is (Powell and DiMaggio, 1991). The following review is organized so as to distinguish the main features of the institutional perspective from other approaches, to distinguish its sociology approach from economic approach, and to distinguish new sociology tradition from old one.

2.3.1. The distinction between the institutional approach and others

Institutional analysis is deeply rooted in the notion that social context and the durability of social institutions matter, and collective political and economic behaviour can not be interpreted as the aggregate consequence of individual choice which behavioralists stand for. To some extent, the new development of institutionalism is a reaction against this behavioral revolution of recent decades. The findings from studies of organizational and political change point to that rational-actor or functionalist accounts hardly correspond with reality (DiMaggio and Powell, 1991). It leads to efforts to replace rational theories of technical contingency or strategic choice with alternative models that are more consistent with the institutional reality.

2.3.2. The distinction between economic and sociological approaches

In recent decades, institutional analysis has been developed substantially both in economics and sociology for organizational analysis, but with divergent orientations. The differences between them can be illustrated from three aspects: the definition of institution, the view of individual choice, and the dependence and efficiency of institution.

First, institution has different meanings in economic and sociological approaches. In the economic approach, institution is defined as "the rules of the game in a society or more formally, are the humanly devised constraints that shape human interaction" (North 1990) or as governance structures and social arrangements (Williamson, 1985). In the sociological approach, institution is defined as "an organized, established, procedure" or "those social patterns that, when chronically reproduced, owe their survival to relatively self-activating social processes" (Jepperson, 1991). The key difference is that the former emphasises on "institutions are the product of human design, the outcomes of purposive actions by institutionally oriented individuals, but in the latter, while institutions are certainly the result of human activities, they are not necessarily the products of conscious design" (Powell and DiMaggio, 1991). It is routinely reproductive procedures supporting and sustaining the social patterns. In this sense, the sociological approach is more restrictive than that of economics. On the other hand, sociological approach is much more encompassing. That is to say, whereas most economists focus on economic rules of the game, sociologists find institutions everywhere, from handshakes to marriages to strategic-planning departments. Moreover, sociologists view behaviours as potentially institutionalizable over a wide territorial range, from understanding within a single family to myths of rationality and progress in the world system (Meyer and Rowan, 1991). Therefore it has been suggested that "the theory of institutions is the sociological counterpart of the theory of competition in economics" (Lachmann, 1971). In order to avoid the confusion with common sense, the term institutionalization is used as the same as the notion of institution defined here in this thesis.

Second, the two approaches have different answers to the question of whether institutions

reflect the preferences of individuals. Most institutional economists assume that actors construct institutions that achieve the outcomes they desire. In other words, institutional arrangements are conceived as adaptive solutions to problems of opportunism, imperfect or asymmetric information, and costly monitoring. The sociological oriented institutional approach rejects this view, because first individuals do not choose freely among institutions, customs, social norms, or legal procedures which is always associated with certain situations by rules of appropriateness" (March and Olsen, 1984). Second is the question of whether individual choices and preferences can be properly understood outside of the cultural and historical frameworks in which they are embedded. The sociological institutionalists argue that the very notion of rational choice reflects modern secular rituals and myths that constitute and constrain legitimate action (Jepperson & Meyer, 1991; and Friedland & Alford, 1991).

A third point of the difference between the two approaches is the notion of efficiency and stability of institutions. For most institutional economists, institutions are viewed as a "provisional , temporary resting place on the way to an efficient equilibrium solution" and institutions represent "efficient solutions to problems of governance" (Powell and DiMaggio, 1991). They offer functional explanations of the ways in which institutions represent efficient solutions to problems of governance. But some argue that institutional arrangements "constrain individual behaviour by rendering some choices unviable, precluding particular courses of action, and restraining certain patterns of resource allocation" (Powell and DiMaggio, 1991). For example, some emphasize the role of rules, norms, and culture in organizational change and doubt that market competition is able to ensure the selection of efficient organizational structures and processes (Nelson and

Winter, 1982).

For institutional sociologists, the adaptive view of efficient solutions is less persuasive. They argue that behaviour and structures that are institutionalized are ordinarily slower to change than those that are not. They agree with rational-choice scholars (economists) that technical interdependence and physical sunk costs are partly responsible for institutional inertia, but argue that another more important factor impacts on it. That is "institutionalized arrangements are reproduced because individuals often cannot even conceive of appropriate alternatives (or because they regard as unrealistic the alternatives they can imagine)". "Institutions do not just constrain options: they establish the very criteria by which people discover their preferences. In other words, some of the most important sunk costs are cognitive" (Powell and DiMaggio, 1991). In this view, they emphasize the importance of understanding the meaning of action. For the reasons of change, institutional sociologists "reject functional explanations and focus instead on the way in which institutions complicate and constitute the paths by which solutions are sought" (Powell and DiMaggio, 1991).

In brief, the meanings of institution have been developed in divergent ways within the economic and sociological approaches. For economists, the emphasis is on the economic features of institution in which actors' behaviours are studied referring to economic rationality, the concept of institution is defined referring to the immediate result of human design in economic structure, and the establishment and change of institution is viewed referring to the functional needs of economic mechanism. In contrast, the sociological approach emphasizes on the social, and cultural aspects of people's behaviour, on the

phenomenological (that is taken for granted character of relationship and action) and cognitive feature of institution, and on the complexity of setting and changing of institutions. In short, the economic approach focuses more on economic factors and short time horizon, whereas the sociological approach more on social and culture factors as well as historical effects.

2.3.3. The distinction between old and new institutional sociology

The new institutionalism has been developed since the 1970s, compared with the old one in which Selznick's works are considered as its representatives (Selznick, 1949 and 1957). The new approach departs from the old one in significant ways. First, the old institutionalism was more politically oriented towards analyzing group conflict and organizational strategy referring to different interests. By contrast, the new one is more administratively oriented to focus on role relationship referring to stability and legitimacy. Second, the old institutionalism highlighted informal interaction to illustrate how the informal structures deviated from and constrained aspects of formal structure. The new one, by contrast, focuses on formal structure to point to irrationality with respect to interorganizational influences, conformity and cultural accounts. Third, the old institutionalism focuses on the change of institutions as organic wholes to adapt to their environment, whereas the new one focuses on the persistence of institutions in which standardized elements such as organizational forms, structural components, and rules are loosely coupled. Fourth, significantly different views of cognitive forms occurs between the two. For the old institutionalists, the salient cognitive forms were values, norms, and attitudes, whereas for the new one, it is taken-for-granted scripts, rules, and classifications. In other words, the transition from the old to new institutionalism means a shift "from a

normative to a cognitive approach to action: from commitment to routine, from values to premises, from motivation to the logic of rule following" (Powell and DiMaggio, 1991). By and large, the new institutionalists attempt to apply the new knowledge advanced by ethnomethodology and phenomenology to institutional analysis.

2.4. The Introduction of Institutional Change

By comparison, the economic approach of institutional analysis, especially from the economic historians has paid more attention on institutional change than the sociological approach. As a consequence, the latter calls for much more research and theory on institutional change. As Powell points out "We need an enhanced understanding of both the sources of heterogeneity in institutional environments and the processes that generate institutional change" (Powell, 1991). Meanwhile the sociology approach attempts to put the subject under a wider examination apart from economic consideration. Several questions have been put forward:

- What kinds of social processes have irreversible tendencies ?
- Why is it that once established, some beliefs and procedures are relatively immune to challenge, while others are easily delegitimated ?
- What actions taken to respond to challenges and crises lead to the establishment of new institutional powers and precedents ?

It is also realized that "to explain how social actors and the patterns of action they engage in are institutional anchored ...needs both detailed ethnographic studies that reveal how institutional practice come to be legitimated, and large-scale, longitudinal studies that explore the staying power of institutional arrangements" (Powell, 1991). Several areas are

required to conduct empirical studies that are to study the roles which different actors assume, the mechanism which motivate actors to perform their roles accordingly, the myths or rationalizations that are put into place to ensure the legitimacy of the new arrangements, and the methods whereby the system reproduces itself (Galaskiewicz, 1991).

As explicated by Berger and Luckmann, institutionalization involves three phrases that are: externalization, objectivation, and internalization (Berger and Luckmann, 1967). It means that "we and our associates take action (Externalization), but we together interpret our actions as having an external reality separate from ourselves (objectivation); further, the objectivated world is internalized by us, coming to determine the subjective structures of consciousness itself (internalization)" (Scott, 1987). This is still quite a general statement to empirical study.

In these areas, the economic approach has made its own significant contributions which can be summarized into three aspects. First, economists have advanced a basic concept of transaction costs as the fundamental cause of institutional change which is further developed in the property rights school (Coase, 1937, 1960; Cheung, 1974, 1983; Williamson, 1975, 1985; North, 1981, 1990). Second, Arthur's theory of self-reinforcing mechanism illustrates the process of institutional change (Arthur, 1988, 1989). And third North has provided a theoretical paradigm to study institutional change (North, 1990). By concerning property rights school and North's paradigm are regarded here as being more relevant to this research, they are given as the separate sections in 2.5 and 2.6., while the theory of self-reinforcing mechanism is given briefly introduction in the following.

In the theory of self-reinforcing mechanisms, Arthur argues four types of mechanism that are (1) large setup or fixed costs, which give the advantage of falling unit costs as output increases; (2) learning effects, which improve products or lower their costs as their prevalence increases; (3) coordination effects, which confer advantages to cooperation with other economic agents taking similar action; and (4) adaptive expectations, where increased prevalence on the market enhances beliefs of further prevalence. The consequence of these self-reinforcing mechanisms is characterized by four properties: (1) multiple equilibria --- a number of solutions are possible and the outcome is indeterminate; (2) possible inefficiencies --- a technology that is inherently better than another loses out because of bad luck in gaining adherence; (3) lock-in --- once reached, a solution is difficult to exit from; (4) path dependence --- the consequence of small events and chance circumstances can determine solutions that, once they prevail, lead one to a particular path (Arthur, 1988; North 1990). This theory has influenced the studies of institutional change both in economic and sociological approaches.

2.5. The Property Rights Approach

2.5.1. The definition of property rights

The property rights approach attempts to answer the question of how the structure of property rights evolves in response to individual incentives and behavioural patterns subject to institutional arrangements. As stated previously, property rights are defined as "the set of economic and social relations defining the position of each individual with respect to the utilization of scarce resources" (Furubotn and Pejovich, 1972,). This definition implies that the understanding of property rights refers to legal system, social norms and the economic system. More specifically, from the view of the property rights

approach, "Property rights do not refer to relations between men and things but, rather, to the sanctioned behavioural relations among men that arise from the existence of things and pertain to their use" (Furubotn and Pejovich, 1972).

Furthermore, the right of ownership is considered as a subcategory of the general concept of property rights. It implies individual rights over assets, which consist of three elements: "the right to use the assets, the right to appropriate returns from the asset, and the right to change the asset's form and /or substance" (Furubotn and Pejovich, 1974). Others, like Barzel, do not specifically distinguish ownership from property rights, but more precisely define property rights of individuals over asset as the rights, or the powers, "to consume, obtain income from, and alienate these assets" (Barzel, 1989). Obtaining income from assets and alienating assets require exchange during which transaction costs are supposed to be positive. Further illustrations of transaction costs are given below.

2.5.2. Property rights are not absolute

Barzel's contribution to property rights theory is to make a clear statement of the basic features of property rights: "The rights people have over assets (including themselves and other people) are not constant; they are a function of their own direct efforts at protection, of other people's capture attempts, and of government protection" (Barzel, 1989).

He further points out that "Economists' past failure to exploit the property rights notion in the analysis of behaviour probably stems from their tendency to consider rights as absolute" (Barzel, 1989). This dynamic feature of property rights creates opportunities for owners and other people to discover and to capture wealth. In other words, property rights are subject to amendment by fiat, regulation, and negotiations which permit room for

interpretation.

The nature of property rights stems from the fact that the attributes of an asset are not fully known to prospective owners and are often not known to the current owner either. In other words, an asset's attributes are of the costliness of measuring accurately. Therefore rights are never fully delineated and property is consequently in danger of appropriation by others-not just by theft but also by excessive choosing, adverse selection, free riding, and shirking (Barzel, 1989).

2.5.3. Externality and the public domain

For a long time, the property school used the term externality to illustrate their major theme that "a primary function of property rights is that of guiding incentives to achieve a greater internalization of externalities" (Demsetz, 1967). But Demsetz also confesses that externality is an ambiguous concept. According to Demsetz, externality includes "external costs, external benefits, and pecuniary as well as non-pecuniary externalities." "Even cost and benefit associated with social interdependencies is a potential externality (Demsetz, 1967). Cheung has argued that the concept of externality is to go "astray and attain nothing useful." "The concept of externality is vague because every economic action has effects; it is confusing because classifications and theories are varied, arbitrary, and ad hoc." (Cheung, 1974).

Barzel used the public domain as the key concept to illustrate the similar feature of property rights and its operational consequence (Barzel, 1989). Because of the inherent difficulty of delineating rights fully, "those properties that people have chosen not to

delineate are in the public domain." "The public domain is ubiquitous; innumerable commodity attributes are placed in it". For example, "any service not fully charged for on the margin is at least partly relinquished to the public domain" (Barzel, 1989). The public domain is a pertinent idea when rights cannot be delineated because it is either too costly or too difficult for them to be known, though such rights still exist and can always be exploited. It implies that property rights are not exclusive and any institutional arrangement, either contract or legal regulation, always creates the public domain.

"Properties in the public domain can be augmented or diminished. As the values of commodities and of commodity attributes change, and as the costs of delineation and of protection change, people's decisions regarding what to leave in, what to relinquish to, and what to reclaim from the public domain will change correspondingly" (Barzel, 1989). In other words, the reasons for the increase or reduction of properties in the public domain are due to the change of commodities' market value or of the cost of information on the property rights delineation. The incentive for change in the public domain, however, seems to have more dimensions, including non-economic reasons, which remain to be worked out.

The term "people's decisions" used here is somewhat dangerous, since it implies that the entire scope of the public domain is deliberately decided by "people". In fact, it is not, because of the inability to recognize all the possibilities. It is related to the assumption of bounded rationality which has implicitly stressed by Barzel, but sometimes confused with it.

2.5.4. The basic assumptions of the property rights school

Property rights school appeared in the post-war period, and its development was mainly

due to the intensified criticisms of the traditional theory of production and exchange. Since then, several crucial changes have been introduced into it.

*** profit maximization versus utility maximization**

The conventional analytical framework assumed that economic man's behaviour is fundamentally oriented towards profit maximization. This assumption has considerably narrowed down its applicability to the complexity of economic activities in the real world. The property rights school shifted that to the utility function by which economic man supposes to maximize the utility function subject to appropriate constraints. Under such an assumption, various behaviours which occur in the economic sphere, for example, seeking prestige, desiring for good relations, or looking for a quiet life by sacrificing profit, could be interpreted as maximizing utility. The particular utility function reflects the decision maker's preferences (Furubotn and Pejovich, 1972). It is a simple, yet important step to open up "new possibilities for studying different patterns of managerial behaviour, and permits greater insight into the way firms operate when faced with different institutional conditions" (Furubotn and Pejovich, 1974). Some authors, especially in the organizational field, who also rejected profit maximization assumption, developed the "satisficing" hypothesis (Simon, 1959; Shubik, 1961; Vickers, 1968). They argued that decision makers in economic organizations seek a level of achievement (normally profits) which is satisfactory relative to the norm they held, rather than the maximum level theoretically possible. The property rights approach tends to reject the satisficing hypothesis yet still fits its model into the conventional optimization framework. It greatly extends the applicability of classical marginalism and gives more potential for the application of economic theories.

*** individuals versus organizations**

The unit of analysis in the property rights literature has shifted from the firm or organization level to the individual decision maker. " The business manager, for example, is no longer regarded as a passive agent who automatically obeys orders from high authorities; rather, he is assumed to seek his own interests and to maximize utility subject to the limits established by the existing organizational structure" (Furubotn and Pejovich, 1974). The organizations or institutional arrangement, for example, the firm and the legal system, are treated as constraints imposed on the individuals behaviour, while the individuals in these organizations can still be studied in property rights terms. It creates an approach whereby "the detailed analysis of the interrelations between institutional arrangement and economic behaviour becomes feasible" (Furubotn and Pejovich, 1974). As the result, contractual arrangements become vitally important to the study.

*** zero transaction cost versus positive transaction cost**

The other assumption which is different from the conventional framework is that "transaction costs are recognized as being greater than zero in virtually all cases of practical importance" (Furubotn and Pejovich, 1972). This idea was initially developed by Coase. In his article on "the nature of the firm" (Coase, 1937), he pointed out, that "there is a cost of using the price mechanism," for example, discovering what the relevant prices are, the costs of negotiating and making decisions, and finally the costs of policing and enforcing contracts. A firm emerges, because " the operation of a market costs something and by forming an organization and allowing some authority to direct the resources, certain marketing costs are saved." (Coase, 1937). It becomes possible to explain the conditions under which markets should or should not be extended into new areas by this approach.

The property rights school has further developed this idea, and even created a new theory of the firm. Basically, transaction costs occur not only in markets, but in all constraining transactions, for example, the employment contract, because of the problem of delineating ownership. Some authors, therefore, for example Barzel, prefer to classify transactions into constraining transactions and caveat emptor transactions which was originally used in describing a type of trading. "Once concluded, leave no obligation remaining between transactors" (Barzel, 1989) is the nature of the latter. In fact, caveat emptor transactions are costly, because the additional risk to the buyer has got to be reflected in a lower than otherwise selling price i.e. there is a transaction cost. So it governs only a small fraction of the total volume of trade. Transactions are accompanied by restrictions on the transactors, for instance, sellers' obligations, are an alternative to caveat emptor transactions (Barzel, 1989). Oliver Williamson has also significantly developed this idea by postulating a continuum of complex forms of organization to deal with from straightforward spot market exchanges to trust based "clans" (Williamson, 1975, 1981. and 1985).

"Implementing and policing constraints require correspondingly different organizations" (Barzel, 1989). Therefore, Cheung suggests that all constraining transactions should be studied, whether they take place in the firm or in the market. He further developed the theory of the firm arguing that the organizations falling under the label "firm" are in reality diverse; that the wage contract does not sufficiently characterize them; and most important, that there is no satisfactory operational definition of the firm. He suggests that economists should abandon the firm as a vehicle of their analysis and should instead focus on contracts (Cheung, 1983). Generally speaking, the concept of transaction costs is a key

one in interpreting institutionalization in which transaction costs are defined as the primary constraints in determining institutional arrangements. Cheung classifies this broadly defined transaction cost into two categories: (a) those incurred in the operation of an institutional arrangement; (b) those incurred in adopting or changing an institution. He further argues that because the private property rights permit the largest range of institutional choice and enhance competition, the market system has lower transaction costs than the command economy (Cheung, 1983).

2.5.5. Contract

All the writers from the property rights school, no matter how different they are, agree that contracts play the central role in the approach, because contracts represent the means by which the bundles of rights are changed (Furubotn and Pejovich, 1974). Furthermore, the more radical view supposes that the firm could be conceived as a "nexus of contracts" (Cheung, 1983), which is derived from Commons (1924) pioneering work.

The basic nature of contracts is to permit people to engage in a voluntary exchange with two parties' intention and consent, although the contract forms are substantially varied. In the property rights approach, all the contracts are viewed as taking place at the individual level, no matter that some contracting parties act on behalf of organizations, such as firms, governments, clubs. "Because individuals' objectives are relatively clear, it is useful to define all property rights as rights possessed by individuals." "The functioning of any organization can be similarly reduced to the ceding of various rights from one individual associated with it to another" (Barzel, 1989). The concept of contract provides a basic unit in the study of the structure of property rights and the individuals' behaviour. It can be

considered to be in line with the assumption of individual maximization in the property rights approach, which has been mentioned before.

There exist various ways of studying contracts. According to Cheung, who has made a major contribution to the study of contract, -----, "The contract terms or stipulations, which constitute the contract structure, are designed to specify (a) the distribution of income among the participants and (b) the conditions of resource use" (Cheung, 1974). Under the market system, so called "transferable rights", provide the underlying mechanism for allocating resources, and "these stipulations are consistent with, or determined by competition in the market place" (Cheung, 1974). Maximization implies that "the contractual stipulations are designed to maximize the return to all resources subject to the constraint of competition." Generally speaking, "the structure of the contract will be such that the marginal gain and cost are equal" (Cheung, 1974,). Therefore, it requires all the stipulations are consistent with increasing efficiency, or consistent with equality at the margin.

Externality or the public domain created by contracting is attributed to "either (a) the absence of the right to contract, (b) the presence of a contract but with incomplete stipulations, or (c) the presence of stipulations that are somehow inconsistent with some marginal equalities" (Cheung, 1974).

From Barzel's point of view, "contracts, whether formal or informal," "reallocate rights among contracting parties" (Barzel, 1989). The design of contract is expected to minimize the costs of exchange of given transactions. Two types of costs occur in contracting. These

are conventional production cost as well as the costs associated with the capture of wealth. The latter occurs, because (a) measuring each parties' contribution to output is necessary, but costly, (b) it is impossible to predict all the variability in output. It creates the public domain or so called common property. Each party spends resources to capture this wealth.

Different contracts encounter different incentive problems, which lead to various unexpected behaviours, such as shirking, free riding, and adverse selecting. Therefore the choice of contract form is important in many cases. Cheung argues that " the choice of contracts is determined by transaction costs, natural (economic) risks, and legal (political) arrangement" (Cheung, 1974). The case of the tenancy contract is a good example showing the use of the property rights approach in tackling the problem of contracting (Cheung, 1969).

As stated before, contracting problems are caused by several factors. The crucial one is how to deal with information. The difficulty and costs of measuring and policing attributes of input and output could be regarded as the problem of identifying information, and the variability of input and output could also be viewed as the problem of collecting information. As a result, some attributes would not be stipulated, so called "free attributes", while some would not be completely stipulated.

Eventually one has to ask who should be the residual claimant lies at the centre of how to allocate resources most efficiently. Barzel argues that "a basic principle underlying the maximization process is that individual attributes will be placed under the control of the party who can more readily affect the net value of the outcome by manipulating the

attribute" (Barzel, 1989).

2.5.6. The role of the legal system

Another important question which has not been tackled is the role of the legal system. Although in modern societies, in a general sense, private property rights require the recognition and enforcement of law, one still can argue that "legal rights enhance economic rights, but the former are neither necessary nor sufficient for the existence of the latter" (Barzel, 1989). From another point of view, the reason for requiring the legal system is to lower transaction cost. However, "history has repeatedly demonstrated that market response is much quicker than legal response to changing economic conditions" (Cheung, 1974).

From the legal point of view, for example, common law can be conceived in economic terms as having three parts (Posner, 1986):

- (1) the law of property, concerned with creating and defining property rights, which are rights to the exclusive use of valuable resources;
- (2) the law of contracts, concerned with facilitating the voluntary movement of property rights into the hands of those who value them the most; and
- (3) the law of torts, concerned with protecting property rights, including the right to bodily integrity.

The huge gap between the two notions is due to their completely different views of the nature of property rights. The legal position is based on the view that property rights as a bundle of distinct rights are exclusive, while the economists' position assumes that the nominal property owner will rarely have exclusive power over his property (Posner, 1986).

To sum up, the property rights approach draws attention to the fact that subtle changes in the content of property rights can change the micro behaviour of economic actors and macroperformance of an economic system. The most important feature of property rights is that the right is not absolute, but depends on the process of delineation, measurement and enforcement. According to this school of thought, contract is a key element for transacting property rights.

2.6. North's Approach on Institution and Institutional Change

Douglas C. North is one of the major contributors to Neo-institutional Economics. He has developed an overall framework to tackle the relationship between economic activities and their institutional settings in contrast to the neoclassical economics approach which takes institutions as given. This approach is characterised by his dynamic and comparative view on economic development referring to institutional settings.

North's theory of institutions and institutional change (North 1990) provides an analytical framework to study human interaction between institutions and economic organizations. In other words, how institutions evolve in response to individual incentives, strategies, and choices; and how institutions affect the performance of political and economic systems.

2.6.1. The key elements of institution

According to North, institutions are defined as "the rules of the game in a society or, more formally, as the humanly devised constraints that shape human interaction." The major role of institutions in a society is "to reduce uncertainty by establishing a stable (but not

necessarily efficient) structure to human interaction" (North, 1990).

A crucial distinction in North's framework is made between institutions and organizations. He refers it to the competitive sport game by differentiating the rules from the players. "The purpose of the rules is to define the way the game is played. But the objective of the team within that set of rules is to win the game --- by a combination of skills, strategy, and coordination; by fair means and sometimes by foul means." Therefore, modelling institutions is analyzing the creation, evolution, and consequences of the rules, whereas modelling organizations is analyzing governance structures, strategies, skills, and how learning by doing will determine the organization's success over time.

Institutions consist of formal and informal constraints, and enforcement. Formal constraints are classified as explicit rules which include political rules, economic rules and contracts. In any economic system, economic rules in the words of North (1990), "define property rights, that is the bundle of rights over the use and the income to be derived from property and the ability to alienate an asset or a resource". And contracts deal with "the provisions specific to a particular agreement in exchange". When the complexity of a society related to specialization and division of labour is increasing, formal constraints would be expanded because the rate of return to the formalization of constraints is rising.

Informal constraints are classified as (1) conventions, acting as extensions, elaborations, and modification of formal rules; (2) socially sanctioned norms of behaviour; (3) internally enforced standards of conduct or codes. Informal constraints come from socially transmitted information and are a part of the heritage that we call culture. In all societies

from the most primitive to the most advanced, informal constraints are important and pervasive. The study of informal constraints is the subject of multi-disciplines.

The third element of institutional constraints is enforcement which can be done by self-enforced with compliance and third-party enforcement. The more complex the exchange in time and space, the more is the enforcement mechanism necessary to realize cooperative outcomes. "Quite complex exchange can be realized by creating third-party enforcement via voluntary institutions." "Third-party enforcement means the development of the state as a coercive force able to monitor property rights and enforce contracts effectively" (North, 1990). But creating a system of effective enforcement and of moral constraints on behaviour is a long, slow process that requires time to develop.

2.6.2. Institutional change

The dynamic part of North's theory is about institutional change, focusing on the relationship between stability and change of institutions. On the one hand the institutional constraints define the basic structure by which human beings through out history created order and attempted to reduce uncertainty in exchange; on the other hand, the institutional structure provide the opportunity set and shape choice set in various contexts in which organizations and their entrepreneurs engage in purposive activity and shape the direction of institutional change.

North argues that the fundamental feature of the change is that it is overwhelmingly an incremental process. In the process of institutional change, "the sources of change are changing relative prices or preferences." The issue of path dependence advanced by Paul

David (David 1985) is considered as one of the major tools to understand this process. Path dependence defined by Arthur (Arthur 1988) is that the consequences of small events and chance circumstances can determine solutions which, once they prevail, lead one to a particular path. It implies the entrepreneurs' subjective modelling of the environment. Another issue, of adaptive efficiency via allocative efficiency advanced by Pelikan (Pelikan 1987) is introduced to understand the development of institution and organization. In allocative efficiency, the standard neoclassical Pareto condition obtains, whereas adaptive efficiency is concerned with "the kind of rules that shape the way an economy evolves through time. It is also concerned with the willingness of a society to acquire knowledge and learning to induce innovation, to undertake risk and creative activity of all sorts, as well as to resolve problems and bottlenecks of the society through time" (Pelikan, 1987).

2.6.3. Behavioural assumptions and transaction costs

North's approach builds its institutional theory on two fundamental issues: behavioural assumptions and the costs of transacting. The foundation of individual choices, namely the choice theoretical approach of neoclassical economic theory, he views, is a step toward "reconciling differences between economics and other social sciences" and a condition in unifying social science research (North, 1990). North argues that all theorizing in the social sciences builds, implicitly or explicitly, upon conceptions of human behaviour. Motivation and deciphering the environment are regarded as two basic dimensions in dealing with behavioural assumption. The motivation of the actors is more complicated than assumed in neoclassical economics, such as wealth-maximization, altruism, and self-imposed constraints. And individuals receive incomplete information and make choice based on subjective derived models that in most cases there is no tendency to converge (North,

1990). He conceives of a modification of expected utility theory which is the underlying behavioural assumption of neoclassical economics, as an essential step to further progress in the social science.

North points out that rational assumption do not imply that everybody's behaviour is consistent with rational choice. But competitive forces make selection, those who behave in a rational manner will survive, and those who do not will fail. Therefore in a well established market economy, the neoclassical model has been a very effective model for analyzing economic phenomena. In contrast, it implies that this theory does not guarantee the application to a non-market economy.

As an economic approach, the concept of transaction costs founded by Coase is also used by North as a basic theoretical block to explain why institutions exist and how they change. Coase discovers that there is a cost of using the price mechanism (Coase 1937). This idea has been advanced, most notably by Cheung (Cheung 1974 and 1983), Barzel (Barzel 1982 and 1989), and North (North 1981, 1984 and 1990) in line with neoinstitutional economics. "Transaction costs are the most observable dimension of the institutional framework that underlies the constraints in exchange" (North 1990). North further points out that the total costs of production consist of transforming costs that are the resource inputs of land, labour, and capital involved in transforming the physical attributes of a good, such as size, weight, colour, location, chemical composition, and transacting costs that are defining, protecting, and enforcing the property rights to goods (the right to use, the right to derive from the use of, the right to exclude, and the right to exchange). The reason for the costliness of transacting is the costs of measurement and enforcement.

In his theory of institutions, North concludes that "institutions provide the structure for exchange that (together with the technology employed) determines the cost of transacting and the cost of transformation. How well institutions solve the problem of coordination and production is determined by the motivation of the players (their utility function), the complexity of the environment, and the ability of the players to decipher and order the environment (measurement and enforcement)." "The greater the specialization and the number and variability of valuable attributes, the more weight must be put on reliable institutions that allow individuals to engage in complex contracting with a minimum of uncertainty about whether the terms of the contract can be realized" (North 1990).

To sum up, North's work focuses on the interactions of institutions, defined as any constraint humans devise to shape their interactions, and organizations, created to take advantage of the opportunities presented by institutions in shaping the development of economies. The importance of institutions arises from the costliness of measuring what is valuable, protecting rights, and policing and enforcing agreements.

Conclusion

The institutional perspective is a wide and rich subject which has been developed in different periods and areas. It reflects the trend in social science to be more specific in disciplines and also to be able to develop a general subject area like institutional analysis as well. At present, the institutional change has provided a focus of specific attention from the economic point of view. It is possibly explained by the fact that economic development is still a dominant issue in the West and one which is also applicable to change in command economies. Furthermore, the latter case entails more fundamental changes in

which economic development is closely linked to institutional change. Thus institutional analysis is even more relevant. The next chapter is about how to apply the institutional approach to the research presented in this thesis.

CHAPTER 3

RESEARCH DESIGN

The research design aims at solving two problems: first to build up a theoretical framework to lead an investigation of the CMRS, and second to choose a scientific approach to conduct the investigation. The former is to concern the theoretical issues of the subject, and the latter is to consider the methodological problems of the research. In addition, the last part of the chapter is to describe the research process. Thus the chapter is presented under three headings:

- Formulating the theoretical framework,
- Some methodological considerations,
- The actual research process.

3.1. Formulating Theoretical Framework

To formulate a powerful theoretical framework is the most challenging step in conducting this research. This is due to the fact that the CMRS essentially is the subject of how to set up new institutions for the economic transition, but also it involves many management issues as well. The challenge is how to find out an approach to be able to deal with these two types of issues together. More precisely, there are three areas the research needs to deal with: first the CMRS is about to set up a new institutional relationship between the government and the state-owned enterprise which includes the issue of setting up rules,

procedures and enforcement mechanism. Meanwhile it inevitably creates an interactive process which involves the managers' and employees' activities as well. The most important management issue and the second area for research in this process is the managers' strategic response to the new arrangement which will impact on the future of the system. Third the research needs to be able to answer the question of how to assess the future of the CMRS. Therefore it needs a powerful theoretical framework to study this complicated interactive process of institutional change.

The theoretical framework adopted in the research is based on the structural paradigm (See Chapter 2). This paradigm provides all the key elements for constructing a framework to analyze the CMRS in terms of institutional change. The six key elements identified by Smelser in the structural paradigm (Smelser, 1988) can be used to formulate a theoretical framework.

First, the structural paradigm will guide the choice of the basic units of analysis which possess relational characteristics of some kind. The latter can be conceived of as role relationships or group relationships. A kind of role relationship would further constitute an institutional relationship arising from interaction among persons. In the research, the basic units of analysis are the government and the state-owned enterprise which are considered as an inter-role relationship of an institutionalised nature. During the transition of the economic reform, both of them are changing their roles and their institutional positions. The notion of role relationship is more adaptable to the study of the economic reform than group relationship, because it draws attention primarily to the actions taken by both parties instead of grouping people. It might provide a more objective view of the

economic system, especially during the period of change.

Second, the notion of structure also implies that the basic units of analysis have some kind of special or non-random relationship which is a definite, systematic relationship with one another. In this research, the property rights structure is considered as the basic structural relationship between the government and the enterprise. It is due to the consideration of property rights as the fundamental nature of an economic system and the basic elements for economic exchange (Furubotn and Pejovich, 1972). According to the property rights school, the content of the property rights are not simply defined by law, but continuously explored in the process (Barzel, 1989). During the change of economic system, the property rights structure obviously becomes an even more critical issue. The CMRS essentially is a kind of new arrangement for the property rights structure which is further modified by interaction between the two parties. For a range of reasons, the CMRS can be considered as a kind of definite and systematic relationship appropriate to the analysis of property rights structure.

Third, closely related to this notion of structure is the implication that interactions among the basic elements of analysis are repetitive in space and time. Actually the notion of repetition is centred to a dynamic or process view of relationship. In other words, "structure and process are two expressions of the same thing: Structure is a kind of generalization based on observation of repeated processes of interaction among the basic units of analysis, and process is the behavioral manifestation and evidence for structure" (Smelser, 1988). This dynamic view is particularly powerful in analysing the institutional change. As mentioned before, the property rights are not absolute, but further explored in

the process. As an institutional arrangement, the CMRS provides opportunities and constraints to both sides which response in one way or another. The implementation of the CMRS is an interactive process, composed of strategic decisions made by both sides. Eventually it shapes the development of the CMRS, and how these have subsequently developed in the perception of the actors.

Fourth, the notion of structure implies the notion of boundaries. It means that "the relationships within a structure are different from relationships with units that are considered to lie outside the structure" (Smelser, 1988). This idea further clarifies the concept of structure in terms of frame of reference, in other words, the notion of difference-from-outside. It is also powerful to describe the change of structures and institutions. It provides another dimension to look at the change of institutions. The change of boundaries implies the change of institutions. And to some extent the ambiguity and stability of boundaries account for the degree of institutionalization. All these issues are relevant to the study of the CMRS. It highlights the outcome of interaction in terms of previously defined boundaries between the government and the state-owned enterprise.

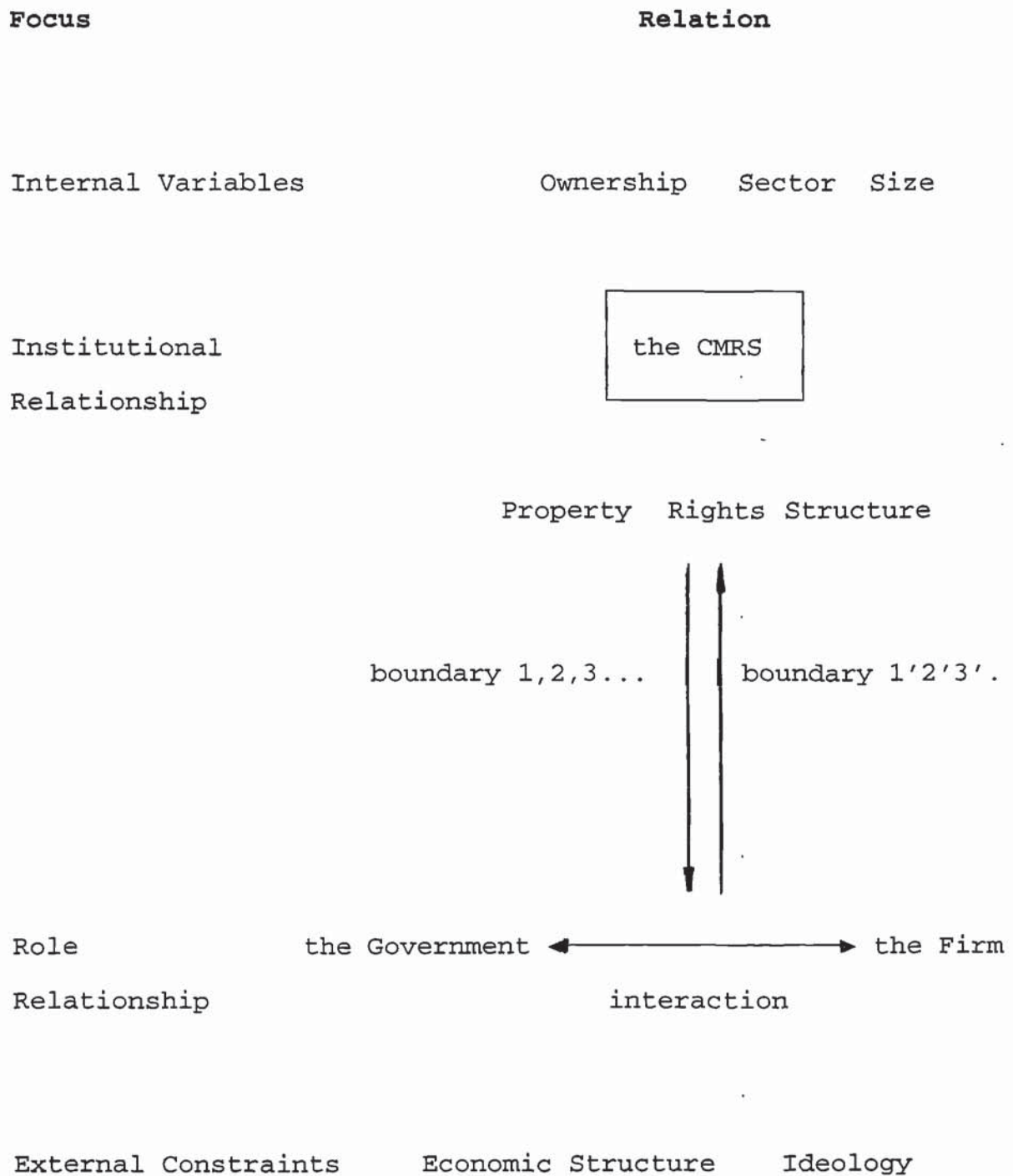
Fifth, the notion of boundaries leads to the notion of structure-in-situation and structure-in-environment and the degree of their impacts. It means that structure is varied by internal variables and restricted by external constraints. The significance and impact of these factors is a matter of degree. In this research, the internal variables are identified as the ownership status of the company, the industrial sector it belongs to, and its size in terms of employees and assets employed. The external constraints are the economic structure in terms of market and planning, and ideological issues related to the economic sphere.

It assumes that these factors have the most impact on the rule of the CMRS. The empirical study focuses on these factors.

Finally, the notion of structure possibly includes a consideration of the reasons for, or causes of structure. These accounts are shaped by the theoretical differences. For example, a structural-functional explanation is more adopted by sociologists, and the notion of transaction costs are forwarded by institutional economists. This research is more inclined to the structural-functional approach, although it does not exclude the economic analysis. Two functions, dynamic and control are considered as the main causes for the continuation of the CMRS in its evolutionary pattern.

As a result, all these considerations can be expressed in a diagram shown in Figure 3.3. In this diagram, the government and the enterprise are seen as two basic units of analysis of a kind of role relationship, involving in meaningful interaction to one another. And the CMRS is conceived as a kind of institutional relationship to delimit the boundaries of the role relationship, but also to be further shifted by their responses. All these activities are constrained by internal variables and external constraints. All in all the property rights structure is considered as the basic relational pattern to govern the structural analysis. The diagram provides a dynamic picture with all key elements to study the complicated process of institutional change.

Figure 3.1. The Theoretical Framework



From this diagram, the three key research questions mentioned before can be further identified as follows:

- to study the structural features of the CMRS which includes the role relationship between the government and the state-owned enterprise as well as the institutional feature of the CMRS with respect to property rights structure;
- to study the interaction process between the government and the state-owned enterprise which includes the actions taken by both sides and the motivation inspired by the system, as well as how the meaningful actions are constrained by internal variables and external constraints;
- to study causes or reasons to explain whether or not the CMRS as a new institutional arrangement can be institutionalized.

To answer these three questions, the research is conducted by an empirical study through four in-depth case studies (See chapters 5 and 6), and with a further theoretical interpretation in terms of institutional perspective (See chapters 7, 8, and 9). The methodological considerations are identified below. Since the three questions are interrelated to the process of institutional change, the study may provide insights for a better understanding of the theoretical issues of institutional change, and also might to have a better view of the economic reform as a mass process of institutional change. Those considerations are addresses in the last chapter of theoretical and policy implications (See chapter 10).

3.2. Some Methodological Considerations

Given the abstract nature of the theoretical framework of the subject, the important thing

is to find a proper way to carry out the empirical study. This needs methodological consideration. The starting point for that is how to cope with the nature of the research problems. Different destinations need different routes. For instance, the study on macro economy is inclined to be quantitative research, while the ethnographic research is very much qualitative research oriented.

In this research it is rather difficult to answer the three main questions by conducting a quantitative survey, because key variables and general relationships need to be emerged through grounded research rather than to be pre-determined in a questionnaire. Although some studies have been done in the past, these are rather fragmented and do not offer a clear framework for a quantitative survey. Since the CMRS is a new institutional arrangement to deal with a critical link between micro and macro levels it involves many fundamental issues in the economic transition. At this stage it needs an overview which evaluates the CMRS as a whole by considering it as an independent system with its own boundary. It leads to holistic approach in which a qualitative method can be used to conduct an empirical study.

3.2.1 Holistic approach and qualitative method

The holistic approach "takes as its problem the nature of a total system, rather than of a particular process within the situation" (Weiss, 1968). In other words, the subject is conceived as an independent system with its own boundaries, the so-called bounded system (Ashby, 1960). The study is to assess the system as a whole rather than to study some of its elements. In holistic research, the product of the research aims not at the testing of a set of hypotheses but rather at the discovery of new patterning organization, institution or

system. In other words, holistic research is essentially hypothesis-generating rather than hypothesis-testing (Becker, Geer, Hughes, and Strauss, 1961). The method allows discovery of the variables themselves as well as relationships between variables. In other words, the research aims at empirical generalization which is a "statement of relationship that is constructed by first observing the existence of a relationship in one or a few instance, and then it generalizing to say that the observed relationship holds in all cases or most cases" (Bailey, 1987). Essentially it is a grounded methodology or inductive approach in which variables and hypothesis are emerging from the data rather than being determined in advance (Glaser, and Strauss, 1967; Bailey, 1987).

To conduct holistic research, a qualitative method is more suitable than a quantitative one. Weiss argues that "qualitative data are apt to be superior to quantitative data in density of information, vividness, and clarity of meaning---characteristics more important, in holistic work, than precision and reproducibility" (Weiss, 1968). This is due to the fact that holistic assessment requires data that concern virtually every important issue which may emerge from the system, this demand for density leads to the case study or small sample study as preferred research design. The case method could involve the use of unstructured or partly structured interviews, participant observation and document study. In other words, it is a kind of triangulation in terms of the use of multiple methods in research (Denzin, 1978; Jick, 1979). The purpose of using multiple methods is to achieve a particularly good understanding of the system in order to gain a holistic view.

In the qualitative research, the important question is how to assess credibility of qualitative data for holistic research. Apart from the usual criteria (evidence for important

assertions, correspondence to facts the reader already knows, internal consistency), many authors emphasize the effects of the sympathetic understanding (Glaser and Strauss, 1965; Weiss, 1968). Qualitative data can bring the reader to visualize the situation in its terms and elicit an empathic response. "A theory has been accepted not because it has been demonstrated but rather because it is appealing" (Weiss, 1968). However the problem of qualitative data also arises from the fact that it might be appealing but might not compel. This shortcoming can be compensated by conducting similar qualitative research or by further quantitative studies. Nevertheless, the holistic approach using qualitative methods has a unique value in conducting certain type of research. This approach appears valuable for the empirical study of the CMRS. It aims at perceiving all important issues, discovering variables and relationship between variables, and eventually generating hypotheses. More specifically a case study method with semi-structured interview is chosen for this qualitative study.

3.2.2. Case method and semi-structured interview

The reason for choosing a case study method and semi-structured interview is that the research has to deal with a complex and longitudinal of the process. The complexity is basically caused by the occurrences taking place at both institutional and organizational levels, to deal with interorganizational decisions on the one hand and individual choice on the other hand. Furthermore the study deals not only with people's behaviours, but their motivations as well, that is to say, the ways they interpret the world. In terms of the time horizon, the study covers a five-year period during which the CMRS completed a first contractual term and started a new term, which makes a longitudinal comparative study possible.

Taking all these factors into account, the case method has two major advantages:

(1) to be flexible, because the interviewer can probe for more specific answers and can repeat a question when the response indicates that the respondent misunderstood. A more important point is that different questions are appropriate for different respondents; the interview situation makes it possible for the interviewer to decide what questions are appropriate.

(2) to be able to investigate complicated issues, because a more complex questionnaire or semi-structured interview can be used in case study. For the latter, topics and hypotheses are selected in advance, but actual questions are not specified in advance. The interviewer is able to "tailored to probe avenues of exploration that seems to yield information relevant for the hypothesis or topic being studied" (Bailey 1987). As Merton argues, this method includes "unanticipated responses, gives rise to fresh hypotheses for more systematic and rigorous investigation" (Merton, Fiske, and Kendall, 1956).

The semi-structured interview is particularly suitable for Chinese managers in comparison with the structured questionnaires which was only introduced very recently in China. It has been part of the daily routine for the Chinese managers to participate in long discussions either with their colleagues or leaders, and this is regarded as the most important approach to communication. Through face-to-face communication it is easier in China to find common ground and to break down barriers between participants, such as social status, ages and sex; and also to avoid any risks involved in written language, especially when one needs to express controversial issues. A semi-structured interview is closer to this approach and is readily accepted.

The obvious disadvantages of this method are that it is time consuming and more expensive, which makes the sample smaller. An even more important obstacle to use of this method, not always recognized by researchers, is the necessity of sophisticated communication skills. It requires researchers able to deal with all sorts of interviewees to understand their positions, to appraise their personalities and to appreciate their culture in the wide and the narrow sense. The last point means that foreigners need to understand the culture of another country as well as a specific organization, while local researchers may take national culture for granted. This problem is related to another basic methodological concern which is the meaning of action.

The notion of meaning is a critical point of the research, because all the investigations are to link actions to subjective meanings. This feature of social actions is brought out in phenomenological methodology (Smelser, 1988). In the interactive process, individuals communicate with one another, create and derive meaning, and act on it accordingly. It means that process is not only the accumulation of events, but mental constructs as well (Berger & Luckman 1967). This highlights the importance of meaning which is not only a tool to understand action, but is process itself. In other words, "members of society use the practice of commonsense reasoning not only to make sense of their world, but even to construct and perpetuate the ongoing social world" (Bailey 1987).

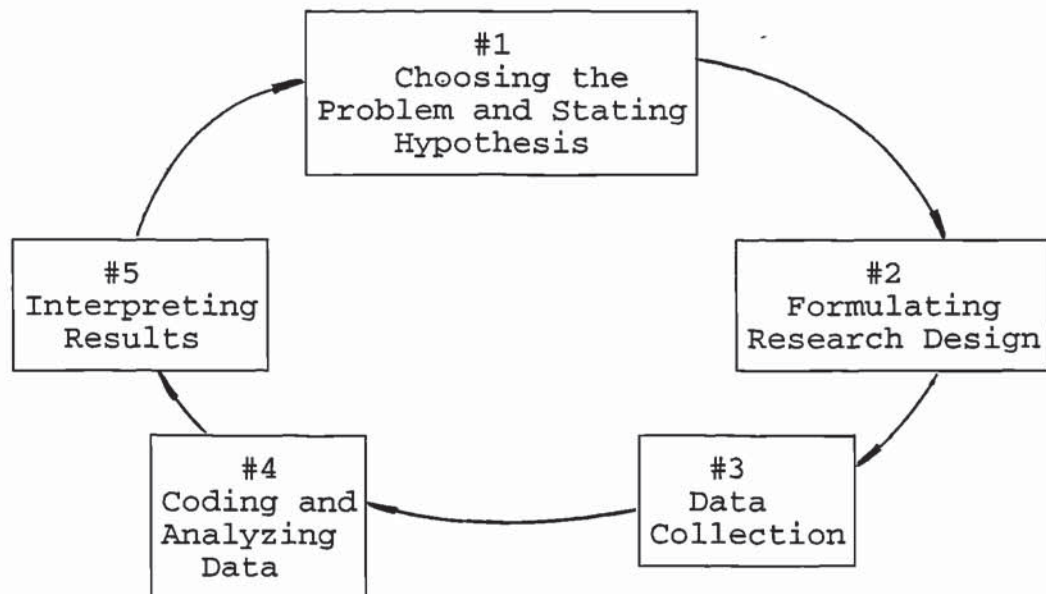
This view has important implications for the research, because the reform not only changes the way of doing things, but the value system as well. Broadly speaking, the interpretation of economic activities in China is shifting from the dominant ideology of a command bureaucracy towards economic rationality. This has substantially impacted on economic

choices. Therefore during the case investigation, it is important to attempt to trace the meaning of actions. This has been attempted through semi-structured interviews. The actual data collection process is given below, including the questions when used in the interviews and other explorations.

3.3. The Actual Research Process

As a scientific research, the process is usually characterized by several stages which is best received as a circle shown in Figure 3.1. (Bailey, 1987):

Figure 3.2. Stages in the Research Process



One of the important issues in this diagram is where to start and where to end. It is essentially a matter of choice and the understanding of the problem. Some people might be puzzled by occurrences, others excited by new explanations. They decide their way of conducting research, for example, either by hypothesis testing or by a new theory building. This research started with the puzzle of the complicated phenomenon occurring in the

economic reform, and searches for a better explanation. As described, it is a kind of inductive process with from a holistic view point.

3.3.1. The research stages

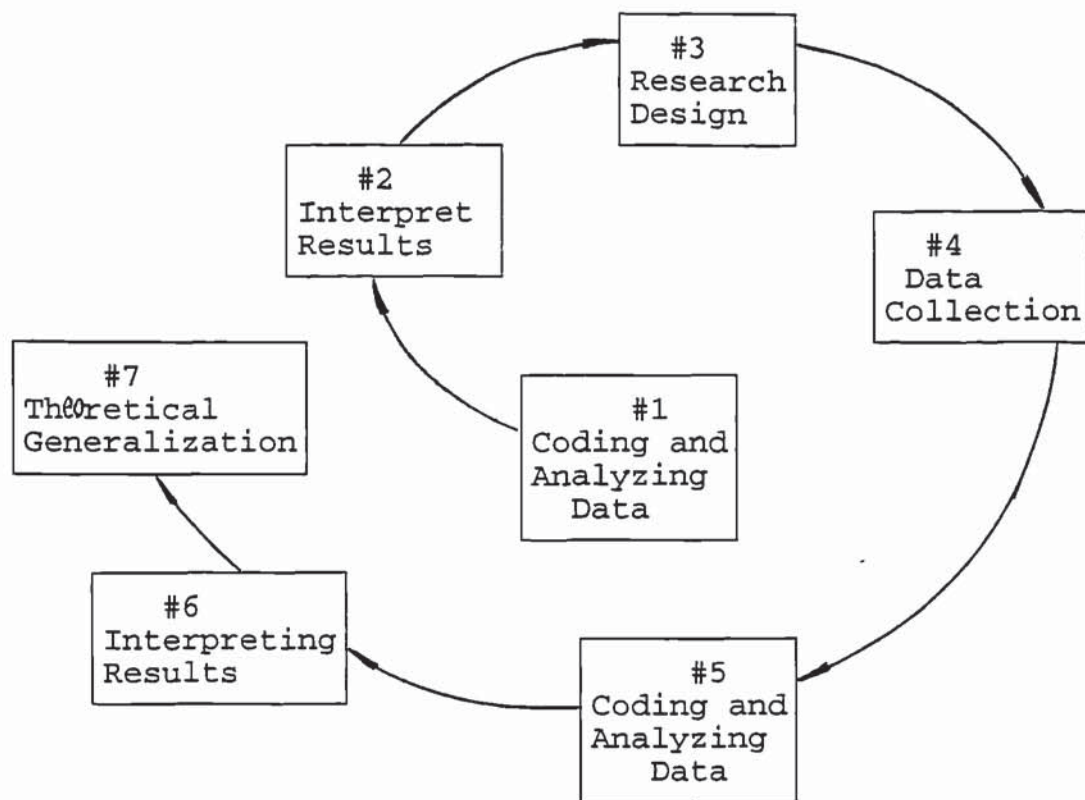
The actual process of the research is shown in Figure 3.2. The research started by coding and analysing the existing data, and then attempted to make a primary interpretation of the data by applying some theories, for example, agency theory and Williamson's transaction costs approach. But the analysis showed that the existing data, for example the study conducted by the research group on Chinese enterprise reform (Research Group on Chinese Enterprise Reform, 1988), were not sufficient to demonstrate what happened in reality, and also the chosen theories were not powerful enough to explain the complexity and novelty of the problem. Therefore, it was not possible to define accurate hypotheses to be further tested at that stage.

After such a primary assessment, the turning point comes in achieving a holistic view of the system as a whole is required, rather than testing a few hypotheses. In order to achieve this, the research was carried out by the substantive investigation through wide-ranging interviews in both formal and informal settings. Four companies were chosen as the formal base to carry out the systematic case studies. Meanwhile the author also used every opportunities for informal contact with people who were involved in the CMRS in one way or another but from different organizations, such as the managers, the workers, the engineers, the researchers, and the officials, to get their views on the CMRS. This helped a great deal to formulate a coherent picture of the main issues occurring in the system. To some extent it further proved the representative nature of the limited case samples.

Furthermore the author's previous working experience helped in achieving a better understanding of the problems and in communicating with the people.

One year's field study resulted in rich empirical material. The next step was to find out a proper theoretical framework to account for the results. This led to a process of learning and searching for adequate theoretical perspectives and explanations. It was the most difficult part of the research, because the academic and language barriers encountered by the author who comes from a different academic tradition and a non-English speaking country, and proved as enormous challenge. Eventually an institutional perspective was chosen as the main approach, and the outcome of the research is the empirical generalization about the institutional change.

Figure 3.3. The Actual Process of the Research



3.3.2. the process of data collection

Several things need to be mentioned here which concern the empirical work: first, how the companies for the case studies were chosen; second the process of interviews which includes what questions were asked during interviewing and who were interviewed from the companies, and third what are the major difficulties encountered in the process.

*** the selection of the four companies**

The criteria for choosing the companies are that they should be being representative, comparable and manageable. First, obviously the companies must be state-owned,

otherwise they do not adopt the CMRS. But one type of company, the so-called "higher collective enterprise" i.e. a quasi state-owned enterprise is also selected, because it represents a type of state-owned company with some collective features due to historical reasons (See the case of BLSC). In other words in the Chinese industrial ownership spectrum between the state-owned company to the collectively owned and to small private business it this kind of company closer to the state-owned enterprise, but not occupying exactly the same place. There is a high proportion of this type of companies in light industry. The empirical study shows that the subtle distinction between ownership structures has rather an important impact on the managers' strategic choice. Therefore the ownership status is conceived as one variable.

Second, all the chosen companies are medium- or large-sized, according to the number of employees, fixed assets, and turnover. This is because the large- and medium-sized companies were exclusively state owned, with a very high proportion of output and turnover in Chinese industry in the pre-reform period (See chapter 4). Since 1979, these two types of companies have always been at the heart of enterprise reform. Therefore the study of the state-owned enterprise is desirable to focus on these two types of the companies. Among the four chosen companies, three are medium-sized and one large-sized, corresponding to the distribution of a higher proportion enterprises with medium size and a lower with large size in the industry (See chapter 4). The impact of size has to be taken into account, because it associates to decision making in a hierarchical system. But economic scale is closely linked to technology, most of large-sized enterprises are in heavy industry. In the following chapters, sometimes size is more emphasized, sometimes not, depending on the type of decision evolved.

Third, the four companies are chosen for the case studies, two in heavy industry, and two in light industry. Four companies assume to be manageable in terms of in-depth case studies. And also, as a comparative study, four companies provide opportunities to have a minimum comparison within the same sector and between two sectors. Moreover the chosen companies within each sector the produce similar products that is to say, two in electrical engineering and two in consumer products, which make a comparison still easier.

Fifth, the selection of two sectors, light and heavy industries is derived from the primary study in which all the messages show that the distinction between two sectors has enormous influence on the decisions taken by both sides. It can be traced back to the development pattern of the socialist economy and still has strong impact on the current economic structure. Therefore the research takes it as a key variable.

Sixth, all the four chosen companies are located in the same city, Beijing, the capital of China. The major advantage is that the implementation of the government policy in the capital is closer to the original form with less distortion by the official's personal judgement. This issue is specially important for studying the relationship between the government and the enterprise. Another advantage is that the author has a better channels of information in Beijing than other cities. Compared with the south of China, the Beijing managers' behaviour might be less market oriented, more radical compared with north, so that the research might provide one type of the behaviour under the CMRS which can be further exploited in other studies.

Seventh, all the four companies belong to the best performing companies in the sector

which provide a comparable base for their behaviours and decisions. More detail of the background of each company is given in Chapter 6.

Based on these criteria, the four companies are chosen as follows:

- Beijing Electric Power Generator Company (BEPGC),
- Beijing Transformer Company (BTC),
- Beijing Dahua Shirt Company (BDSC),
- Beijing No.1 Leather Shoe Company (BLSC).

*** the questions and the people interviewed**

The interview process was rather complicated and time consuming, but all the conversations with the officials and the managers were around the following three questions:

- What do you think about the CMRS ?
- What kinds of key decisions you have made in formulating and implementing the contracts ?
- What kinds of motivations and interests are behind these decisions and how do you perceive the other party's decisions ?

The first question attempts to explore their attitudes and beliefs, especially referring to the role of the government and the firm, and also referring to what kinds of expectations on the economic transition they hold. The second question aims to discover the real decisions they made in order to know the characteristics of their behaviours. And the third question is about the motivations and interests behind their strategic decisions. It assumes that the

better the information we obtain from the three questions, the better we understand the interaction process.

During the investigation, about the sixty managers and officials who had involved in the CMRS were interviewed. Each interview usually took two to four hours, and 50% of the interviewee was interviewed more than twice which made deeper conversations possible.

The managers who had the important positions referring to the CMRS in the four companies were interviewed as follows:

- the director of the company,
- the deputy directors who are responsible for financial issues and the company's strategic development,
- the middle-rank managers who are responsible for financial, personnel, marketing, and general management decisions, as well as the manager who is responsible for the general office in company (1),
- Some key staff in those departments who usually have first hand knowledge about what happened in the companies and more willing to disclose information.

On the government side, it is difficult to conduct a systematic interview in each important position. But it is still possible to have a few key persons with deep talks. The most important conversations were held with the following people:

- the deputy director of the management department in the state planning commission,
- the chief advisor for economic reform in the Economic and Social Development Centre under the State Council,

- the head of management department in Beijing Economic Commission who is responsible for implementing the CMRS in Beijing,
- the official in Beijing Industrial and Commercial Bank,
- the official in Beijing State Assets Administrative Bureau,
- the official in Beijing Financial Bureau,
- the official in Beijing Labour Bureau,
- the official in Beijing Machinery Bureau,
- the official in the management department of Beijing light industrial bureau,
- the official in Beijing United Clothing Company (i.e. a kind of quasi-bureau).

3.3.3. The understanding of the interview

Apart from the normal difficulties occurring in interview, such as the difficulty of finding right people, getting agreement, making appointment, and talking openly, one thing more is needed for such open interviews with Chinese managers and officials. That is to build up a kind of interest or belief that your research is valuable for something important, such as policy making to macro-economy or specially important training programmes, which is not necessarily of direct benefit to their own company or themselves. If convinced, they are ready to contribute as much as possible. Of course they would not simply believe an official letter or statement, but need to assess your position, your experience, and your communication skill etc. before they speak openly and deeply. Otherwise, the interview would go on superficially with few or no new discoveries. The other way of doing it is to find friends or acquaintances to collect data, the so called "guan xi", but it is unrealistic to have such people in every place. By and large this phenomena might account for the cultural and ideological impacts on scientific research.

To sum up, this chapter covers the major issues in terms of theoretical framework and research methodology which will provide a foundation for further describing and interpreting the research results.

Note:

(1) The manager who is responsible for the general office usually is the person who has a regular contact with the government agencies. Under the CMRS, this is the important position to link the company with the government.

PART II

As given before, the CMRS aims at changing the relationship between the government and the state-owned enterprise. It bases on the idea of separating management from ownership which supposes to be widely applicable in modern economies, both to public and private ownerships. This thesis is not going to argue whether this assumption is true or not, but to study what actually happens between the government and the state-owned enterprise under the new institutional arrangement of the CMRS: their role and institutional relationships in terms of the property rights structure through their interactions. And then the thesis is going to the further theoretical analysis with respect to the institutional perspective. It assumes that the empirical based research is critical to understand the process of this institutional change. Thus the empirical study, presented in Part II, is an important part of the research. It includes the background material of the CMRS in Chapter 4, the formulation of the contracts in Chapter 5, and the implementation of contracts in Chapter 6.

CHAPTER 4
BACKGROUND
--- THE RELATION BETWEEN THE GOVERNMENT AND
THE ENTERPRISE

The relationship between the government and the state-owned enterprise is the core of the CMRS. The changes of this relationship are inevitably influenced by its historical development (Jiang , 1980; Granik, 1990). This chapter attempts to highlight the basic features of the relationship in the pre-reform period, and also points out the different ideas towards economic development which determines the nature of this relationship. And then it will move to the introduction of the CMRS in terms of its historical experience and current development.

4.1. The Relationship between the Government and the
Enterprise Before the Economic Reform

4.1.1. The functional structure of the relationship

As widely acknowledged, the command economy was characterized by two features, central planning and public ownership which is deeply rooted in the socialist doctrine. Moreover this notion can be further interpreted by its structural feature. As the theory of totalitarianism argues, in the previous Soviet society, the boundary between state and society was destroyed and the possibility of establishing any autonomous social institutions was eliminated. The whole society was under the party-dominated hierarchical control

(Friedrich, 1954). Broadly speaking, this notion was well applied to the Chinese society in the pre-reform period as well. All the organizations, no matter whether they dealt with political, social or economic matters, were exclusively under the government direct administrative control. Beyond that, any autonomous unit was not allowed to exist, for example, it was even impossible to organize a club by individuals themselves. Under this rule, organizations and institutions were differentiated by functions, not by the notion of independent identities. Each organization only played certain functions in a big administrative network, and they were inter-dependent on each other.

The relationship between the government and the enterprise could be conceived as an important chain in this big network. In terms of central planning, the enterprise acted as a basic production unit, and in terms of public ownership, the enterprise was a basic social unit.

As a production unit, the enterprise was only responsible for transforming inputs to outputs according to plans, in other words, how to get inputs and how to distribute outputs were beyond their responsibilities. The whole arrangements of inputs, including labour force, raw materials and lands were allocated by government agencies, and the outputs were distributed by them as well. Under this system, the enterprises had to hand over to the government all the profits they generated, and to get grants for its investment if necessary. Nee names it as a redistribution economy (Nee, 1989). The role of the manager at the enterprise level was similar to the role of a line manager in the West. In financial terms, the enterprise performed as a cost centre rather than a profit or investment centre which means the company was only responsible for costs occurring in the transformation of

inputs to outputs.

As a social unit, it took all sorts of social responsibilities which included employees' career development, housing, medical care, pension funds, children's education and even family matters. To some extent it played the role of a traditional family. As a consequence, it has substantially reduced the employees' dependence on their family ties which has been often shown in the overseas Chinese societies. Effectively the enterprise became a blending organization to entail production and social functions, the so-called production-centred communities (Andor, 1977). In this sense, economic and social functions were not differentiated in the Chinese planned economy.

On the government side, the whole industry was organized as one single company, coordinated by a bureaucratic force through hierarchical structure. In order to carry out all the transactions "internally", the economic departments in the government were classified as three functions:

- Personnel administration which was responsible for deciding on managerial staff, professional staff and workers for each enterprise in terms of job design, motivation scheme, and training etc. As a rule, in the command economy, every one should have a working position in the society, without unemployment, but also there is no personal choice for their career development as well.

- Tangible assets administration, which was to decide the allocation of physical inputs (input provision) and the distribution of final products (output procurement). In other words, it was a kind of supply and sales agent, but organized by the government, either at the central government or local levels, depending on the government policy in the

degree of centralization versus decentralization which was changing from period to period.

- Fiscal administration, which was to decide all sorts of financial issues including profit remittance, working capital (circulation funds), investment funds, wage control and welfare funds etc. There was no income tax for the state-owned enterprise due to the nature of public ownership.

Correspondingly, administrations were conducted by functional structure, but organized in a metric way. It means that on the one side there were functional bureaus; on the other side, they were central or local governments (See Figure 4.1). A kind of general office, such as the state economic commission at the central level and the industrial bureau at the local level to coordinate these functional organizations. The structure of the system was complicated, but the principle is simple: a metric-functional structure right through macro to micro levels.

Under this system, enforcement mechanism was carried out by administrative or political or ideological forces, but not relying on a legal system which did not yet exist in the Chinese economic arena. The overwhelming power came from the political force to deal with the most difficult problems, for example, changing economic policy.

**Figure 4.1. A Functional-Metric Structure of the
Planned Economy**

	National	Local
Personnel	NPM	LPB
Tangible Assets	NTAM	LTAB
Financial	NFM	LFB
General	SEC & SPC	LEC & LPC
	IM	LIB

NPM : National Personnel Ministry,
 NTAM: National Tangible Assets Ministry,
 NFM: National Financial Ministry,
 SEC: State Economic Commission,
 SPC: State-Planning Commission,
 LPB: Local Personnel Bureau,
 LTAB: Local Tangible Assets Bureau,
 LFB: Local Financial Bureau,
 LEC: Local Economic Commission,
 LPC: Local Planning Commission,

IM: Industrial Ministries (1),
 LIB: Local Industrial Bureau.

(1): A Functional-Metric Structure in Ministries

	IM (Industrial Ministries)		
	X1	X2	X3
Personnel	X1PB	X2PB	X3PB
Tangible Assets	X1PAB	X2PAB	X3PAB
Financial	X1FB	X2FB	X3FB
General	X1GB	X2GB	X3FB

4.1.2. the ownership structure of the industry

Public ownership was the most essential issue in the socialist economy as private ownership is in the capitalist economy. After the communist party took over the regime, the first thing was to transfer the private companies into a kind of public-owned firm, either under the heading of owned by the "whole people", (state-owned), or owned by a group of people (collectively owned).

This movement was took place in the 1950s in China. The interesting thing is that this transformation took a much milder approach than that in the former Soviet Unit. At the very beginning all companies or business were classified as three types:

- owned by bureaucrat-comprador bourgeoisie, mainly in heavy industry with medium or large sizes,
- owned by national bourgeoisie, mainly in light industry with medium or small sizes,
- owned by handicraftsman with small size.

For the first type, the companies were immediately confiscated into the state-owned after the regime was changed, while for the other two, the treatments were different. In the first five years, private business were allowed to co-exist with state-owned companies. It even encouraged entrepreneurs to set up new businesses. The nationalization of the second sector took place in 1956 not by confiscation, but by redemption. It meant the government would pay the previous owners the 5% interest rate for their assets in 20 years time (This payment was stopped during the Cultural Revolution and continued afterwards). Meanwhile the small handicraft businesses were either re-organized into the collectively owned companies (many of them became the so-called higher collective company) or still

managed as a one-man business. Since 1957 the state-owned companies had played a dominant role in Chinese industry. Between 1957-1978, there was no dramatic change in the ownership structure, except in a small scale of newly established township companies in the 1960s (Editorial Board for the Contemporary Chinese Economy and Management, 1986).

When the CMRS was introduced in 1987, the state-owned companies with large and medium sizes still had a leading position in Chinese industry (See Table 4.1., 4.2. and Figure 4.2). The tables show that although the number of this section is relatively small, the output they produced and the fixed assets they possessed are very high. If we consider that higher technology products are mainly produced in this section, their importance is even more transparent.

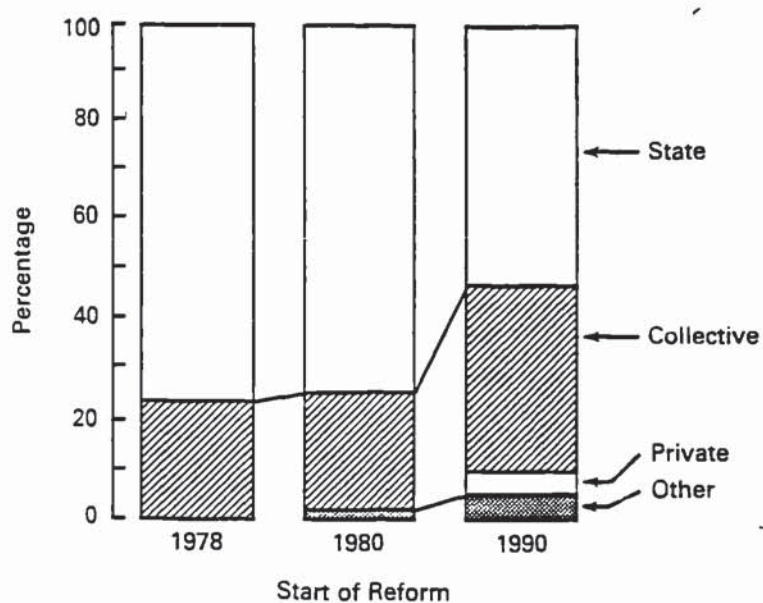
Table 4.1.

Composition of Industrial Enterprises by Ownership

	1988		1990	
	No.	%	No.	%
total	420,929	100	421,000	100
State-owned	72,494	17.2		
Collective	343,866	81.7	344,799	81.9

Source: State Statistical Bureau 1990: 271

Figure 4.2. The Structure of Industrial Output Value



* Source: State Statistical Bureau (1991: 447).

Table 4.2.

**Relative Importance of Large, Medium and small Enterprises
in 1990**

	Large	Medium	Small
% of Population	0.8	1.8	97.5
% of Output	30.7	19.7	49.6
% of Net Fixed Assets	45.6	20.0	34.4
% of Employment	19.0	14.0	67.0

Source: State Statistical Bureau 1990: 277&320.

4.2. Two Approaches for the Economic Development

Given the similar structural and ownership features of the system, the Chinese economy is by no means a simple copy of the Soviet-type. The latter had remained a highly centralized and very rigid form for several decades, while the former had experienced several changes. But the economic targets were more or less the same: rapid growth through a steep rise in the rate of accumulation; selective growth focusing on heavy industry; and output and employment maximization (Brus and Laski, 1989). The major difference in these targets is that the Chinese economy had paid much more attention to developing agriculture and light industry rather than only on heavy industry.

In China in the pre-reform period, the frequent changes had taken place in terms of centralization and decentralization. It meant that the decision-making power was shifted between the central and local governments (Andor, 1977). It also meant the power was shifted among party-politicians, technocrats and blue-collar workers. Generally speaking, the thirty years planned economy could be roughly classified as four periods referring to the degree of centralization and employees' participation, although each period had its own policy focus (See Table 4.5.).

Table 4.3.

Comparisons of the Administrative Structure in 1950-1978

Periods	Centralization	Participation		
		* TC	PP	WR
1950-1957	** +	+	-	-
1958-1960	-	-	+	+
1962-1966	+	+	-	-
1967-1978	-	-	+	+

* TC: Technocrats; PP: Party-Politician;
 WR: Worker.

** + = higher; - = low

These frequent changes demonstrate different ideas for economic and social development. Lee argues two policy-making approaches which are administrative versus preceptoral approaches in the pre-reform period (Lee, 1987). Someone emphasises on Maoist mobilizational approach versus highly centralized planning approach (Stark and Nee, 1989). Chen points out two models could be abstracted from the thirty years practice, which contain different principles towards economic and social development (Chen, 1988). Model One concerns that economic development is an unbalanced and dynamic process even under a socialist economy. The central planning only plays a limited role. In contrast, a mass movement with strong charismatic leaders could be applied to the economic

domain. It calls for a rather decentralized administrative structure. The emphasis is on how to arouse the initiatives, especially from the people who are directly involved in the first production line, such as workers and the line managers. An example was the policy, the so called "two participation, one reform, three-ways combination" i.e. cadre participation in production process and worker participation in management; reform of irrational and outmoded rules and regulations; close cooperation among workers, cadres and engineers (Editorial Board of the Contemporary Chinese Economy and Management, 1986). This view believes that ideology plays a very important role in motivating people as well as coordinating their activities. As a consequence, this model usually led to a kind of policy which created a dynamic situation at the beginning, but ended up in a chaotic situation by the end. The Great Leap Forward was a typical example. It was mainly due to the lack of economic thought of rationality.

Model Two emphasises the rationality of the planned system which was supposed to lead to a balanced and planned way of developing. This idea is in line with Lange's argument about socialist economy (Lange, 1936). It believes that a planned system could achieve a super-efficiency for resource allocation which could be even higher than that in a market system. It prefers a rather centralized structure. Correspondingly, it emphasises the role of professional people who deal with technical and administrative problems and material incentives as well. As a consequence, it led to a rather stable but rigid economic situation in China.

By and large, Model One is inclined to a dynamic, but less rationalized approach, depending on charismatic leader and mass movement, while Model Two is inclined to a

rigid, but more rationalized approach, depending on rational planning and hierarchical control. This long-lasting debate has had a profound impact on the thoughts of economic reform. That is to say, how to achieve both dynamic and control functions in an economic system is a real challenge for the reform. It leads to the concern about the role of the enterprise. The past experience showed that centralization versus decentralization did not change the function of the enterprise, it only shifted power between the central and local governments. In the reform it needs to give a new role to the enterprise and to establish a new relationship between the government and the enterprise, the state-owned in particular.

4.3. The Development of the Contract Management Responsibility

System

To find out a new institutional arrangement between the government and the state-owned enterprise is at the heart of the economic reform. As described before, in the previous system, to transfer the enterprise into an independent economic identity was never put on the agenda, no matter how many changes had taken place in the relationship between the central government and the local government. "Free firm" was conceived as a product of market economy which is not suitable for a planned economy. In 1979, since the idea of a commodity economy was accepted as one of the basic principles of the socialist economy, the new role enterprise has been concerned. The emergence of the CMRS, therefore, originated from this conceptual change. Meanwhile the ownership reform in agriculture acted as a trigger to promote the idea of a contracting system for the industrial enterprise. In addition, the idea of setting up a contracting system could also be traced back to Chinese history during which it also evoked much controversy.

Before entering a detailed discussion of the CMRS, it is necessary to clarify the term contracting system in the Chinese content which is different from the concept of contract based on the modern contract law in the West. The basic idea of contracting system, the so-called "Cheng Bao" is to sign an overall agreement between the first party who is willing to delegate a task to others and the second party who is willing to undertake that task. Under such an overall agreement, the outcome, with certain specifications, is bound by the two parties, but the detailed provisions of a contract are not supposed to be specified. As a result, the second party has autonomy to manage the process and the first party is guaranteed to possess the outcome. Essentially it is a kind of principle-agent relation, providing that the first party has no right to monitor or police the process, but only the right to gain.

In China the contracting system has been widely applied to the economic sphere in the past and now. In some ancient dynasties, a contracting system replaced the income tax system to collect government revenue. In some areas, such as construction projects, a contracting system was adopted by businessman. Since the reform, the most important step to vitalize Chinese agriculture was to introduce a contracting system at householder level. And then the CMRS was introduced into industrial enterprise. Under the CMRS, the enterprise guarantees the government revenue in a fixed term, instead of paying income tax, and also has to fulfil a few other obligations. Apart from these, the enterprise is supposed to have autonomy to manage its own business.

4.3.1. A contracting system replacing income tax system in Chinese history

A contracting system set up for tax purpose can be traced back to the tenth century in

China, when was the Five Dynasties (907 - 960). And then it was further developed in the Yuan Dynasty (1271-1368), but also ended up in that period when the Dynasty was overthrown (The History Writing Group, 1976).

Under the contract tax system, the feudal government asked merchants to collect income tax on specific products, for example, a tax for a mercury mine. In agreements, the merchants were obliged to hand over to the government a fixed amount of tax revenue regularly from certain regions. Meanwhile the merchants had some rights to extend or modifying tax rates, through which they benefitted. This system was mainly applied to the taxes on processing products such as mines and salt, which were easier to be collected by the merchants than the officials. It has similarity with "tax farming" in the middle ages of Europe (The Economist, 1987). Nevertheless this contracting tax system was widely criticized even at that time. It was conceived as an instrument to reduce government revenue and to increase the citizens' burden, but was only beneficial to merchants. It is conceived as a system which emerged when the government was weak, with a lack of administrative ability and heavily corrupted. After the Yuan Dynasty, this contract tax system was disappeared in China.

4.3.2. The householder responsibility system (HRS) in agriculture

Economic reform in China started in rural areas in 1978. Its quick achievements through the householder responsibility system largely stimulated the reform in cities. The HRS is widely acknowledged as a very powerful instrument to motivate people due to the change of the ownership structure.

Before the reform, ownership in rural areas was collectively owned by nature, in which farmers were organized into groups responsible for their gain or loss. The size of a group as a basic accounting unit was changing from period to period. During some periods, the people's commune was a basic accounting unit to account for revenue and to re-allocate income for each member. Most of time, the production team was usually organized around a residential village, which was a basic accounting unit. In other words, the Chinese government had never taken the whole responsibility for farmers' lives by setting up state-owned agricultural companies as in the case of the previous Soviet Unit.

Even under such a collectively owned system, the decision making power was assumed to be much too centralized to motivate the farmers' initiatives. As a consequence, the performance of agriculture was poor. In 1978, one tenth of farmers were below the bottom line of survival. Therefore at the beginning of the reform there was a strong desire to give more decision-making power to farmers themselves. It took several steps to come to the householder responsibility system (The Research Institute of Agricultural Development of CASS, 1990). First it changed the production responsibility system to the output responsibility system at the level of the production team. Second it changed the production unit to the householder level, but with some restrictions. Finally it gave full responsibility to the householders to manage their own business as a tax payer. Under the householder responsibility system, the farmers have to pay the government a fixed amount of profits for using a piece of land. In fact it is a kind of a fixed rent scheme to issue the farmer the rights to use and to gain from the land.

This scheme had a dramatic effect on Chinese agriculture. After two years, the shortage

in many products became surplus, and even with plenty of choices. Most of the coupons for food which had been used in the cities for thirty years were abolished. The tremendous success of the rural reform agitated the belief that the contracting system would be an effective instrument in industry as well.

4.3.3. the introduction of the CMRS in industry

As explained before, the consideration of the enterprise as an independent economic identity has been on the agenda since the reform. However the road towards this target is not ready, and has to be built in practice (Tidrick and Chen 1987; Porter, 1990). It took several steps to the introduction of the CMRS. Before it, the reform can be summarized as three periods (Hussain, 1989):

1978-84 the pilot experiments in enterprise reform;

1984-87 the promulgation and the new regulation on state-owned enterprises, a reduction in the scope of planning and changes in income determination;

1987- the introduction of diverse forms of ownership reform.

*** the more managerial autonomy and benefits to the state-owned enterprises**

At the beginning, the importance of enterprise reform was emphasized in the reform blue print: "Vitalizing the enterprise, especially the state-owned company is the critical stage for the economic reform with its city focus" in 1978 (The Third Plenum of the Eleventh Party Congress). For the implementation, the first step was to give the enterprise more decision-making power and to allow the enterprise to have more benefits from its better performance. Under this policy, the government clarified the five management areas in which the enterprises supposed to have autonomy to decide its

product mix, supply of raw material, supply of energy and subcontractors for production. Meanwhile a bonus system was re-established through the so-called "enterprise funding system", which was initially started in the 1950s and abolished during the Culture Revolution due to the attitude against material incentives. Since the reform started, the value of the material incentive had been recognized again which resulted in the recovery of a bonus system.

The new policy was further developed as an "enterprise profit retaining scheme" in which the enterprise was allowed to keep certain profits, but subject to the usage of three funds: development fund for production, welfare fund for the company's social function and bonus fund for employees' income. This policy only lasted two years, because the enterprise complained it did not get enough autonomy, and the bureau perceived it was losing its control because the new policy was contradictory to the existing system in many ways. As a result, the spending on the bonus was largely increased, and the product mix the enterprise chose did not always match the needs of the customer due to the distorted price system.

*** the Economic Responsibility System**

It led to setting up the so called "Economic Responsibility System" which aimed at controlling the enterprise' behaviour. The idea of the system can be traced back to the 1950s when a similar system was first put forward. At that time, it aimed at setting up a kind of cost accounting system in order to overcome the mess caused by the newly established command economy (Andor, 1977). As a result, a set of indicators, for example, output, output value, quality indicator, raw material consumption etc. was established. The

number of indicators reached its maximum level, more than twenty, at the beginning of the 1960s, but was reduced again during the Culture Revolution (1). The new economic responsibility system had a similar idea, but emphasized on profit as a basic indicator at the beginning, but soon it extended to other indicators again, because the price control made profits an inefficient economic indicator. Until this stage, the enterprise reform did still not depart from the previous system very much.

In 1984, the central government announced two new policies, one aiming at increasing the enterprise autonomy, and one at reducing the planning scope in order to put the reform forward (Wu, 1989). The first was to relax the management decisions in the following aspects:

- the so-called production decision which is concerned with the enterprise has the right to decide what to produce and how to produce;
- the sale decision which is about the right to find its own distributional channel;
- the price decision which is about the right to decide its products' price;
- the buying decision which is about the right to purchase raw materials;
- the cash decision which is about the right to spend money including all sorts of funds;
- the asset disposal decision which is about the right to dispose the fixed assets;
- the organizational decision which is about the right to decide the organizational structure inside the enterprise;
- the personnel decision which is about the right to appoint managers and to hire employees;
- the wage and bonus decision which is about the right to decide its wage and bonus

scheme;

- the decision of the horizontal link which is about the right to set up the business links with other enterprise.

All these rights were further affirmed in the Enterprise Law in 1988. However the implementation of these rights was another story which takes time and is complicated. During the transition, the new and old systems were usually co-existing, for example, the dual price system (2), which characterised this period.

*** to relax the macro control**

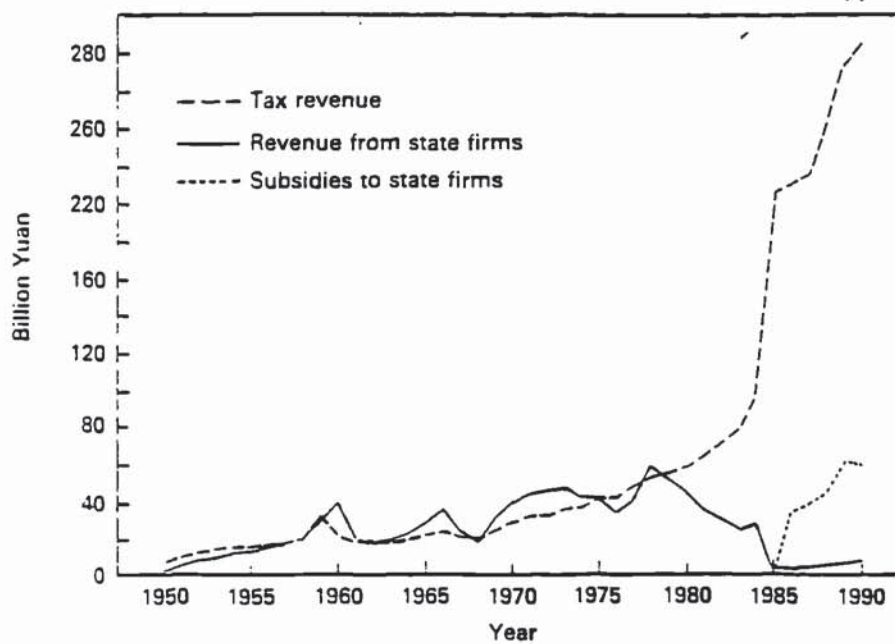
In 1984, the government, to some extent, relaxed price control and decentralized the investment decisions at the macro level. The price scheme was redefined into three areas: government controlled prices, guided prices that is a kind of ceiling price control, and market prices. Under the new scheme, there were only 5 principle agricultural products and 11 main industrial products, prices were still determined by the central government in comparison with 265 main products before (Wu, 1989). For others, the prices were either decided in the markets or only to control the ceiling prices. For the investment decisions, the projects were clarified as either under the central government budget control and/or controlled by the local government's budgets.

*** the tax reform, the trigger of the CMRS**

The intention to introduce income tax was another important step of the enterprise reform (Plasschaert, 1990). As mentioned before, there was no profit tax for the state-owned enterprise before the reform, instead it had to hand over all its profits to the government.

The tax reform supposed to make the enterprise more independent from the government by transferring the enterprise into a tax payer. According to the reform plan, it would take two steps. The first step is to adopt the co-existing scheme of income tax and profit remitted scheme, that is to say, the enterprise has to hand over 55% of its profits as income tax and to share the rest of the profits with the government proportionally. The proportional rate differed from case to case. The second step is to adopt the normal income tax system with a fixed rate. In practice, only the first step was carried out until the CMRS was introduced, because the distorted price system made it impossible to fix a tax rate. Under this system the retained profits for the enterprise were reduced to the lowest level compared with the previous years. As a result of the new tax reform, profits generated from the enterprise and the government revenue collected from the enterprise dramatically declined in 1985-1986 (See Figure 4.3). It could be partly explained by the fact that the new system did not allow the enterprise to share enough profits which induced a very low incentive for the enterprise.

Figure 4.3. State Revenues and Subsidies to State Enterprises



* Source: State Statistical Bureau (1991: 212)

At that moment, it was crucial to find out a new approach to tackle the problem of the government revenue and the relationship between the government and the state-owned enterprise. The success of the Householder Responsibility System in the rural reform and the failure of the new Profit-Tax System stimulated the government to introduce a kind of the contracting system for the tax revenue scheme of the state-owned industrial enterprise.

4.4. The Introduction of the CMRS

In 1986 the Contract Management Responsibility System was introduced in a limited scale. The contracting system initially aimed at improving the way of collecting the government revenue from provincial governments. Under the new scheme, each province had to guarantee to hand over a fixed amount of profits annually to the central government, but to retain the rest of it for themselves. Such a tax revenue system encouraged the local

encouraged the local government to set up a similar scheme for the enterprises, by which each state-owned enterprise was asked to pay a fixed amount of the profits to the local government and to share the rest of the profit with the government. Later on, it further developed another two terms which are to link the total wage bill with its performance, and to fulfil certain investment projects in order to control enterprise behaviour somehow.

In 1987, 95% of the state-owned industrial enterprises adopted the contracting system, but with different schemes. Among the main variants of the schemes are the following (Byrd, 1991 and Yu 1988):

(1) The so-called "double contracting and single linkage" which is the main scheme of the CMRS, applied to most of the large and medium sized enterprises. In this research, the empirical study is in this line. Under this scheme, the enterprise contracts to turn over a fixed amount of profit with any shortfall to be made up from the enterprise's equity (own funds), and profits above this amount are shared between the government and the enterprise in a specified manner. But the tax scheme related to indirect tax is varied from case to case (See Chapter 5). The growth of the enterprise's total wage bill is then linked with the growth in its total realized profits and taxes. Third, the enterprise guarantees to achieve its set target to modernize investment during the contractual period.

(2) Responsibility for annual increase in profit remittance. Under this scheme, the enterprise pays indirect taxes at stipulated rates, and then is responsible for handing over profits to the government equal to some fixed base amount plus an annual percentage increase (often 7%). Only a few enterprises have been allowed to use this method, the most famous example being the Capital Iron and Steel Company.

(3) Remittance of a fixed base amount of profit, sharing of above-quota profits. This

scheme is similar to the first, but without requiring other condition. It has only very limited applications.

(4) Fixed profit remittance or loss targets, for low-profit or money-losing enterprises. The only difference from the above scheme is that the enterprise keeps 100% of above-quota profits or lower-than-targeted losses. It is applied to the poor performed enterprises.

In practice, other schemes, for example, the Asset Management Responsibility System, the Sectoral Input-output Responsibility System etc. have also been experimented (Yu, 1988). But they do not add new principles to the scheme.

As a critical step in the reform, the CMRS has attracted great attention both from practitioners and academics. The views from local people are given in the next chapter, for the author believes it should be considered part of the practice to influence the process. Below, an outsider's view, (Byrd, 1991) with respect to economic rationality is reviewed. Many of the issues will be tackled in the thesis. But it argues that there are different ways of perceiving the process of economic reform, although the problems he points out might be widely accepted.

Byrd argues that the benefits of the CMRS are as follows (Byrd, 1991):

- Reorganization and streamlining of the management team;
- Assertion of independence from the supervisory agency;
- Rationalization of labour;
- More responsible investment behaviour;
- Better wage incentive;

- More focused managerial objectives and a more business-like orientation.

In short, the company has more autonomy to decide its organizational problems, such as personnel, labour, and wages, and it is more responsible for its management decisions.

The problems Byrd points out are (ibid.):

- Move to "Lowest Common Denominator". It means there is a tendency to rush into nationwide implementation of a reform, once the first indications of successful experimentation have emerged, avoiding the harder-to-implement features of the more advanced systems;

- Bargaining between enterprise and supervisory agency has not been narrowed;
- No risk-bearing function for the enterprise director;
- Credibility of contracts in question, due to its inadequate enforcement;
- Rigidities of contracting, due to various kind of hard-to-foresee economic shocks;
- Conflicts with workers, due to tighter management practices;
- Ownership aspects are not touched.

In short, most of the issues relate to the process of implementing contracts which is the focus of the empirical study in this research.

To sum up, this chapter intends to outline a broad background of the CMRS in terms of the basic principle of the relationship between the government and the enterprise under the command economy, of the contracting system for the collection of tax revenue in Chinese history, and of its current development in the reform.

CHAPTER 5
THE CMRS IN PRACTICE I
--- THE FORMULATION OF THE CONTRACTS

5.1. The General Views

Since 1987, when the CMRS was introduced, the debate on the new scheme has always been at the centre of the enterprise reform in China (Wu, 1989; Yang, 1990; Liu and Zhu, 1989; Tian, 1988; Liu, 1991). This is because the CMRS tackles the most sensitive problem in distribution of power and interests between the government and the firms; moreover it points to the possibility of the emergence of a free enterprise system in the future.

Three different views have appeared. First, one in favour of the scheme conceives of it as a potentially new system with Chinese characteristics which could be a contribution to new institutional arrangements between the state and the firm in the context of a socialist economy. The reasons are that it has been proved successfully in agriculture; that it could achieve two purposes at the same time: keeping public ownership and having enterprise autonomy as well, thus killing two birds with one stone; and that it has a high incentive function generated from its profit sharing scheme (Yang 1990). Several extraordinary cases, for example, Beijing Capital Steel and Iron Company (BCDIC), shows that the companies has improved their performance substantially since the CMRS was adopted. The profit ratio in BCDIC has increased about 20% for eight successive years (Yang, 1990).

Finally, the drawbacks of the CMRS are considered to be adjustable during the phase of its implementation.

Second, the opposite view argues that a few examples, specifically supported by the local government, could not prove the rationality of the CMRS (Wu, 1990). In fact the system does not provide a rational approach to decide the profit targets, but is likely to damage the interests of the government, because the determination of the targets is based on the previous performance rather than its potentiality. In addition, it has been worsened by the bargaining process. As a consequence, the total government revenue at the central government from the state-owned enterprises has been reduced continuously by 0.86% in 1987, 10.45% in 1988 and 17.5% in 1989 (Yang, 1990). Furthermore without efficient control instruments, the profit sharing scheme tends to encourage a short-term behaviour in consumption of the state assets, for example, by increasing the employees' income and reducing the efforts on depreciation. Another strategic problem is that the CMRS tends to rigidify the existing industrial structure. That is to say, once the company signs a contract with the government, legitimately the company has the right to survive and to continue its business which could exclude other alternatives, such as merger and bankruptcy. Before the reform, structural adjustment was achieved through administrative decisions by disposing of assets, merging or even closing the companies. Under the CMRS, the previous instruments are no longer applicable because of the protection from the newly established contractual relationship, and there is no other alternative available. The statistical survey shows that the performance improvement in the state-owned sector lags far behind that in other sectors. This view thus concludes that the CMRS has to be abolished as soon as possible.

The third view is that the CMRS was not an ideal choice for the reform, but workable and acceptable in the transition period. Its supporters argue that at present it is too risky to introduce a share-holding system, but impossible to go back to the old planning system. The CMRS provides a temporary solution and tries to seek new approaches. A senior official told the author, "Those academic arguments no matter for or against, always sound great. But it is dangerous to follow any of them for real policy-making. Remember there is no ideal solution for this non-ideal world. The real skill is to find a golden mean."

These three views, in a deep sense, reflect how the different groups perceive the economic reform with respect to socialism, economic rationality and Chinese culture. One school attempts to find a road which allows modernization without giving up socialist ideas and traditional Chinese culture, while the other believes that economic rationality has to be the dominant rule to guide a new system. Moreover the pragmatic approach attempts to survive in between, which might also reflect the Chinese culture of seeking a golden mean and harmony.

All these debates arise from the question of what has really happened under the CMRS, in terms of the formulation of contractual arrangements and the interaction between the government and the company. For example, what kinds of strategic decisions are made by the managers, how does the government react and what are the motivations behind these decisions? Ultimately, how have the basic contractual arrangements evolved over time? As given before this research attempts to contribute a better understanding of these questions by adopting a holistic approach with in-depth case studies. The following findings are based on the four case studies subject to the theoretical framework defined in

Chapter 3.

As given before, an essential question relating to case method is how representative the study could be. In this study the findings are originally derived from the four case studies and further verified by other sources, for example, through informal discussions with other companies, by reviewing the government reports and other research papers. These checks confirm that the findings presented in the case studies are not unique, but to a large extent represent common features and possibilities of institutional development.

5.2. Background of the Four Companies

*** the selection of the four companies**

The four companies were chosen for investigation. The criteria for choosing the four companies are given in Chapter 3 which can be summarized as follows:

- state-owned or quasi state-owned enterprise,
- large or medium-sized enterprise,
- located at the same place, Beijing,
- two in heavy industry, two in light industry,
- one of the better performing companies in each sector,
- easy access to information.

These criteria mainly concern the factors which are related to the determination of the institutional settings. Given the similar conditions for the companies, some common features in the findings could be generalized as convergency from the CMRS, while the divergence is possibly explained by the diversity of technology and ownership status.

The four chosen companies are:

- Beijing Electric Power Generator Company (BEPGC),
- Beijing Transformer Company (BTC),
- Beijing Dahua Shirt Company (BDSC),
- Beijing No.1 Leather Shoe Company (BLSC).

Among the four companies, in terms of the number of employees, three are medium-sized and one large; and in terms of ownership, three are state-owned and one quasi state-

owned(?). The basic products manufactured in each company are easily identified from the name of the company as electric power generators, transformers, men's shirts, and leather shoes. Correspondingly, BEPGC and BTC are under the supervision of the Machinery Bureau, while BDSC and BLSC are under the Textile Bureau and the Light Industrial Bureau. All of them are one of the top ten in their sectors, evaluated by the bureaus. The general background of the four companies is shown in Table 5.1.

Table 5.1.

The General Background of the Four Companies				
	BEPGC	BTC	BDSC	BLSC
Ownership	state	state	state	higher- collective
Size	large	medium	medium	medium
No. of Employees	7700	1998	1400	1299
Sector	heavy	heavy	light	light
Supervisory Bureau	Machinery	Machinery	Textile	No.2 Light Industry

*** the foundation of the four companies and their ownership structure**

All the four companies were established in the 1950s (Table 5.2.), during the period of the so called "socialist transformation" and the years immediately following. At that time, the

main task was to restructure the economy through the nationalization of the former private companies, the merger of the small companies into either state-owned or collectively owned, and the setting up of key industrial companies(see Chapter 4).

Table 5.2

The Foundation of the Four Companies

	BEPGC	BTC	BDSC	BLSC
Year of start	1958	1952	1954	1958
Ownership (O)*	state-own	private	private	collective
Approach	new	merger	merger	merger

* Ownership (O): Original ownership

Among the four companies, BTC was the earliest one to be set up. In 1952, 13 small private repair shops with total assets of 11000 Yuan and 90 employees merged into Beijing Electric Machine Company which is the origin of BTC. At that time the main business of the company was to make small size electric switches and to repair simple transformers. Afterwards another 11 small private firms were merged again in 1956 and became a state-owned company under the supervision of the Beijing Machine Building Bureau. In 1958 with a government grant of 1,200,000 Yuan, the company began to specialize in manufacturing medium-sized transformers and was re-named as Beijing

Transformer Company.

BDSC was established in 1954 by merging 19 small private businesses including 13 textile shops, 4 department stores, 2 shirt-making firms with 157 employees and 40 items of equipments. At the very beginning BDSC remained as a private owned share-holding company for two years, and was then transferred into the state-owned company in 1956 under the supervision of the Beijing No.1 Local Industrial Bureau.

BLSC was set up in 1958 by merging six small hand-made shoe cooperatives with 600 employees and 10 sewing machines. It has retained its collective ownership since then. In the 1960s and 1970s the company had several investment projects granted by the government to expand its size and to up-grade its technology. As a result, a large part of its assets was generated by the government rather than by the company's own initial funds. It raises the question of ownership: to a large extent the government treats it as state-owned by adopting similar policy and regulations in regard to it as to the state-owned companies, although the collective ownership still remains. The fundamental reason is that the collectively owned company is ideologically allowed to exist in the framework of the socialist economy. Practically these companies enjoy less social welfare than the state-owned. Therefore before the reform, the government preferred it to retain its collective nature, while the company always attempted to up-grade it to state-owned.

The origin of BEPGC was two state-owned companies. They were set up in 1958 to manufacture electric power generators for civil and military purposes under the policy of establishing numbers of key heavy industrial enterprises. In 1965 these two companies

were merged into BEPGC which continued to manufacture turbogenerators and steam turbines, but only for civil purposes under the supervision of Beijing Industrial Bureau.

The limited evidence about the origins of the four companies shows that the establishment of new companies under the planned economy is completely subject to political movements. As given in chapter 4, in the 1950s the main objective of the new regime was to change the ownership structure and to start modernization. The implementation was carried out step by step: merging the small businesses first, followed by nationalization, and then finally the establishment of a new heavy industrial firms. During this period, the individual initiative or entrepreneurship in setting up a new business was only allowed to take place at the first stage --- merging small businesses. The sub-case 1 (see Appendix 3) gives an example of the emergence and disappearance of such entrepreneurs. In the latter periods, all the decisions for establishing new companies were exclusively determined by the government. Setting up a new business organization is conceived as a decision which has to be decided by a higher authority within the framework of the socialist economy. In other words, the freedom to set up a new business is conceived as the most sensitive area to be relaxed in reforming the socialist economy.

*** the changes in the organizational structure**

Before the economic reform, the organizational structure of a company was entirely determined by the government and almost always took the form of a functional structure (See chapter4). It originated in the Soviet Union's model based on the idea of integrating the macro and micro structures into one system. Its eminent feature is that the structure of a company at the micro level coincided with the functional structure of the government at

the macro level. Basically the company adopted the same pattern of the functional division as that at the level of the government. It resulted in a unified structural pattern for almost all the companies no matter what differences in size and technology the company evolved.

However it does not mean that there had been no change of the organizational structure in the pre-reform period, but the changes in the state-owned companies had followed a similar pattern. The sub-case 4 describes the organizational changes which took place in BDSC during the period of the 1950s to 1980s. To a large extent it presents the general pattern of the organizational changes in the state-owned company at that period. Several features can be identified as follows:

(1) The change of leadership in terms of interest groups was one of the major structural changes. The position of the leadership had been shifted from one group to the other in accordance with the political movements (Table 5.3.).

Table 5. 3.

The Leadership Change of BDSC in 1954-1990

Board of Director (1954-1956)	Socialist Transformation
Party Secretary (1956-1966)	Planned Economy
Revolutionary Committee (1966-1969)	Cultural Revolution
Party Secretary (1970-1985)	Planned Economy
Director (1986-1990)	Economic Reform

(2) The number of functional departments had been continuously increasing which were largely in response to the change of the government structure. For example, from 1954 to 1985, the five major departments --- production, finance, supply and sales, technology and quality control, and administration, remained the same, while ten more departments were added which were construction, energy, general office, personnel, labour, propaganda, management, education, security and military departments. Such expansion was mainly attributed to an on-going departmentalization of the government, although it was partly due to the expansion of the company.

(3) None of the existing departments had been abolished since it was set up. It shows that there is a strong tendency to maintain the existing organizations and sub-organizations, although the government from time to time demanded the company to streamline its structure.

*** merger and expansion**

Over more than thirty years, the major approach adopted for the economic development in China was to expand production capacity (World Bank, 1985). The opportunity of increasing organizational size was conceived as a crucial step for a company's development. Kornai argues it characterises the central planned economy (Kornai, 1986). However the decisions about expansion were entirely rested on the government, either by merger or by new investments.

In the four company's histories, for each at least one large government-financed expansion project has been carried out. In 1969 a big investment project enabled BEPGC to produce

turbogenerators with a total capacity of 600 MW and electric motors with a total power output of 200 MW per year. BEPGC became one of the key generator-manufacturing companies in China.

In the 1950s and 1960s, several small state-owned and collective companies were merged into BDSC. In 1973, according to the local government plan, BDSC moved to a new location which is eight times larger than its previous place and received a government grant of 2,300,000 Yuan for constructing new buildings and purchasing new equipments. Thus BDSC became one of the largest clothing-manufacturing companies in Beijing.

The story was similar in the cases of BTC and BLSC. In 1974, BTC moved to a new location in which the local government invested in 10,000,000 Yuan for construction and purchasing. For BLSC, the mergers with other companies took place in 1960s and 1970s. In 1983, due to the setting up of a new national library, BLSC had to leave its original location, but compensated by a government grant of a new larger place with 3,500,000 Yuan as well as a low interest loan of 3,500,000 Yuan. As a result, the company was substantially expanded.

All these projects reflected the mainstream views, developing the company by increasing size and production capacity. As a consequence, the status of the company and the managers were moved up in the administrative hierarchy once the company expanded. It induced a strong motivation for the managers to secure these projects. Thus, in practice the investment decisions were taken through the planning mechanism, but often upon the initiative of the managers. For example, at the beginning BEPGC was supposed to

manufacture only medium sized turbogenerators, but after the company showed its ability to make key components, the bureau changed its mind.

*** suppliers and customers**

Broadly speaking, the perception of types of suppliers and the customers the company deals with, depends not only on the physical characteristics of the products, but on their social nature as well. In the context of a planned economy, goods are classified as the means of subsistence (or livelihood) and the means of production. Accordingly light industry falls under the former heading, and heavy industry under the latter. Furthermore in terms of ownership, the means of subsistence is largely owned by householders and individuals, while the means of production can only be publicly owned, according to the socialist doctrine.

For such reasons the company's attitudes towards its customers differed from sector to sector, even if prices, distribution channels and market structures were determined by the government. For example, products like shirts and shoes which were owned by individuals, and not always in short supply, to some extent, would attract the company's attention to the customer's needs.

For BEPGC, the major customers were the owners of power stations which might be either the energy ministry or the local governments, depending on the size of the stations. In this case, possible customers were absolutely determined by the government's plan.

For BTC, its customers were mainly the local companies and the products were distributed

by the official distribution agents. In comparison with BEPGC, BTC had more bargaining powers in locating customers, although basically determined by the government's plan.

For BDSC and BLSC, although customers were restricted to the local markets, there was some flexibility in distribution channels for choosing agents and customers. Furthermore since these consumer products were to some extent exported in the 1950s, it was important for the company to reach higher quality of its products in order to be selected as an exporting base. It was a strong motivations for some companies. For example, BDSC created a famous brand of men's shirt, Tian Tan (Temple of Heaven in Chinese) which allowed the company to export its products since 1950s and started to import advanced equipment in the 1970s. The following is the summary of the customers for the four companies.

In respect of supply, most of the raw materials and components used in the four companies were in short supply. This gave the government and suppliers decisive power and left little bargaining power to the company itself. As a result, the supply department enjoyed a much more higher status than the sales department before the reform.

Table 5.4.

The Customers of the Four Companies

	BEPGC	BTC	BDSC	BLSC
End Users	ministry company	company	individual	individual
Markets	home (national)	home (local)	home (local) & abroad	home (local) & abroad
Distribution	bureau	bureau	bureau	bureau

5.3. The Establishment of Contractual Relationship

As compared with the previous system, the main thrust of the CMRS is an attempt at establishing a kind of arm's length contractual relationship between the government and a state-owned company, instead of a hierarchical relationship. Several major issues then arise: who will be the contractor on the two sides; whether the two parties are equal partner in the determination of the contractual relationship and what kind of rationality and factors are involved in the process. In answering these questions, there is very little information available from the literature. The following case provides some facts and insights about it.

5.3.1. The Determination of the Contractors on the Two Sides

*** one centre and one core**

In principle, the contract has to be signed between the authorized government organization and the people who are going to take full responsibility for managing the company (Appendix 1). Since the introduction of the CMRS, the director has become a legitimate person to be the head of the company instead of party secretary. This is conceived as a critical step forward in the enterprise reform. It implies that the consideration of economic rationality is given priority over ideology. Since a long lasting debate on the importance of ideology or economics which was started 30 years ago under the heading of "putting either proletarian politics in command or economic development in command" in China, it has been the first time that a leading position of the director is legitimated.

It is not too difficult to imagine that such a fundamental change cannot possibly be carried out in a straight forward manner. In 1989 after the Tian An Men events, a widespread

argument on the issue of "one centre and one core" took place. "One centre" describes the leading position of the director as the centre of the company, while "one core" represents the position of the party secretary. Although it looks like a compromise between the two roles, the question of who should be the most powerful person in the company has inevitably arisen. After a short time, it had shown a real impact on the management, the extent to which varied from case to case.

Among the four companies, the director of BEPGC has taken on both the roles of director and party secretary, which obviously eliminates the problem. In BTC and BLSC, the party secretaries are not competent enough to challenge the power of the directors, as one is very young with little experience, and one close to his retirement with an easygoing leadership style. Only in the case of BDSC, are both the director and the party secretary experienced managers and have been working in the company for years. When the issue arose, very soon some reactions appeared in the company. For example, in changing the reporting procedures, the party secretary asked the heads of departments to report him directly instead of going through the director. It confused and divided people. The director said, "Can you have a car driven by two drivers at the same time?" Before this debate intensified further, however, the higher authority stopped it by re-affirming the legitimacy of the director responsibility system and the supporting function of the party committee.

*** the selection of the directors**

There are two approaches to selecting the director, either through a "one way" process in which only the government has authority to appoint the director, or through a "two way" process in which people are allowed to apply and to compete first, and then the

government makes final selections.

In the provision of the CMRS, the selection procedure supposes to be through the "two way" approach, the so called bidding system, but it also permits other approaches which have to be approved by the government. For each company which approach should be applied is the decision of the government.

In practice, the bidding system is a kind of experimental process which has only been practised in a few companies, while most of directors are selected by the bureaus (CESRRG 1988). In the second phase of the CMRS, the bidding system has in fact been stopped, according to a government internal report. The reason could be attributed to a lack of democratic conventions and techniques. For example, people are not used to apply for a high rank job which was always been decided by superiors in the past.

Among the four companies, only the director in BLSC has been through the procedure of the bidding system, while the others are appointed by the bureaus. The reason for BLSC going through the bidding system is its quasi-collective ownership in which the employees supposedly have rights to choose their leader. But the whole process of bidding is a kind of ritual rather than a real practice. In the three companies, the directors, although appointed by the government, to some extent reflect in their different personalities referring to the nature of the company. For example the director of BEPGC is characterized with more bureaucratic style than the others. This might be explained by the company's size and its close relation with the bureau. The director of BTC is rather technical oriented with an engineering background. This reflects the general feature of the manager in the

medium-sized, state-owned heavy industrial company. The directors of BDSC and BLSC are very business and entrepreneurship oriented which might be more suitable for such consumer product companies.

*** the director's income: the reward and penalty scheme**

According to the principles underlying the CMRS, authority has been delegated to the directors for managing the company, so that the reward and penalty scheme becomes an essential element of the contract. In the provision of the CMRS (See Appendix 1), a kind of remuneration scheme is specified, related to the director's income. Meanwhile two kinds of penalties are introduced as follows:

- if the targets for remitted profit are not reached, it has to be compensated by the company's own funds,

- in the second phase of the CMRS, a contract mortgage fund is introduced.

As shown in the provision of the CMRS, the director's annual income is allowed to be one to three times higher than the employee's average income, and higher than the other managers as well. If one fails to fulfil the contract, the director's income will be reduced until half of his/her basic salary and other managers' incomes will also be reduced.

Among the four companies, this item has been specified in varying ways from case to case. In the contract of BEPGC and BTC, it is briefly mentioned as such "if successful, the director will receive a reward from the government and if he fails, he will be penalized". Some officers and directors take the view that a kind of financial reward or penalty is not essential for the director's motivation. The director, Mr.Li said, "I have been

working in the company about thirty years with a low salary. Money has never come to my mind as the first consideration. I don't think such a reward will change my attitude." The other director said, "There is a dilemma: on the one hand, the higher responsibility, the more reward; on the other, the higher position, the more conscientious working attitude. How can the new system trade off moral sense and financial reward and how big can the gap be?"

For BDSC, the contractual terms for reward and penalty is clearly specified as:

- if the remitted profits are just fulfilled, there will be no reward and no penalty;
- if the targets are exceeded by 5%, the director's income will be 0.5 times higher than the average level;
- if exceeded by 10%, his income will be double the average;
- if exceeded by 15%, 1.5 times higher than the average;
- if exceeded by 20%, his salary will be moved up one salary level;
- if failed, no bonus;
- if lowered by 5%, his income will be reduced by 10%;
- if lowered by 10%, it will be reduced by 20%.

BLSC adopted the similar contractual term. But the directors of the two companies strongly support the financial reward system and perceive it as an important step for setting up a new motivation mechanism. Mr. Niu, the director of BDSC, pointed out, "The value of the money buttresses responsibilities. As the top managers, you have to take your job seriously, if you are rewarded ten times more than others. I see the current scheme is one step forward, but amount of money the director is rewarded is not compatible with a kind

of job the director takes. It seems lack of rationale." It shows his view is rather different from other directors.

*** the contractor on the government side**

In the provision of the CMRS, who should be the contractor on the government side is not clearly defined, but it should be an organization approved by the government. In most of the cases, the local industrial bureau is the contractor on behalf of the government to sign the contract with the company. But it varies from large key companies to small consumer companies. For large key companies, the government asks several bureaus jointly to sign a contract, while for small consumer companies, the so-call general company(???3) which is supposed to be acted as a kind of holding company under the industrial bureau will sign a contract on behalf of the government.

Among the four companies, BEPGC is conceived as one of eight key enterprises in Beijing machinery industry. Hence the five local bureaus are asked to be involved in the negotiations and to sign a contract as follows:

- the Machinery Bureau under the Beijing Municipal Economic Commission which is the direct administrative supervisory body of the company,
- the Labour bureau which is a kind of functional bureau in charge of personnel and wages policies,
- the Financial bureau which is another functional bureau responsible for the government budget and revenue, major investment decisions, and other financial issues,
- the local branch of the China Industrial and Commercial Bank which is an authorized body from which the company is able to get a loan,

- the Tax Bureau which is an organization working with the Financial Bureau responsible for collecting taxes,

In the second period of the CMRS, the State-Assets Administrative Bureau joins in, which is a newly developed body, designed to look after the state-owned assets.

For BTC, the contract is only signed between the Beijing Machinery Bureau and the company. But previously this bureau has signed an overall contract with other bureaus which are:

- the Beijing Economic Commission,
- the Beijing Labour Bureau,
- the Beijing Financial Bureau,
- the Beijing Tax Bureau,
- the local branch of the China Industrial and Commercial Bank,
- the Beijing State-Assets Administrative Bureau.

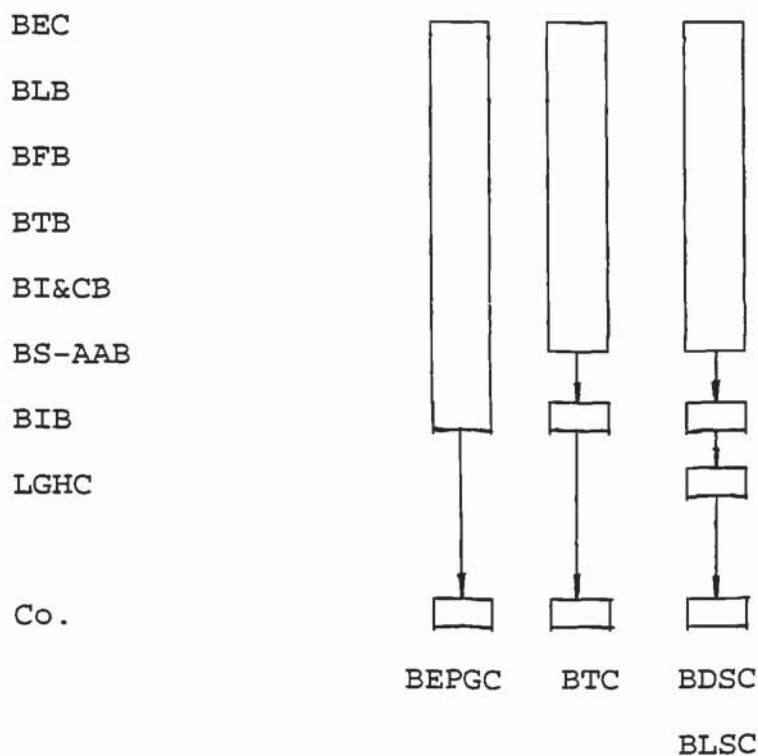
This contract contains the overall targets for all the companies under the supervisory of the Beijing Machinery Bureau, and then these will be further broken down into targets for each company.

For BDSC and BLSC, the contracts are signed between the company and the general holding companies, that is to say, Beijing General Clothing Manufacturing Company with BDSC and Beijing General Leather Product Company with BLSC. Those two general companies who are under the supervisory of the Beijing Textile Bureau and the Beijing

Light Industrial Bureau, play the part of bureau's functions and has his own business as well (2).

In sum, the contractor on the government side, is organized hierarchically (Figure 5.1.) subject to the industrial status of the company in terms of size and products.

Figure 5.1. the Structure of the Contractors on the Government side for the four companies



BEC: Beijing Economic Commission,
 BLB: Beijing Labour Bureau,
 BFB: Beijing Financial Bureau,
 BTB: Beijing Tax Bureau,
 BI&CB: Beijing Industrial and Commercial Bank,
 BSAAB: Beijing State-Assets Administrative Bureau,
 BIB: Beijing Industrial Bureau,
 LGHC: Local General Holding Companies.

5.3.2. The Determination of the Contract Terms in the First Contractual Period

* the time horizon of the CMRS

Although the CMRS was widely applied to the state-owned companies' in 1987, some companies had started earlier and some only did so later. Among the four companies, BEPGC was the earliest one to start the CMRS in 1986, whereas BDSC and BLSC adopted it in 1988(Table 5.5.). As a large key company, BEPGC's contract is designed so as to be in line with the Seven-Five year plan, while others are not necessarily linked to the national plan.

Table. 5.5.

The Time Scheme of the CMRS in the Four Companies

	BEPGC	BTC	BDSC	BLSC
the First Period	86-90	87-90	88-90	88-90
Duration (years)	5	4	3	3
the Second Period	91-95	91-95	91-95	91-95
Duration (years)	5	5	5	5

* the three main contract terms

As given before, the contract is composed of three main contract terms adopted in the two periods between 1986(or 87 or 88) to 1990 and between 1991 to 1995:

- the profit-sharing scheme including the targeted amount of gross profits to be remitted to the government and excess profits which will be shared between the government and

the company,

- the projects for up-grading the company's technology ability and improving its management,

- the scheme for setting wages and bonus subject to the company's performance.

Consideration of these three terms with respect to three elements of the property rights: the right to use, the right to earn income, and the right to transfer. However, the idea of the CMRS is not supposed to delineate all these rights, but selectively focusing on some aspects of them. In the case study, the focus lies on how and to what extent the property rights are delineated and what kinds of rationales is in the decision-making in terms of economic rationality, politics and ideology.

*** the general view of the two periods**

According to the provision of the CMRS, several rules have been enacted to determine the contract terms, especially for the profit targets. The basic criterion refers to the previous performance, taking one or three years into account and then making some adjustment for the future. In practice, it is affected by many other factors which have been changed from the first period (1987-1990) to the second (1991-1995). In the first period, the administrative force still played dominant role, for example, the targets had to be in line with the Five Year plan. Meanwhile expectations of the new system from the two sides were very high which expected to work smoothly between the two sides under the new system. It resulted in cooperative negotiation with soft bargaining for the first period of the contracts.

In the second period, however, after three to five years interaction between the government and the company, the attitudes, especially from the company's side, have changed a great deal. Most of the state-owned company did not want to renew the contract at the beginning, partly because the macro economic situation was deteriorating, thus increasing uncertainty for the company, partly because the company contested the legitimacy or rationality of the system after several years experience. Furthermore the company had got more negotiating power than before by increasing their weight in the markets. The result was a rather conflict-filled negotiation with hard bargaining between the bureau and the company, and higher authority had to exert its political power into the negotiation when the block occurred.

The following describes how the four companies decide their contract terms in the first contractual period and leaves the second period for latter consideration (See 5.3.3.). Although each contract has covered many performance indicators, the focus is on the three main contractual terms, because they are the major consideration from both sides. If something is conceived specifically important, it will be pointed out.

*** the determination of the profit sharing scheme**

As an outcome-based parameter, more attention has been paid to the profit-sharing scheme than to the other two, because of its visibility and ex ante nature.

For BEPGC, the first contract was signed in 1986 at the time when the Seventh Five-Year plan was started. It was earlier than the normal time in adopting the CMRS in the state-owned companies, due to the consideration of making two systems coherent. At that time

the government policy was to give the large-sized state-owned company a certain management autonomy and to reduce the amount of remitted profits from the company, so called "Enlarging the pond so the fish can grow larger". Therefore BEPGC was exempted from all sorts of taxes, such as value added tax, instead only turning over a fixed amount of profits to the government. Meanwhile as one of the key companies to produce energy generators, its targets are largely subject to the national plan. That is to say, the GNP in the coming Five-Year plan is supposed to be ???doubled, so that BEPGC's major targets have to be doubled as well.

In practice, all the key production targets in the contract were twice as high than before, but the total remitted profit targets were only increased by 44% (Table 5.6). In addition, the company was allowed to retain all the profits above the remitted profits, providing that it would give priority to the implementation of technology up-grading projects. The contract does not specify a detailed rule in spending the retained profits, only requires that it has to be under the government's supervision. If BEPGC would not fulfil the remitted profits targets, it would have to pay back from its own resources. The negotiation of the contract went ahead smoothly, partly because the major production targets have already been determined, and partly because the company has benefited a great deal from the government's concession in its profit-sharing scheme.

Table 5.6.

The Contract Targets in BEPGC										
	81	82	83	84	85	86	87	88	89	90
Outputs										
MY					81					162
MW					130					260
Profits										
MY						11.6	11.8	12.1	12.5	13.0
Total Profits										
MY	<----- 41.5----->				<----- 60.0 ----->					

BTC, , like most of the state-owned companies, was in a very bad shape under the new tax-profit scheme before the CMRS was introduced. Its productivity had dropped dramatically due to the very low incentive of the tax-profit scheme (See chapter4). In 1987 BTC was chosen by Mayor Chen as one of a few experimental companies adopting the CMRS first. In order to reach an agreement efficiently, Mayor Chen asked several bureaus, including the Financial Bureau, the Tax Bureau, the Labour Bureau and the Industrial and Commercial Bank to hold a meeting on the company's premises to resolve all the problems at once. This would provide an opportunity directly to exchange information and views among the parties and also to exert pressure to work cooperatively and decisively in the presence of a higher authority.

As a result, the fixed amount of remitted profits which is designed to replace income tax and adjustment tax, was increased by 38% for the next four years (Table 5.7). Any failure will be compensated by the company's own fund. Profits above the remitted target will be redistributed among the central government, the local government and the company according to the scheme shown as Table 5.8. The requirements on how to use the retained profits are the same as those in BEPGC.

Table 5.7.

The Remitted Profits in BTC

	Income Tax & Adjustment Tax				Remitted Profit (CMRS)			
	84	85	86		87	88	89	90
Profit	277	320	388		430	447	465	465
Average		328				452		
%		1				1.38		

Table 5.8.

The Distributio the Above-Remitted Profits in BTC.

Profits above Target	if < 5%	if >5%
Retained Profits to		
Central Government	51.45%	51.45%
Local Government	49.55% x 30%	0
BTC	49.55% x 70%	49.55%

The contract terms on the profit sharing scheme in BDSC and BLSC are specified much less clear than in the former two firms, partly due to the fact that the education level in light industry is lower than that in heavy industry, and partly due to the management control in light industry is less formal than that in heavy industry.

In the case of BDSC, the company is already facing a buyer's market and the competition is getting fiercer. The local government therefore agrees that the targets for the realized profits and the fixed remitted profit should remain at the same level for the next three years, i.e. 4,650,000 Yuan and 2,650,000 Yuan respectively. As compared with the average level in the previous three years, total remitted profits will increase by 16%. But the scheme for sharing the profits above the fixed remitted profits and how it will be used are not clearly specified in the contract. In practice, it adopts a similar rule as that in BTC. In any failure of performance, the company has to compensate the state by drawing on its own funds.

Table 5.9.

The Profit Targets in BDSC in 1988-1995

	88	89	90	91	92	93	94	95
Period	<----- 1 ----->				<----- 2 ----->			
RP1* (M)	4.60	4.60	4.60	4.50	4.59	4.68	4.78	4.87
RP2** (M)	2.65	2.65	2.65	2.55	2.55	2.55	2.55	2.48

* RP1: Realized Profits

** RP2: Remitted Profits

For BLSC, only the total profit target is specified in the contract which is supposed to be fulfilled. Meanwhile, the company is still required to pay a fixed percentage of income tax, and allowed to retain all the after tax profits in the company itself, because of its status as a large collectively owned company. Therefore there is no direct enforcement of the remitted profit target. This scheme differs from the state-owned, and also from collective and private firms which have no profit target at all. In addition, the director's career is supposed to be linked to the company's performance as that in the state-owned company. For BLSC, the profit targets are determined rather arbitrarily, because it is difficult to cope with the fluctuations occurred over the previous five years (Table 5.10.).

Table 5.10.

the Profit Targets in BLSC

83	84	85	86	87	88	89	90	91	92	93
Profits before Income Tax (PBIT)					Contractual PBIT					
					<----- 1 ----->			<----- 2 ----->		
2.83	2.85	4.13	3.70	2.38	2.80	3.20	3.50	1.40	1.54	1.7

To sum up, the profit sharing scheme could be characterized as follows:

- The profit sharing scheme directly relates to income tax system. To what extent the profits cover income tax depends on the nature of the company. Generally speaking the larger and the more technology oriented the company, the less proportion of total profits the tax payment; also the more collective the ownership, the more market oriented the profit payment scheme becomes.

- The determination of the profit targets is affected by many factors: macro economic policy, previous performance, leadership style, economic calculation and bargaining power etc.

*** the determination of the wage bill control scheme**

The wage bill control, as a contract term, directly links to the employees' income. In principle, the total wage bill is subject to the performance of the company, but the scheme for each company varies.

Among the four companies, BEPGC and BTC have adopted the most popular scheme: the growth of the company's total wage bill is linked to the growth in its total realized profits and taxes. The proportional link of the two rates of growth is $1 : 0.75$, that is to say, a 1% increase in the realized profits and taxes allow a 0.75% increase in the total wage bill. This rate was decided by the labour ministry at the central government level because of its sensitivity and wide application. For BDSC, the total wage bill is linked with the total number of shirts, up to standard, the company produces. This scheme was introduced in 1987 before the CMRS was adopted and its original idea was to apply the piece wage system at the company level. The rate is a matter for negotiation between the company and the local labour bureau. For BLSC, the wage bill control in the contract is not explicitly specified, but the firm is asked to abide by the government policies.

In the implementation of this scheme, a fixed amount of total wage bill was worked out for each company at the beginning of a year, based on the complicated calculation and some negotiations on the previous performance.

*** the technology up-grading projects**

The government bureau and the company have different orientations towards technology up-grading projects. It is due to the fact that the government has its own priority to sectors in investment projects, while the company needs a strategy to develop its own company.

As one of the key companies to produce energy generators in China, BEPGC's technology up-grading project has already been fixed under the national Seven-Five Year plan. It comes automatically under the contract terms for the CMRS. The project aims at making

BEPGC one of the manufacturing centres capable of producing large-sized turbogenerators. In the next five years, the total investment for setting up three heavy manufacturing workshops and purchasing ten advanced large machine tools will be 85,000,000 Yuan. The amount of investment will come partly from the government's grant and partly from the loan. In fact, most of the remitted profits will be transferred into the government's grant returning back to the firm as an investment fund.

BTC's technology up-grading project is very controversial. Some argue that over the last five years, the company has already made a big investment, and now it is time to exploit its potential rather than to pursue new investments; others argue that under the CMRS it has to follow the previous pattern that is, to have another big investment project. As a result, an investment project of 6,000,000 Yuan figures in the contract, but its use has not been specified.

For BDSC, no specific technological investment project has been mentioned in the contract; instead quality control, storage control and production safety targets are all specified as performance criteria linked to the director's reward and penalty scheme. The lack of an priority for investment projects is due to the firm's low level of technology. It leaves many options open for the further development, relying either on labour intensive or on more advanced technology depending on the company's chosen strategy.

A similar arrangement applies to BLSC as well. There is no investment project specified in the contract, but quality control targets in terms of the product failure ratio and new production level is mentioned in the contract.

To sum up, it is readily apparent that the higher the technology the company employs, the more explicitly the investment project is specified in the contract. However for a company with a low level of technology, further investment depends more on its own chosen strategy. Nevertheless the technology up-grading projects are less emphasised in light industry than those in heavy industry.

*** conclusion**

On the one hand the contract terms in the four companies follow the basic institutional arrangement of the CMRS, on the other, they vary as a function of the technology the company employs and of the ownership status the company possesses. The key terms of each enterprise contract is shown in Appendix 2.

5.3.3. The Major Changes in the Formulation of the Contracts

During the Second Period of the CMRS

*** before the negotiation started**

After three to five years of contract experience, when the government began to address the issue of renewing the contracts in 1990, most of the companies in Beijing were very reluctant to sign new contracts and even argued against the continuation of the CMRS. The main reasons were that the overall economic situation was deteriorating and the CMRS did not operate as well as the managers had expected. For example, the directors considered that they did not have enough autonomy to run their businesses and that the government had too much power to modify the regulation of the CMRS in its own interests. The local bureaus were also not very keen to get involved in the process for they realized that renewing the contract would be tough negotiations.

Facing such a difficult situation, the central government stressed the continuation of the CMRS as an key element of the economic policy which had to be followed by all the officials and managers. It stopped the debate and initiated the process of negotiation. In order to ensure successful implementation, the higher authorities were made responsible for the negotiation process.

By learning from its previous experience, each contract was proceeded in four major stages by the two sides:

- gathering information on the company's business situation and on employees' attitudes towards the CMRS,
- conducting a feasibility study on the required profit targets,
- drawing up a draft of the contract,
- signing a contract.

*** the difficult negotiation process**

Negotiations started in August of 1990 and took two to four months to complete, some firms moving faster and some more slowly. As the government's internal report pointed out when comparing firm size and sector, the larger companies in the heavy industry took a longer time than the others because there were more conflicts between the bureaus and the companies than before. This was firstly because as government revenue comes mainly from the medium and large state-owned companies, especially in heavy industry, when the economy is in a bad shape, negotiations on the profit-sharing scheme quickly become more difficult. Secondly, the government still controls more managerial decisions

in the heavy industry sector than in other sectors, for example, in the matters of price, personnel and investment. This fact intensifies the arguments concerning how much autonomy the company should have under the CMRS, and this affects the contract renewal process. Negotiations proceed differently in the light industry sector. As many companies became very much more market oriented after the first contractual period, the bureau now has less power to control them than before. Thus in the negotiation, the two parties shows a much more evenly balanced power relationship than before, mainly based on economic calculation. Nevertheless the negotiation of the contracts in both sectors became much more difficult than in the previous period. The following provides some details on the process of new contract formulation in the four companies.

As mentioned before, from the very beginning there was a consensus on the company side to refuse a renewal of the contract. But after the government stressed the importance of abiding by the communist party's policy, the process started, but with strong reservations. Mr. Li, the director of BTC pointed out, "As a party member, I am obliged to follow party decisions, but I am afraid that political power has to follow the economic logics, otherwise another tragedy like the Great Leap Forward might happen again."

Meanwhile the local government signed an overall contract with the central government which became a base for a further breaking down into sub-contracts, one with each company. The primary concern on the government side was to lower the profit targets for the first year in order to allow firms to cope with the economic difficulties of that time and then to raise the targets again at a later date.

The parties to the negotiations remained more or less the same, the only change being to add a new bureau, the Beijing State-Assets Administrative Bureau to join the government side. As given before., this bureau is a newly developed body, designed to look after state-owned assets.

The negotiation started at different times, among the four companies, but all aimed at signing contracts for the next five years (Table 5.11), thus bringing the CMRS into alignment with the Eighth Five-year plan. BEPGC renewed its contract in the middle of 1989, one and a half years before the expiry of the first period of the contract; whereas the other three companies signed their new contracts by the end of 1990. The reason for such a special arrangement for BEPGC was again due to a policy which gave priority to the development of key companies. It was also due implicitly to an attempt to maintain an existing relationship between the government and the company in order to prevent the further loss of control by the former.

Table 5.11.

**The Time Schedule in the Second Period of the Contract
in the Four Companies**

	BEPGC	BTC	BDSC	BLSC
TSC*	Apr.1989	Nov.1990	Dec.1990	Sept.1990
Duration(Year)	5	5	5	3

*TSC: Time to sign the contracts

The negotiation process in the four companies was complicated, and varied from case to case. Its general features could be characterised as follows (Chen and Faure, 1992):

- Both sides were very active. The companies emphasised all the factors affecting their performance such as government intervention, the uncertainty faced by the company, their social responsibilities etc, while the bureau stressed the importance of government policy and the prospects of future economic growth.

- During the negotiations, various approaches, both formal and informal, individual and collective, were explored for the exchange of information.

- The procedure for determining the profit targets remained more or less the same as before: first to consider the previous performance, and then to make adjustment for other factors, especially the possibility of future developments.

- The perceptions on the future business prospects diverged considerably, being rather pessimistic on the company side.

- Since several bureaus jointed the negotiation process, their different interests affected its progress. For example, in the case of BEPGC the Financial Bureau focused on the issue of the remitted profit targets, while the Machinery Bureau was more concerned with BEPGC's future development.

- Sometimes when a deadlock occurred, the higher authorities intervened acting as a mediator. They were a key factor in breaking any deadlock.

*** structural changes in the contract**

Generally speaking in all the four companies the structure of the contract in terms of three key items remained more or less the same, but several changes occurred. First the targets were further rationalized by emphasizing some targets more and leaving out some others

as irrelevant. For example, how to use the remitted profits were simplified as 10% for the employees' benefits and 90% for production and technology development, whereas the realized profits and production targets were omitted because it was not considered necessary to control them. Second, a so-called contractual risk fund which accounts for 2% of the remitted profits was added in order to compensate for a failure of the contract. Third the growth in the net value of fixed assets was specified as one of the contract targets as below. It aims at preventing the company's short term behaviour by consuming the company's assets:

- For BEPGC, the total investment in fixed assets was to be 55,000,000 Yuan during the period of the Eighth Five-year plan.

- For BTC, the net value of fixed assets by the end of 1995 was to be kept the same as that in 1990.

- For BDSC, the net value of fixed assets were to be increased by 6.4% every year.

- For BLSC, the total fixed assets were required to be insured and remained positive during the contract period.

*** the results of the three targets**

As compared with their previous contracts, the remitted profit targets in the three companies, BTC, BDSC and BLSC, were lower than before (Table 5.12.). This could be explained by the difficult economic environment, changes in the tax structure as well as tough bargaining by the firms. When BLSC, for example, negotiated with the bureau, the first proposed by the government was 1.9 Million Yuan as a remitted profit target, while BLSC offered 1.2 M Yuan. In the second round the government reduced the figure to 1.6 M Yuan, while BLSC stayed at the same level. Finally both sides agreed to 1.4 M Yuan.

"Such a tough negotiation has never happened before." Mr.Liu, the head of management office admitted. Yet since the government has recently increased other taxes, profits remitted by firms has less impact on state revenues.

Table 5.12.

The Profit Targets in Three Companies

	87	88	89	90	91	92	93	94	95
BTC	4.3	4.47	4.65	4.65	3.74	4.08	4.20	4.42	4.72
BDSC		2.65	2.65	2.65	2.55	2.55	2.55	2.55	2.48
BLSC		2.8	3.2	3.5	1.4	1.54	1.69		

The wage control scheme still followed the same principle as before, but two of the companies pushed for a maximum wage reduction in consideration of future losses, in both case limited at 20% of the previous total wage bill. Mr. Zhang deputy director of BTC leading the negotiation team, points out, "In renewing the contract, the critical challenge in the negotiation is to find the wage scheme which best serves the employees' interests. Others issues are too complex to be rationally resolved."

Technology up-grading projects were less emphasized than before, partly because of the

less favourable investment environment, and partly because of the unsolved problem of how to modify the industrial structure, i.e. whether by market forces or, as before, through administrative decisions. For BEPGC and BTC, the contracts indicated the total amount of technological investment as being 55,000,000 Yuan and 13,000,000 Yuan respectively, but with little specification of what the projects might be. These would depend more on the firm's annual plan. For BDSC and BLSC, this item was ignored in the contracts.

Note:

(1). BLSC is a kind of company, so called higher-collective-owned enterprise which is treated by the government more or less the same as the state-owned company. The history is traced back to 1950s during the period of socialist transformation, when all the private companies in heavy industry and part of them in light industry were transferred into the state-owned company, some in light industry were allowed to keep their collective ownership. In the following twenty or thirty years, those companies became 20 or 30 times larger than before, mainly through the government investment. For all sorts of reason, mainly due to the different welfare policy, however, they remained the status as a collective owned. In course of the economic reform, these companies become more sensitive about their ownership status.

(2). The General Company was set up around 1984, aiming at change the bureaucratic function of the bureau by breaking down an industrial bureau into several holding companies. In fact it creates a new level of bureaucracy. As a result, some of them have been stopped and some never properly functioning.

CHAPTER 6

THE CMRS IN PRACTICE II

--- THE IMPLEMENTATION OF THE CONTRACTS

To study the implementation of the CMRS, this research attempts to find out the interaction between the government and the company, with respect to the basic contractual arrangements. As regards the government side, the focus is first on the decisions which might alter the basic institutional structure, and second on the measures which aim at monitoring and enforcing the contracts. As regards the company side, the focus is first on behaviour towards the contractual targets, and second on the company's strategic decisions which would impact on the institutional relations between the government and the firm. In other words, any bureaucratic or management problems which do not directly link to the institutional arrangements will be ignored.

In the case studies, all these aspects are presented under the four headings:

- the extent of enterprise autonomy, described in terms of constraints imposed by the government policy and decisions on the major managerial decisions;
- the implementation of the three key contract targets, presented in terms of the companies' behaviours and performance and the government interventions;
- the companies' chosen strategies, illustrated by the companies' strategic response to the institutional settings;
- the effects of the policy instruments, described in terms of measurements and enforcements.

The implementation process can be characterized as several features. On the government side, first some decisions are viewed as national policies which have to be taken at the central government level, while others can leave in the hands of the local government. As regards the three main contract terms, the profit sharing scheme related to the government revenue has been altered apparently by changing the tax structure. In this aspect, the source of the government revenue has been shifted from taxing profits the company generated, to taxing resources the company used, and products the company sold etc. As to the wage policy, the central government leaves power to the local labour bureau to formulate its own policy which varies from case to case. As to the technology investment projects, the government's attention is differed from sector to sector, for example the key heavy industrial companies received more than others.

Second, in respect of measurement, no specific instrument has been designed to monitor and to police the CMRS as compared with the previous system, even some former methods are still used under new names. The measurement system mainly relies on the existing accounting and reporting system. Moreover, the so called financial resident system has been restored in which the representatives from the local financial bureau are sent to work at the company to monitor the accounting process. This system was established in the 1950s and stopped during the Cultural Revolution. Finally, another popular measure is to organize various appraisal and inspection campaigns related to management problems, for example, quality control, accounting, labour management etc. These campaigns are supposed to be multi-functioned, serving to access information, to motivate and to enforce the contracts. These campaigns can be traced back to the 1950s in China and to the 1920s in the previous USSR, the so-called "Staharnov Campaign"(Brus and Laski, 1989).

Third the major enforcement scheme devised in the CMRS is the reward and penalty scheme applied to the directors. But in practice for various reasons the original arrangements have been either altered, or never realized. More detail is given in the case study below.

On the company side, although fulfilment of the contract targets varies from company to company, managerial behaviour has actually shown some common features. First, in conflicts of interests between the government, firm and employees, the first priority is always given to employees by increasing the wage bills to a socially compatible level. Secondly there is a strong tendency for the workers to leave production lines and to become the office staff, in order to avoid accurate job evaluations. More detailed explanation is given in the case studies.

Having been given a degree of managerial autonomy, the companies are responding differently through their strategic decisions. At the one extreme, the company intends to move away from the existing relationship with the government towards free enterprise; at the other, the company attempts to continue the government support as much as possible. The lower the technology the company employs, the easier it is for the company to establish links with non state-owned companies in order to move further towards free enterprise.

Another feature shown in the implementation of the CMRS is the exclusion of legal system; that is to say, in the resolution of any dispute between the government and a firm, there is never any attempt to rely on the legal system as it in the West. The reasons are

first that the court is part of the government which makes it difficult for it to be impartial, second that to use a legal approach is perceived as ruining bilateral relations, based upon trust, and harmony.

Before going on to the details of the case studies, the changes in the tax system are explained in general terms.

6.1. The Changes of the Tax System

In the planned economy, the surplus generated from industries, especially from the state-owned companies were regarded as the major source of government revenue. As given before, one of the initial purposes of the CMRS was to lay out a profit remittance scheme on the state-owned companies, replacing the previous income tax and adjustment tax as sources of the government revenue (See chapter4). In the course of the implementation of the CMRS, the government has modified the structure of the tax system to shift the weight from remitted profits to other taxes.

In 1978 there were only two types of taxes on industrial sectors: industrial and commercial tax, and income tax for collective companies. In 1984 it was increased to seven taxes including product tax, value added tax, transactions tax, resources tax, salt tax, income tax and adjustment tax. In 1989 the total was up to twenty taxes. In addition, a set of fees were introduced, such as an energy and transportation fee, a budget adjustment fee, an education added fee, and an electricity development fee, etc. These have been criticized as arbitrarily introduced by the central government. Among these taxes and fees, the sources of the government revenue could be characterized from four channels: - the

taxes imposed on elements of inputs including those on land, vehicles, buildings, natural resources, in particular the oil tax, and stamp duty;

- the taxes imposed on sales revenue;
- the taxes imposed on gross revenue that is the remitted profits under the CMRS;
- the fees imposed on the retained profits, such as energy and transportation fee and budget adjustment fee etc.

The survey on the 193 state-owned companies conducted by the China Industrial Economic Association (CIEA) presents the picture of the structural change of the government revenue (Table 6.1.). The tax on sales was substantially increased from 40.1% in 1984, to 64.2% in 1989 and 79.3% in 1990. It is explained by the fact that allowing effective checks from the tax administration.

Table 6.1.

The Structure of the Government Revenue in 193 Companies*

	1986 (1)	1989 (2)	% (1/2)
<hr/>			
Type of Tax:			
on Inputs	44	287	6.50
on Sales	4145	5351	1.29
on Profits		1550	
E&T Fee**	256	540	2.11
Others	244	336	1.38

* Source: the report from CIEA

** E&T Fee: Energy and Transportation Fee

6.2. The Case of Beijing Electric Power Generator Company (BEPGC)

6.2.1. The enterprise autonomy in general

*** the customers and the price control**

As mentioned previously, the main customers of BEPGC are the central government and the local government for its energy generators, namely turbogenerators and steam turbines. In the course of the economic reform, the determination of the customers and distribution channels becomes complicated. On the one hand, the demand of these products is still very sensitive to the national plan and to overall economic policy. For example, in 1989 when the government called for an austerity programme for investment projects, several provinces cancelled their orders for energy generators, but BEPGC did not get any compensation for the products in progress. On the other hand, the central government no longer directly allocates all the products, instead it only controls the local budgets by which the end-users have rights to choose the companies they prefer. It encourages competition among the producers. In some areas, such as certain types of small and medium sized turbogenerators and steam turbines, the supply has already exceeded the demand.

The prices for power generators are partly decided by the government and partly by the market. As price relaxation<1> proceeds, these products are among the few over which the government is still reluctant to release its control. For example, the prices of large-sized turbogenerators and steam turbines, i.e. above 50,000 KW are still controlled by the central government; moreover their prices have been fixed since 1985. In 1991 the cost of manufacturing a turbogenerator of 100,000 KW capacity was 2.8 M Yuan more than its set price. But any attempt to raise this price is so sensitive that the price bureau has no

authority to change it. In 1988, several ministries including the Machinery and Electricity Ministry, the State Price Bureau, the Financial Ministry and the State Planning Commission jointly decided to raise the price by 30%, approved by one of the vice prime ministers. But the main user, the energy ministry, refused to pay such a high price because the price distortion for energy products is even more serious than that for energy generators. Another effort to raise the prices was made in 1989 again, but nothing changed. Mr.Liu, deputy director points out, "Being able to produce large-sized turbogenerators and steam turbines is the competitive advantage of BEPGC. But under such a price control, how can we make a long term strategy? From any point of view, this situation cannot continue, either we go back to the old system or let prices free."

For medium and small sized generators, the prices are negotiable among the local price bureau, industrial bureaus and the company. The prices of other products BEPGC makes are, in general, determined by markets.

*** the suppliers and the price control**

Since 1984, the supply of raw materials for BEPGC has come through dual channels, the government at planned prices, and the market at multiple prices. In principle, the government attempts to guarantee the supply of raw materials for the key companies. For BEPGC, 70% of the raw materials for turbogenerators and steam turbines are under the official plan, but in practice BEPGC has to turn to markets to buy some of them because in many cases the official supply cannot provide good quality raw materials. Average market prices are 26% higher than official prices. BEPGC is facing a similar problem over imported raw materials. Under the dual distributional channels, the government agents are

shrinking and the government subsidy is decreasing so that the company has to find non-official agents to get higher quality goods. Generally speaking the channels for supplying raw materials are changing from the planned system towards markets which creates a painful process for BEPGC to adapt to.

*** the investment decisions**

As mentioned before, the major investment projects have been defined in the contract which has to follow the Eighth Five-year plan. In accordance with this, the decision power of purchasing new equipment for BEPGC is increasing from 50,000 Yuan to 30,000,000 Yuan since the introduction of CMRS. However the government still imposes rigid restrictions on building construction, such that any construction project, even to build a toilet, has to go through all administrative procedures which might need about a hundred official stamps. The aim is to avoid spending money on non-production buildings, such as offices and flats. However this depends on the compliance of managers, as there is no efficient enforcement system in this rule is violated.

*** the organizational decisions**

According to the contract, the company has authority to decide its own organizational structure and personnel decisions. In practice, the major intervention from the government is in decision about deputy director posts. At the beginning of the contract, when the director appointed several senior managers at the level of deputy directors, the local personnel bureau did not raise any opposition. But in 1989 the bureau started to point out that these people were not officially recognized, while the director did not want to revoke his decisions. As a result, these people become the so called "black officers" in the

company. The official at the bureau explains that as a trial-and-error process: "At the beginning the government attempted to give the director power to select these people, but then it found that many of them were not qualified as the government expected, therefore it has to be rectified." The managers in the company have different opinions on it. One manager complains that, "First, the bureau is afraid of losing its power, and second we pay more attention to professional skills while the bureau pays more to the political and ideology aspects." Other managers argue, "It is very easy to show nepotism."

On the issue of organizational structure, BEPGC has never attempted to change the basic functional structure. To establish a joint venture and other connections, BEPGC is entitled to carry out changes, but faces many constraints. More detail is given below.

*** the financial constraints**

Besides the constraints imposed on the investment decisions given above, another financial constraint is on circulation fund. Before the reform, circulation fund was given by the government as a grant. Since 1984, the government has stopped providing it as a grant; instead the company has to borrow from banks if necessary.

During the first period of the CMRS, the need for circulation fund was greatly increased (Table 6.2.), due to the rise in costs and debts among the companies, the so called "triangle debts". The need to borrow more money means that negotiation with the banks and attempt to get the bureaus' support became the major managerial issues.

Table 6.2.

The Increase of Circulation Fund in BEPGC in 1984-1990

	84	85	86	87	88	89
<hr/>						
TCF*						
(M)	80.4	100.0	111.9	122.8	161.2	210.1
%	0.80	1	1.12	1.23	1.61	2.10
Loan						
(M)	24.7	30.4	42.2	58.1	75.7	98.9
%	0.81	1	1.39	1.91	2.49	3.25

* TCF: total circulation fund in BEPGC

6.2.2 The fulfilment of the contract targets

*** the profit targets and its related factors**

As the general picture shown before, the tax structure in BEPGC has also been changed since the CMRS was introduced. The importance of income tax has been shifted to that of sales tax (Table.6.3.)

Table 6.3.

The Profits and Tax Structure in BEPGC in 1984-1989

	85	86	87	88	89	90
Profit targets	11.62	11.80	12.10	12.50	13.00	
Income tax (M)	6.71	6.67	6.79	7.23	6.60	7.66
Value add tax (M)	2.65	4.81	11.60	9.98	11.81	3.05
IT/VAT (%)	2.5	1.38	0.58	0.72	0.55	0.59
TT&F* (M)	15.16	19.23	22.59	26.15	24.12	19.74

*TT&F: total taxes and fees,

In principle it does not affect the amount of remaining profit for BEPGC, according to the special arrangements in the contract in which the remitted profit target includes both income tax and other taxes. However the company still complains that the real remaining profits is reducing (Table 6.4.) due to the increase of fees, while the bureau argues that a large part of the remitted profit in fact returns to BEPGC for its technology investment project. Nevertheless both sides admit that arguments on this issue will never end until the company becomes a real independent economic identity or alternatively returns to the previous system.

Table 6.4.

The Retained Profits in BEPGC in 1985-1990

	85	86	87	88	89	90
TRP*	6.13	6.36	2.92	4.99	3.83	5.43

*TRP: total retained profits

Over the first five years contractual period, BEPGC fulfilled its profit targets (Table 6.5.). By the end of 1990, the performance of BEPGC still made it one of the best companies in Beijing. Broadly speaking the production has been increasing in terms of physical and financial measurements, but the profitability decreasing (Table 6.5.). The main reasons are the increasing costs of inputs both in domestic markets and abroad as well as the price control on the large sized energy generators. In addition, the increasing expenditure on working capital, wage bill and intra-company debts are other factors which impact on it. Nevertheless the basic contributors to the overall success of the company are the high demand for its products and its special status in the state-owned sector.

Table 6.5.

The Performance of BEPGC in 1985-1990

%	85	86	87	88	89	90
Output	1	1.09	1.24	1.52	1.81	1.91
Turnover	1	1.40	1.45	1.74	2.23	2.34
Gross Profits	1	1.15	0.88	1.29	0.98	
Taxes & Fees	1	1.27	1.49	1.72	1.59	1.53
Remained Profits	1	1.04	0.48	0.81	0.63	0.88

*** the wage bill control**

According to the accounts, the average wage per employee has been increasing yearly, more steeply than the increase of productivity (Table 9.6.). But the real income per person seems even higher than that figures shown. It is estimated as about 300 Yuan per capita, because the company has run some collective businesses beyond the normal accounting control, such as restaurants, guest house, and consultant works etc. Mr.Kang, a young manager points out, "As a large well-known company, we have to be attractive in wages in order to keep good people. To create some collective businesses is a way to solve this problem." When the author asked the official about this mixture of ownership structure, he answered, "During the transition, we have to try every thing. If it is really bad, we can stop it later on." Nevertheless, the total wage bills are assumed to be under the control according to the formal accounting books, but everybody admits there are other ways to

issue fringe benefits.

Table 6.6.

The Wages and Productivity in BEPGC in 1985-1990

	85	86	87	88	89	90
AW/M*	99	128	158	186	221	254
%	1	1.30	1.60	1.88	2.24	2.57
Productivity	1	1.09	1.24	1.51	1.83	1.94
*AW/M: average wage per person per month						

Like many state-owned enterprises, the organizational structure is shifting towards more office staff and fewer people working in the production line (Table 6.7.). It results from the implementation of the idea that the income should be subject to performance on each job. Measurement of performance is much easier at the workshop level, such as by adopting piece wage rate, than that in office work. Thus it induces a strong expectation for employees to leave the production front line and to become office staff (Table 6.7.). There is no mechanism which can prevent people using all available excuses and personal influence to make their lives easier, because the company has no right to make redundancy to their employees. Moreover if it is thought of as a general social tendency, most directors and managers will feel powerless to stop it through their own efforts.

Table 6.7.

The Job Structure in BEPGC in 1985-1990						
	85	86	87	88	89	90
Total	6515	6495	6580	7072	7715	7696
%	1	0.99	1.01	1.08	1.18	1.18
Worker	3819	3785	3835	4099	4325	
%	1	0.99	1	1.07	1.17	
Apprentice	226	349	335	490	430	
%	1	1.5	1.48	2.17	1.90	
Technical	725	753	772	901	946	
%	1	1.04	1.06	1.24	1.30	
Manager	752	761	780	883	1069	
%	1	1.01	1.04	1.17	1.42	
Service	788	709	711	686	944	
%	1	0.90	0.90	0.87	1.20	
Others	205	138	147	94	133	
%	1	0.67	0.71	0.46	0.65	

*** the technology investment project**

See the investment decisions in 6.2.3.

6.2.3. The company's strategic decisions

* the continuation of bargaining with the bureaus

As previously described, price control drives the company to continue negotiating with the government. As a result, the local price bureau and machinery bureau agreed to raise the prices for medium and small-sized generators in 1989.

Moreover the increase of costs of raw materials gives more bargaining power to the company for financial support. As mentioned before, the need for circulation fund has been significantly increased (Table 6.8.) due to the rise of costs and debts among the companies. Eventually the government has to make a special policy for the key companies, the so called "two guarantees" companies in which the government guarantees to provide raw materials with cheaper prices and to subsidize part of circulation fund. BEPGC is one of 234 "two guarantees" companies in China.

Table 6.8.

The Structure of the Circulation Fund in BEPGC

	84	85	86	87	88	89
GCF*	80.4	100.1	111.9	122.8	161.2	210.2
CCF**	44.0	42.3	42.5	42.6	42.7	48.0
Loan	24.7	30.4	42.2	58.1	75.6	98.9

* GCF: the granted circulation fund

** CCF: the company-owned circulation fund

*** diversification of its product mix**

Because of the price control on large sized turbogenerators and steam turbines, in order to increase its profitability, the company adopts the strategy of diversification of its products, without increasing production of these large-sized generators. The product mix has been developed since 1979, from only manufacturing electric generators to making other related products, for example producing components, repairing motors and other equipment, and refitting vehicles (Table 6.9.). Meanwhile the total number of 100,000 kw and 200,000 kw turbogenerators and steam turbines has been remained more or less the same (Table 6.10.).

Table 6.9.

The Change of Product Mix in BEPGC in 1979-1988 (%)

	79	80	81	82	83	84	85	86	87	88
Total	1	0.83	0.22	0.38	0.52	0.79	0.84	0.92	1.03	1.44
TG*	1	0.76	0.07	0.36	0.70	1.07	0.95	1.04	1.21	1.65
ST**	1	0.73	0.09	0.14	0.56	0.99	1.14	1.20	1.60	2.08
Motor	1	0.67	0.14	0.17	0.20	0.41	0.43	0.72	0.55	0.53
Component	1	2.11	0.56	1.97	1.22	1.37	1.28	1.87	2.80	3.20
Repairing	1	1.61	2.45	4.09	4.27	2.36	3.25	2.12	1.77	1.30
RV***	1	1.72	0.85	1.38	1.72	1.83	1.87	1.22	1.82	2.07

* TG: Turbogenerator, ** ST: Steam Turbine,

*** RV: Refitting Vehicles.

Table 6.10.

The Production of Large-sized Generators in BEPGC

	83	84	85	86	87	88	89
<hr/>							
Turbogenerator							
100,000 kw	3	4	4	4	3	2	2
200,000 kw		1	1	1	2	2	2
Steam turbine							
100,000 kw	3	3	3	4	3	3	2
200,000 kw		1	1	1	2	2	3
Total	6	9	9	10	10	9	10

*** the investment decisions**

The company's investment project has already been defined by the contract. During implementation, there is no problem in getting bank loans as well as support from the bureaus. The main problem comes from the company itself which is that the target for financial investment has been reached, while in terms of the technical content, the objectives have not been achieved. The reasons are partly because of inflation and partly because of the high human cost. The investment projects very easily become a kind of resource for bonus payments, project performance being difficult to monitor and measure.

Among the senior managers in BEPGC, the real controversial issue concerns what long-

term strategy the company should pursue. One viewpoint is that BEPGC should develop large-sized turbogenerators, such as 600,000 KW, giving the company a competitive advantage to meet potential markets. The first deputy director, chief engineer and several young managers support this view. The director disagrees and prefers to adopt a practical approach, emphasising the need to be flexible and to take advantage of the current policy. He argues that as a large state-owned company, BEPGC's fate rests largely on government decisions and it is correspondingly very difficult for the company to develop its own strategy and make progress by its own efforts. As his secretary said, "The most important thing is to grasp each opportunity, for example, if the government encourages the import of equipment and transfer technology, the right thing is to react quickly and correctly to up-grade the company, but if the government gives some flexibility over building construction, you should give first priority to employee housing." During the first contractual period, the company used all sorts of rationales to achieve the construction of eight large office buildings and renovation of employee's flats. Mr. Kung, points out, "Before retirement, the director is keen to erect a monument to himself and to build up his public image, rather than to set up a long-term strategy for the company."

*** the discussion on the joint venture with foreign company**

With all the constraints imposed on the company, setting up a joint venture with foreign companies appears to be a way of circumventing them. It can be argued that this is the only efficient way of changing the company's behaviour by pushing the company towards international markets.

In 1985 BEPGC started to have joint production programme with the French company

Alstom which were initiated by the two governments. After several years of successful cooperation, both sides considered setting up a joint venture. Three years on-going negotiation, however have revealed several obstacles which are:

- on the French side, they only want to be a joint venture with one part of BEPGC, which is not accepted by the Chinese side, because it believes that such a joint venture would leave the remaining part even more difficult to manage;
- the Machinery Ministry fears loss of government control over such an important sector once the company becomes a joint venture;
- the director of BEPGC is also anxious about losing his power when the company has to be managed jointly with foreigners.

The negotiation is still going on and the company is likely to become a joint venture because many people believe that eventually the consideration of economic efficiency has to be a leading issue.

6.2.4. The measurement and enforcement mechanism

*** Director's financial rewards and penalties**

The contract did not clearly specified directors financial rewards and penalties. In practice by the end of the first contract year the bureau awarded a bonus of 1000 Yuan to the director. At the beginning he did not take it because it was so new for the leader to take such a financial reward. It was generally accepted that the leader should work conscientiously rather than being motivated by money. Eventually the bureau had to force him to accept it. Two or three years after, however, a similar amount of money is regarded as too small for the director who has to undertake such heavy responsibilities.

"As a large company, the real motivation for the director is his career and his power. In the current system, it is difficult to design a remuneration system separately from other form of motivation. The idea of awarding such small bonus payments, in any sense, is ridiculous." the deputy director points out.

*** no change of accounting procedures**

Under the CMRS, there is no basic change of accounting procedures, but an important role is played by the financial residents who have rights to check any account book and relevant documents at any time. "The danger is the they might be allowed too much power. Who can guarantee their behaviour?" Mr.Zhou, the financial manager points out.

*** the management appraisal and inspection campaigns**

For a large company, these campaigns have already become a kind of routine, carried out by a group of people, especially by the general management department. There have had little effect on performance.

6.3. The Case of Beijing Transformer Company (BTC)

6.3.1 The enterprise autonomy in general

*** the customers and the competitors**

The main product manufactured by BTC is medium-sized transformers, with about a hundred models below the capacity of 6300 KVA. Recently many state-owned or even township companies have become able to manufacture such transformers; the number of the companies has increased dramatically, from 53 in the 1970s to about 800 in 1990. Gradually, the company has had to face to a buyer's market. Correspondingly the price control has been relaxed since 1985. At the very beginning, it adopted a dual price system and moved to free market prices in 1989 when the supply was close to the demand. Meanwhile the distribution channels have been changed as well. Before the economic reform, the national plan with the trade fair organized by the government was the major way in which orders were allocated. In this way, BTC never needed to find customers by itself. Since the reform, the company gets less government and has to increase efforts to find and to keep customers. For example, only about 20% of the order in 1990 came from the government plan.

Before the reform, BTC's customers mainly came from Beijing and the North of China. In recent years as the company attempts to expand its markets into other regions, it faces a kind of barrier; the local companies have to buy transformers made locally first. "Recently local protection is getting difficult, especially for many consumer products, but the products like transformers which are used in the heavy industry are still more easily controlled by local government." Mr. Wang, the head of sales department, points out.

*** the suppliers and its multi channels**

Like many companies, BTC's supply channels for most raw materials have moved, since the reform, from the planned system to a mixed system or the market place. For example, the key material for making transformer is silicon steel sheet which is still in short supply, especially as regards high quality models. This created a complicated supply set of channels which provides multi prices through multi agents, such as a government agent with a quota price, personal links with negotiable prices, and a kind of markets with market prices. For most of the other raw materials, the supply is basically through the market places.

*** the investment decisions**

See 6.3.2. "the technology investment project".

*** the organizational and personnel decisions**

Like BEPGC, BTC faces many constraints in its organizational decisions such as appointing its deputy directors, making redundancies and streamlining its organizational structure. The last point concerns the problem in dealing with other social organizations which will be described below in the case of BDSC which has similar problems (See 6.4.1.)

*** the financial constraints**

Under the CMRS, although the sources of investment and circulation funds have been changed from grants to loans, BTC is still not free to access financial sources. For example, the bureau has rights to stop investment funding, even if it has already been

approved by the bureau. More detail is given below. The bureau explains that it is due to the difficulty of deciding reasonable investment projects in advance so that adjustments are necessary during the process. For the circulation funds, there is only one bank, the Industrial and Commercial bank, from which the company can borrow money. This places the real decision making power in the hands of the junior banking staff who are responsible for short loan borrowing. Mr. Li, the director complains, "At present, the real VIP's for the company are those young junior fellows who have little professional knowledge, but enormous power to affect our daily management. They don't act in a reliable way."

6.3.2. The fulfilment of the contract targets

*** the profits targets and its related factors**

During the first period of the contract, BTC was among the one third of companies under the supervision of the Beijing Machinery Bureau which, fulfilled the profit targets, (one third made losses and another third was in break-even points). But the real achievement was a complicated story. In the first contract year of 1987, BTC achieved its target of the remitted profits. In 1988 BTC delayed paying 0.30 M of its remitted profit targets, due to the increase of the prices of raw materials. In 1989 and 1990 since the economic situation was deteriorated, BTC was allowed to reduce its remitted profits by 0.8 M and to free part of the loan interests for the circulation fund. As a consequence BTC has only fulfilled 87% of the original targets (Table 6.11.). Nevertheless, considering so many unpredictable factors, the government regards the performance of the companies like BTC as acceptable.

Table 6.11.

The Implementation of the Remitted Profit Targets in BTC

	87	88	89	90	Total
Profit targets	4.30	4.47	4.65	4.65	18.07
Changes					
increase due to merger			+0.34	+0.34	
deduction			-0.80	-0.80	
Realized payment	4.30	4.47	3.45	3.45	15.67

However the company further argues that its actual contribution to the government budget has been increased if all sorts of taxes, fees, as well as the remitted profits are taken into account (Table 6.12).

Table. 6.12.

The Tax Structure in BTC in 1983-1990

	84	85	86	87	88	89	90
Total	5.83	7.56	9.50	11.51	8.58	17.58	15.33
Sales tax	1.07	1.47	1.91	2.70	2.84	2.97	
Resource tax	0.12	0.41	0.50	0.51	0.10	0.11	
Profits tax	2.32	2.74	3.14	3.48	3.44	2.27	
Others	2.32	2.94	3.95	4.83	2.20		

With respect to the incentive of the CMRS on profitability, Mr. Zhang, the deputy director argues strongly that profitability cannot be increased steadily as expected in the CMRS. What happened in BTC illustrates that the new system could have high incentives in the first two or three years as the indicators show (Table 6.13.), but the system does not provide a vehicle for sustained growth. He points out that the achievement can be explained by the improvement of the employee's working attitude inspired by the new system. For instance, any increase in bonus could result in increased productivity at the beginning. But there is an economic limitation of rising costs and a psychological limitation of motivation by this instrument. As a result, on the one hand, the unit cost has already been raised five times, from 4 to 5 Yuan to 20 to 25 Yuan per hour within the four years. The company cannot afford to continue in this way. On the other hand, the employees' expectation are rising. For example, at the beginning 10 Yuan was rather a high bonus, but now 50 Yuan might produce similar effects. Above all, the most

important factor for keeping a high profitability is willingness to invest and investment possibilities. But at present BTC has no strong incentive to invest because of the uncertainty of economic policy and markets. "In this way, soon or later profitability will go down, which is likely to result in a change of director. With a new director, it is possible to sign a contract starting at lower level with a rather high growth rate of profitability. It would become a kind of political game rather than economic issues." Mr.Zhang comments.

Table 6.13.

The Performance of BTC in 1986-1990

	86	87	88	89	90
Total output (M)	12.8	12.9	16.7	29.4	28.1
Turnover (M)	34.6	44.3	49.5	73.0	67.0
Profitability (M)	5.16	4.33	5.98	8.28	6.98

*** control of the wage bill**

From many senior managers' point of view, as Mr. Zhang points out, "The real autonomy given by the CMRS is the determination of income distribution inside the company." In the past under government control, the payment system was subject to pre-determined factors, such as age, education, sector etc., but with very little consideration of performance. A person with good performance might not be paid well. Under the new

system, the company can make any rule for its payment system. For example, a piece rate wage has been introduced in the workshops and a flexible bonus system is adopted in the offices, especially giving priority to the professional people.

But some managers complained that the wage system is a mess now, because too much decision-making power has already been decentralized to the lower level by the so called "inside contracting system". As a result, the senior managers have no power to intervene, except for requiring proportional profits from each sub-organization. In other words, each workshop and department become a profit centre rather than a cost centre. Furthermore, "A strong perception of a contracting system, no matter at which level the system is carried out, whether at firm or workshop level, is that the contractor is only responsible for the outcome to a higher authority, but has entire autonomy to manipulate the process. As a common saying goes: turn enough profits over to you, and leave me alone." Mr. An, the head of the management office points out this popular conception of a contractual relationship in China. "As you know, the CMRS originates from the word of undertenant between a landlord and a peasant or between merchants. Each side expects to benefit, without knowing much of the other's activities" (See Chapter4).

As in the case of BEPGC, there is a strong tendency for workers to escape the piece rate wage system by becoming clerks working in the office. Mr. An estimates only about one third of the employees works according to piece rate. It has a substantially impact on productivity and workers' morale. "Before, this problem could be solved by the threats of class struggle. But now this enforcement mechanism no longer works, but no new system is available, such as making people redundant." Mr. Zhang points out, " Many things are

changing, except one: people still enjoys their permanent status as the so-called masters of the company, but without responsibility for it and with no need to worry about losing it."

As a consequence, the average income is increasing steadily and more rapidly than the increase of profitability (Table 6.14.), although the total wage bills are assumed subject to the contractual conditions.

Table 6.14.

The Performance and Payment in BTC in 1986-1990

	86	87	88	89	90
TWB* allowed (M)	2.92	3.16	3.50	52.9	58.4
TWB realized (M)	2.84	3.13	3.49	46.6	58.4
No.of employee	1836	1813	1972	1998	1928
Wage (Y)	129	144	168	194	252
%	1	1.12	1.30	1.50	1.95
Net Value (M)	12.82	12.88	16.72	29.43	28.13
Productivity (Y)	698	710	848	1473	1459
%	1	1.02	1.21	2.11	2.09
Profitability (Y)	4188	4761	4292	5973	4799
%	1	1.14	1.02	1.43	1.15

* TWB: total wage bill

*** the technology investment projects**

The technology investment project defined in the contract has not been implemented properly, because neither side put enough efforts into it. On the government side, until the end of 1990, BTC had not yet received the loan of 3.2 M Yuan for the project, while the budget is increased from 6 M Yuan to 8 M Yuan, as a result of re-examination of the contract in 1988. On the company side, actually only 1 M Yuan, one third of the budget has been invested.

Such a lack of commitment is mainly due to the low opinion of the importance of the project found on both sides. As mentioned before, during the Sixth Five-year plan (1980-1985), BTC had a big investment project in which 19 Million Yuan was invested to import new technology. As a consequence, the priority is naturally to exploit this new potential rather than to pursue new investments. Moreover in terms of financial constraints, the company is afraid of paying interests, and the bank is also anxious about the high risk of the investment. In addition, the transformer sector has been developed so quickly that supply has exceeded demand. By the end of 1980s, the total production capacity for transformers in the national market had reached 100,000,000 KVA, but the demand was only 60,000,000 KVA. It affected BTC as such: its capacity reached 1,500,000 KVA, but only got orders for 1,000,000 KVA in 1990. Thus BTC is facing a strategic choice for the company's future, either to wait for the industrial adjustment by the government, or to make the first move by itself.

6.3.3. The company's strategic decisions

*** the view and actions on strategic management**

When the director was asked about his strategy, he said, "It is a nice word, but I don't think there is any strategy existing in a state-owned company. Managing a company like sailing a boat with much wind. The most important thing is to find out how the wind blows and to change course in order to sail before the wind. Eventually if we still move forward, that is an achievement." He gave an example of how the government arbitrarily imported new technology from abroad, such as dry transformers, 2 lines in 1985, 13 lines in 1989 and now about 100 lines which substantially exceed the demand. "How can you make strategic decisions with such uncertainties? In fact the market risk is much easier to deal with than the policy uncertainty. It encourages people to behave opportunistically."

These ideas had an impact on formation of the company's strategy. At this stage many senior managers still prefer to pursue its competitive advantage on technology rather than to make a market oriented strategy. Besides the difficulties mentioned before, this can also be attributed to the company's history. In 1958 BTC was the first company to make monocrystalline silicon in Beijing and developed it into silicon elements in 1964. At the beginning of 1980s, BTC was the first company to start making dry transformers and to be able to offer a set of transformers composed of transformer, rectifier and silicon element. But when competition intensified, the company was not ready to cope with it. As Mr. Wu, the head of marketing department complained, "BTC is very bad at dealing with markets which has never been given priority. For example, the company's policy in taking orders is so rigid on order size that we lost many orders in recent years because they ask for a small quantity." "It probably can be explained by the background of senior managers." the official in the bureau pointed out, "Most of them were trained as engineers in the 1950s and 1960s. Obviously technology is their strong point, moreover the status

of salesmen in the company traditionally is very low in terms of their education and behaviour." Meanwhile BTC has great difficulty in keeping its technical edge, because of the financial constraints, and a lack of special supports from the government, as it is not defined as a key company. As a consequence, "The implicit strategy of BTC is to muddle through and to put more weight on the expectation of the changes in environmental conditions." a young manager points out.

*** other organizational innovations**

In 1987 BTC started to build up sub-contractual relations with two township companies in the outskirts of Beijing. After two years this arrangement failed because the two companies could not produce the components up to standard. Meanwhile they attempted to get all sorts of benefits from BTC, for example, to purchase government controlled raw materials and to use the equipment for other purposes. This ended the relationship.

In 1988, one small state-owned company merged with BTC. The managers regard it as an object lesson rather than a success story. The initial request was made by the bureau who proposed several companies as candidates, implying that BTC must take one. The benefits BTC perceived was the additional land space, providing an opportunity to build more flats for its employees. The officials in the bureau admit that this is the major motivation perceived in most of cases of such mergers. After merger, BTC had to pay back the debt of 2 Million Yuan that company owed and to invest 2 Million Yuan in a new product for it. In addition BTC has to keep all its employees and even to raise their salaries level with BTC's. "The socialist ideas give these people so many benefits, even though their company is actually bankrupt." Mr. An the head of management department complained.

For years, BTC has attempted to set up joint ventures with foreign companies. But none of these negotiations were successful, simply because it is difficult to export its poor quality products and not allowed to sell them in the domestic markets once they are made in a joint venture, according to the government policy.

As a medium sized state-owned company in the heavy industrial sector, BTC has been offered very few opportunities. It is hard for it to get government special support and hard for it to compete in the market place. As a consequence, there is some illegal business such as underground economy carried on in the company in order to raise some fringe benefits.

6.3.4. The measurement and enforcement mechanism

*** Directors financial rewards and penalties**

According to the provision of the CMRS, the director's income is allowed to be 1 to 3 times higher than other employees. In 1987, BTC received an implementing regulation which offered a floating range 2 to 3 times higher, while in 1988 it changed to 1.5 to 2 times higher. The bureau explained that this aims at reducing the income gap between the director and the employees. "It is strange. Such a modification is just the opposite of the trend in society; the manager's higher income is more tolerable and expected." a young manager in the management department commented.

In 1987 when the director received his first bonus, about 700 Yuan for the whole year's work, he spent all the money on a banquet for his colleagues. "This reward policy is simply a message to say: do not expect to get any financial reward from the government.

In fact over the last 30 years I has been paid very poorly which did not prevent me from working hard, because of the way we were trained. But this will not be the case for the next generation. The young people tell me, 'I am leaving for a joint venture. Look at you, even I am as good as you, so what?' " Mr.Li, the director reflected.

*** the measurement problem**

The same accounting procedures and the financial resident system are adopted in BTC as in other state-owned companies. At the company level, the financial residents play a vital role in checking the formal financial information, but it is still difficult to know what happens at the lower levels. As mentioned before, the managers believe that the problems encountered in measurement of performance is not only due to the lack of efficient instruments, but people's attitude as well.

*** the management appraisal and inspection campaigns**

In the case of BTC, those campaigns have never been received very much attention, due to the director's attitude.

6.4. The Case of Beijing Dahua Shirt Company (BDSC)

6.4.1. The enterprise autonomy

*** the customers and suppliers**

Market oriented reform started earlier in the clothing manufacturing sector than in heavy industrial sectors. In 1980, the government decided it would no longer act as an agent to sell the BDSC's products in the home market, but it still provided raw materials. In 1986, the bureau stopped supplying raw materials as well. Thus BDSC has had to build up its own supply and market channels. For international markets, although it still needs to rely on the government agency, BDSC has power to decide whether and with whom to sign contracts. Moreover when the demands from international markets decrease, for example, after the Tian An Men event, BDSC would have priority to get orders from the import and export agency. The company's market strategies are given below.

*** the investment decisions**

Since the beginning of the reform, the government has decided not to provide the company with any investment grant. Thus, the investment decisions rest entirely on the company itself. If BDSC wants to invest, it must apply for a bank loan. In practice the company still needs to get government support in order to carry this out, especially to find some low interest rate projects. More examples are given below.

*** the organizational decisions**

In principle, BDSC has power to organize itself as a the company however it likes. In practice, there are several restrictions, first who should be the person with most authority in the company, the director or the party secretary. The debate went on over a period, as

mentioned before. Second who has authority to select the deputy director and other senior members. In 1987 the director supposedly had authority to select his senior staff, but they were not approved by the bureau afterwards. Eventually this divides the staff into two groups, those appointed by the bureau and by the director. Third, the organizational structure is still restricted by the bureaucratic and social stakeholders. For example, the director attempted to streamline the department structure, but it could not cope with the needs of other organizations, for example, social the security office and local medical care, because each of them wants the company to set up special departments to deal with their areas.

*** the financial constraints**

Since 1986, BDSC has become very much a market oriented company. Financially it means that the company has to borrow money for its investment and circulation funds. To be successful, the important thing is to keep a good relationship and record with banks. Consumer products with a well-known brand name give BDSC advantages in getting the banks' support, because it reduces market risk and is possible to provide fringe benefits for banks.

6.4.2. The fulfilment of the contract targets

*** the profit targets and related factors**

During the first contractual period, all the profit targets had been exceeded (Table 6.15.), partly due to efficient management, partly due to rather low profit targets. The director said that his strategy is to create profits as much as possible in the first contractual period, and then the company would be in a better position to invest, seeking opportunities to move

towards international markets.

Table 6.15.

The Performnace of Profit Targets in BDSC

	87	88	89	90
Realized Profit (M)				
target	4.6	4.6	4.6	4.6
actual	5.64	5.70	7.31	6.50
Remitted P (M)				
target	2.65	2.65	2.65	2.65
actual	3.29	3.41	4.30	3.90

The company attempted to reduce costs and to have a market strategy to trade-off between domestic and international markets. Since the prices in home markets are raising rapidly which creates a larger profit margin than that abroad, the company gives priority to the domestic market in the first half of a year when domestic sales are high, and to export in the second half of the year. The main export markets are ???.....As a result, over the last four years, the proportion of exports has been slightly reducing (Table 6. 17.), but the profit ratio is kept high. The company regards it as a very successful strategy, while the export agent i.e. the local export and import company, expects BDSC to earn more hard currency.

Table 6.16.**The Market Share at Home and Abroad in BDSC in 1987-1990**

	87	88	89	90
At Home (%)	28	38	35	39
Abroad (%)	72	62	65	61

*** the wage bill control**

Since 1986-1987 BDSC has started to adopt the total piece rate wage scheme which links the total wage bill with the total number of shirts, up to standard, the company produces. It is a kind of piece rate wage applied to the company's total wage bill. At the very beginning, BDSC was happy about it as it offered a strong incentive. But the essential dispute arising between BDSC and the labour bureau is how to determine the ratio. In 1986-1987, each shirt sold would be allowed to pay 0.637 Yuan for wages (table 6.17). Since the market condition has been changing so rapidly, this scheme reveals its lack of flexibility to react to fashion and quality of the clothing. In 1989 the piece rate increased to 0.670 Yuan for a standard shirt, and added a proportional link 1 to 1.12 to non-standard shirts. In 1990 it was increasing again(table 6.18.). "Honestly it is very difficult to distinguish clearly between standard and non-standard shirts". Mr. Wu, the deputy director who is responsible for wages pointed out, "In the West, the state sets up minimum wage restriction, whereas the government here attempts to control maximum wage payment. How can they do it efficiently once the products become diverse? The company can

always find a better way of doing it and the real constraints are our own interests: to keep certain profitability."

Table 6.17.

The Change of Piece Wage Rate in BDSC in 1986-1990

	86 (87)	88	89	90
Piece Wage Rate	0.6	0.637	0.68	0.73

Table 6.18.

The Piece Wage Scheme in BDSC

	Standard	Non-standard
Piece Wage	1	1.12

Over the three years contract period, the average wage per capita in BDSC was increasing, and outstripping the growth of productivity (Table 6.19.).

Table 6.19.**The Productivity and the Wage Growth in BDSC**

	87	88	89	90
Average Salary (y)	146	183	222	257
%	1	1.25	1.52	1.76
Productivity %	1	1.38	1.36	1.41

*** the technology investment projects**

As mentioned before, there was no technology up-grading project specified in the contract, because of the company's low level of technology. In addition, the company already got a development grant in the 1970s. At present the bureaus would like to help other companies, if there are opportunities. "Broadly speaking, the clothing manufacturing sector is not an industry the government wishes to give priority for its development. It is a matter of the company's own strategy." Mr. Niu, the director points out.

6.4.3. The company's strategic decisions*** the three step strategy**

In 1986, when the company was encouraged to define its own strategy for long-term development, BDSC drew up its three step strategy:

- in the short run, BDSC aims at increasing profitability in face of stiff competition;
- in the medium term, BDSC aims at penetrating all the domestic markets with its men's shirts under the well-known brand name "Tian Tan";

- in the long run, BDSC aims at becoming a competitor in the international markets.

For the first three years contract period, it needed to carry out the short and medium terms goals. In order to do that, the company attempts to build up three stable bases for raw material supply, clothing manufacture and sales. More details about each development are given below.

The director is very proud that BDSC has pursued a strategy which specializes in making men's shirts since the 1950s. To be specialized in such a narrow product arrangement was very rare in the clothing manufacturing sector under the traditional planned economy. When the market competition starts, it shows its competitive advantage over other companies.

To some extent, the idea of laying down a three step strategy becomes a controversial issue. In 1989 after the Tian An Men event when the debate on the reform started again, an issue arisen in BDSC was about this three step strategy. Some people challenged it as too ambitious to escape the government control, but most of the young managers supported the director who should have his own strategy for the company's future.

*** the base for supply of raw materials**

Before 1985 over the last 30 years, the suppliers were required to be local companies according to the government policy. In 1986 BDSC started to looking for suitable suppliers with lower prices and higher quality. After two to three years searching, a local printing and dyeing mill in the North-East region became BDSC's major supplier and its sub-

contractor as well. It provides cheaper and high quality white cloth which is the major raw material BDSC needed, meanwhile part of the business in this company makes men's shirts, having been set up initially with BDSC's help. The deal includes selling them through BDSC's marketing channels, and both sides are happy that such arrangements offer mutual benefits.

*** the manufacturing base formed by small township companies**

Since 1980, BDSC started to build up business relationships with other companies, especially with township companies in the suburbs of Beijing in order to expand its production capacity. At that time demand was very high. The more shirts, the more profits. The first township company they linked with was HUA LIAN Co. which is located in Yan Qin county of Beijing. HU LIAN Co. was initially set up as a collectively owned company to produce simple clothes, supported by the county government. In doing business with BDSC, HUA LIAN Co. is only responsible for manufacturing shirts as a subcontractor. This means that all the orders and raw materials come from BDSC with transfer price. Several managers and technical people from BDSC have been sent to help. BDSC has also sold them some used equipment very cheaply. The contracts of this joint business are signed among the two companies and the county within a ten year period. According to the contract, 20% of total profits would be retained in HUA LIAN Co., and the county and BDSC shared the remaining profit in proportion of 7 to 3. All the taxes are paid separately according to the regulation. The major advantage BDSC enjoys is a low cost of manufacturing and flexible arrangements to respond to demand.

Since 1988, BDSC has gradually increased the number of the subcontractors up to five

township companies in the area of Beijing (Table 6.20.). The tendency is to reduce the contract period in order to avoid uncertainty. The total employees of the five subcontractors are about 780, or average 160 in each.

Table 6.20.

The Subcontractors of BDSC

Company	HL	HS	HY	HH	JH	HJ
Started	1980	1988	1988	1989	1990	1990
Period (Year)	10	10	10	10	5	5

The other business connection is through license. 25 small companies in 16 provinces have been able to use the brand name of Tian Tan to make men's shirts. The price is negotiable with a profit margin about 50%. Meanwhile BDSC directly controls quality by sending technical personnel to these places.

As a consequence, the number of shirts produced in those two types of business are already higher than the total output made in BDSC (Table 6.21.). Furthermore the amount of output produced outside has been counted as part of the capacity of BDSC, even in the fulfilment of the contract targets, but the profit targets are not modified. In this sense, the output of the contract presents the mixed feature of the producers, by the state-owned and collective companies.

Table 6.21.

The structure of Production Capacity in BDSC

	87	88	89	90
Output (M piece)	5.00	5.27	5.07	4.23
BDSC made	2.74	2.44	2.43	1.62
%	72	62	65	62

Currently BDSC is facing a new problem in that some subcontractors become the competitors of BDSC. For example HUA LIAN has created its own brand name, "Bens", to compete with "Tian Tan". Mr. Wu points out, "We helped to foster our opponents in every way by technology transfer, management training, and equipping them." But Mr. Niu, the director has different opinions, "Such horizontal connections are very efficient in responding to market changes, especially to avoid the rigidity of labour management in the state-owned system. Meanwhile it creates an opportunity for BDSC to be a national wide company, and to be ready to become an international company. I perceive competition as a kind of incentive to improve our business."

*** expanding domestic and international markets**

Before the reform, the shirt markets were very much localized: local people buying local products. But the situation is changing dramatically. In 1990 the Xi Dan department store, one of the four large department stores in Beijing, was selling men's shirts made in 30 to 40 different companies from 19 provinces in China, although the largest market share is

still from the companies in Beijing. In face of such a market situation, BDSC's strategy is first to remain a big market share about 70% in Beijing, while secondly increasing market penetrating and market share elsewhere as much as possible. In order to achieve that, the company has to increase the number of salesmen from 6 to 16, and to spend more money on advertisement which has increased 20% every year.

For international markets, although the business still needed to be mediated by the government agency --- the import and export companies, BDSC played a more active role in finding its customers and other business possibilities. And the company was also entitled to use part of hard currency it earned for other business. BDSC has already built up a long term relation with some international companies, such as Arrow Co., Seidensticker Co. and some Japanese companies as a subcontractor. But the director is not very keen to set up a joint venture with them, instead he hopes BDSC will become an international company by itself in the near future. "The danger is that any movement in China is very easy to transfer into a kind of campaign by which you have to follow the same pattern. Now the new tendency is to be a joint venture with foreign company." Mr. Niu said.

6.4.4. The measurement and enforcement mechanism

*** the professional inspections and a grading system**

As mentioned before, in the history of the planned economy, a kind of management campaign played an important role to increase productivity and to improve quality. Under the CMRS, such campaigns are transferred into all sorts of professional inspections which are supposed to have two functions, as motivation and information channels. The inspections are divided by subjects such as finance, quality control, maintenance, safety

and so on. In each area, the government designs a grading system and the company is requested to achieve certain levels.

For BDSC, there were 14 inspections in 1990. Mrs.Zhang, the head of management department who is responsible for them, said, "The importance of these inspections is to offer opportunities to create a nice image of your company to your boss and public. And also it is an opportunity to push people to examine and improve their jobs. But to some extent, the information the bureaus got, is artificial or temporary, which cannot really reflect the daily work." To be cooperative and to work hard during such periods become part of BDSC's culture in order to have better records. Over the past 38 years, the company has got 40 national prizes on those campaigns and inspections. But Mr.Wu, the deputy director contests the principle of this approach, "The idea is deeply rooted in the planned system, and its function is diminishing and costly. Ultimately, the real evaluation of the company's performance is through market force by the customer choices rather than any administrative approaches."

*** Directors financial rewards and penalties**

The director's reward and penalty scheme has been changed three times during the three years contract period. In 1987 the director was allowed to get 2 times average salary as an annual bonus; in 1988 it was changed to 2.5 times but subject to 60% income tax; and in 1989 the bureau introduced a new scheme to compute the bonus by which the director would get 1350 Yuan (Table 6.22.), much less than before. Mr. Niu points out, "As a party member, I am not working for money. But if you want to introduce a system which is motivated and enforced by financial reward, it has to follow its own logic, otherwise

it makes both systems unable to work properly. Such a low bonus gives a wrong signal of the director's responsibilities."

Table 6.22.

The Bonus for the director in BDSC

	87	88	89	90
Bonus (y)	3486	2000	1350	

*** the financial residents**

BDSC has the financial residents check its performance on a daily basis, but both sides get along with each other very well. It seems too difficult to know whether the financial residents deal with this job impartially.

6.5. The Case of Beijing Leather Shoe Company (BLSC)

6.5.1. The enterprise autonomy in general

*** the customers and the suppliers**

As in the case of BDSC, enterprise autonomy differs between the domestic and international markets. For home markets, since 1980, the local bureau no longer plans for BLSC's production and nor is it responsible for its supply and sales. In other words, BLSC has had power to make its own decisions in these areas since the very beginning of the reform. The only control was that the government stipulates a floating price range, up to 10% and down to 20% for the normal products, and favourable prices up to 20% higher for high quality products.

To export goods, the company had to get orders from Beijing Light Industrial Exporting and Importing Company as it did before. BLSC had very little power to negotiate the export prices with that company, because BLSC was still under the quota system to earn hard currency. But the government had to provide proper raw materials for export products.

However the policy towards joint ventures with overseas company is more liberalized: the company is free to decide prices and free to export.

*** the investment decisions and financial constraints**

Although since 1984, the company has been free to borrow from banks for its investment and circulation fund, the procedure to get a loan and the determination of the interest rate substantially depends on the overall economic situation. During the Sixth Five-year plan,

the government encouraged the company to transfer new technology. Therefore many companies were found it easier to get low interest loans from the government. Since 1987 it has been increasingly difficult to get low interest loans.

For BLSC, a shoe-making assembly line from a British company was introduced in 1982 and 1983 when the government issued \$700,000 with a low interest rate to purchase 34 pieces of equipment, technology knowledge and management training. But eventually only half this investment was realized because the overheated economy resulted in a shortage of hard currency. During the contractual period, BLSC attempted to complete this project, but it is not easy to borrow money. Also the company's main policy has been changed from up-grading technology to setting up joint ventures. As a result, there have been very few small investment projects carried out, mainly on the infrastructure from 1987 to 1990.

*** the organizational decisions**

As a "higher collective" company, BLSC has rather extensive freedom to make its own organizational decisions such as changing its organizational structure, appointing senior managers and recruiting new employees, though it is not free to dismiss employees. Since 1988 when the director signed the contract, the number of departments has been reduced from 18 to 14, some young managers have been promoted, and 21 office staff have been sent back to production lines.

6.5.2. The fulfilment of the contract targets

*** the profit targets and related factors**

For BLSC, the total profit targets before income tax have been defined in the contracts.

It means the company has to pay 55% income tax out that amount of profits, and is allowed to keep the remaining profits. The targets are rather high, based on the previous performance. In the first three years contract period, the real profits before income tax are much lower than the targets (Table 6.23.). This is explained by the fact that the government has changed its tax structure so that the real indicator should be total amount of money paid to the government including all sorts of taxes and fees instead of only accounting for income tax (Table 6.23.). As a "higher collective" company, besides paying 55% income tax, it has to pay other 18 types of taxes, amounting to 67-68% of its total gross profits. Half the remaining profit should be used for business purpose and another half for the expenditure of the employees including bonus and welfare. In 1989, the local bureau agreed to reduce the profit target by 1 M Yuan, but it did not have a written document. In 1991 the government formulated a policy which aimed at regarding some failures of the contract targets as normal cases. BLSC is one of them.

Table 6.23.

The Structure of Profit, Tax and Fees in BLSC

	80	84	85	86	87	88	89	90
Targets						2.80	3.20	3.50
PBT*	5.15	2.85	4.15	3.70	2.40	1.45	96.8	1.91
Tax & Fee		3.19	4.38	5.86	2.63	2.38	3.42	3.61

* PBT: Profit before tax

Mr. Sun, the director of BLSC, who is strongly against the frequent changes in government policy, points out, " My job, to some extent, can be interpreted as to struggling with the government policy. If they (the government) increase sales tax and add other taxes in such an arbitrary way, we would try to reduce the gross profits before income tax as much as possible." Its staff disclosed that the real profit in 1990 was about 3 M Yuan instead of 1.91 M Yuan.

*** the wage bill control**

As a "large collective" company, BLSC's wage bill control is much less rigid than the others. But when you look at the average salary the company shows (Table 6.24.), it is lower than the other companies, but higher than the changes in productivity.

Table 6.24.

The Income and Productivity in BLSC				
	87	88	89	90
Total Employees	1508	1415	1299	
Average Salary (Y)	113	130	145	191
(%)	1	1.15	1.28	1.69
Productivity (%)	1	0.85	0.98	1.02

As some people point out, it is difficult to know exactly the salary of each individual, especially top managers, because there is a contracting system inside the company by

which each level has its own accounting system to distribute income without accountability.

Part of the company's policy is to attempt to reduce the total number of employees. The easiest way is not to replace employees as they retire, but still difficult to dismiss people.

*** the investment projects**

In comparison with previous investment, BLSC spent less money on investment projects during the contract periods in 1988 to 1990 (table 6.25.). There are three projects which have been carried out, boiler alterations, environmental protection, and an internal telephone network, but none of them deals with any major issue of company development.

Table 6.25.

The Investment Structure in 1983-1989 in BLSC

	83	84	85	86	87	88	89
TI* (M)	9.13	0.25	0.89	0.62	1.60	0.18	1.63
Financial Sources							
Grant(S)**	3.47						
Grant(L)***	0.27	0.07	0.01	0.23	0	0	0
Loan	2.85	0.18	0.52	0	1.19	0	1.36
Own fund	2.54	0	0.36	0.39	0.41	0.18	0.27

* TI: Total Investment,

** Grant(S): the state grant, *** Grant(L): the local grant.

6.5.3. The company's strategic decisions

*** the joint ventures**

In recent years, the strategic change in the company's structure has been to transfer BLSC into a mixture of joint ventures with a reduced size. The advantages of setting up joint ventures are:

- imported raw materials exempted from taxes,
- freedom to export,
- freedom to decide prices and to enjoy a higher reputation in the domestic markets,
- easy access for technology transfer,
- income tax exemption in three years time,
- higher income, up to 2 to 3 times, for employees,
- freedom to use its own funds,
- more stable policy towards joint venture,
- possible to reduce company's size.

After one year's negotiation, the first joint venture with a Taiwan business man was set up in 1989, with total assets of \$600,000 and a 15 year contract. In 1990 another two joint ventures were set up, one with a American company, and one with a Hong Kong business man, each with \$200,000 investment and a 10 year contract, the same arrangement as the former. As a result, the company is divided into four parts, three joint ventures and BLSC itself. The major contribution from the Chinese side is to provide space and employees, whereas equipment and design come from the other side. Mr. Sun, the director of BLSC is the board of directors of the three joint ventures.

The managers perceived this arrangement as a way of avoiding the disadvantages of the government control, but it also creates new constraints from the foreign partners, for example, the markets are totally controlled by them.

*** the sub-contractors**

Since 1972, BLSC started to have sub-contractors, because at that time the production quota was very high and the company was not allowed to recruit new employees, so that it started to make contracts with small firms in the People's Communes. In 1991 BLSC had 13 sub-contractors with 1500 employees in which produced two-thirds of the total production capacity for BLSC. Recently the labour force in the nearest suburbs of Beijing is getting expensive, and the sub-contractors have been moved to more remote areas, for instance, mountain areas of Beijing in order to reduce labour costs.

*** to streamlining the company's structure**

As mentioned before, the company has changed its structure from 18 departments to 14, and reduced the managers and office staff.

6.5.4. The measurement and enforcement mechanism

*** less attention to the measurements**

As a "higher collective" company, there is no financial resident to check its performance, and also less procedural control than the other companies.

*** Directors financial rewards and penalties**

As the company enjoys higher autonomy than others, the officially defined bonus of

several hundred yuan is not considered as an important reward. In fact the director is rewarded financially by different titles through the several joint ventures. Furthermore the director regards the success of the company is much more important than the reward from the government. He thought his career is in business world rather than in government hierarchy.

Concusion

The four case studies show that the implementation of the CMRS is a complicated story. On the one hand the variation of the government policy is mainly due to the consideration of industrial sectors and ownership status; on the other hand the company's response relates to all the constraints and opportunities the manager perceives, from the government policy, market structure, and employees' expectation etc. Even within three to five years time, many things were changing continusly. Such a dynamic picture provides material to study the process of instutional change. What kind of regularity can be drawn from it in the transition of the economic system?

Notes:

<1>. Since 1979, the price reform in theory is always at the centre of the macro economic reform, whereas in practice, the price relaxation has been continuing (Table 6.26.).

Table 6.26.

Change in the Scope of State Determined Prices

		State-determined Prices			
		1979	1984	1987	1988
<hr/>					
Prices for					
Agricultural products	%	92.6		35.0	25.0
Consumer products	%	83.0		33.0	30.0
Factor products	%	100		60	60
Product in kinds		256			17
Within Factor products					
State Determined Prices	%				17
Ceiling Price Control	%				40
Market Prices	%				40

* Source: Economic Management Publisher (1988)

PART III

Part III attempts to interpret the empirical findings from the case material described in Chapter 5 and 6, referring to the theoretical framework formulated in Chapter 3 and institutional perspective described in Chapter 2.

Drawn on the theoretical framework, the government and the state-owned enterprise are two basic units of analysis which formulate a kind of role and institutional relationships. As institutional arrangements, the CMRS and the Enterprise Law formulate a basic framework, determining the nature of these relationships, meanwhile they also provide opportunities for two parties to further exploit them. In order to understand the dynamic of two parties interaction, the property rights structure is used as a tool to analyze the regularity which has been evolved.

Accordingly, Part III is divided into four chapters: Chapter 7 is about the structural features of the CMRS, Chapter 8 about the interaction between the government and the enterprises under the CMRS, and Chapter 9 about mechanism of the CMRS, in terms of two basic functions, dynamic and control. Conclusion in chapter 10 is about theoretical and policy implications.

CHAPTER 7

THE STRUCTURAL FEATURES OF THE CMRS

This chapter focuses on the basic role relationship between the government and the state-owned enterprise; the structural feature of the provisions of the CMRS and the Enterprise Law in terms of property rights structure.

7.1. The Complicated Role Relationships between the Government and the State-owned Enterprise

As the basic units of analysis, this thesis first focuses on the role relationships between the government and the state-owned enterprise, and their changes during the economic reform, especially under the CMRS.

7.1.1. The dual roles of the government

Broadly speaking, under the central planned economy, the government played two roles, acting as an owner of vast state assets and an administrator of a country. As an owner, the government was responsible for directly managing state assets. As an administrator, the government was in charge of general administration, national defence, and public order; responsible for regulating the economy and making economic policies. In this system, the economic activities were highly centralized and functionalized, there was no need to distinguish between the role of owner and of administrator.

Under the CMRS, the government still attempts to play both roles, that of owner and

administrator, but delegates managerial jobs to the managers. As the owner, the government attempts to set up a kind of contractual relationship with the managers instead of direct control; as the regulator, it is supposed to influence the enterprise indirectly through macro economic instruments. The two roles should function separately. But this leads to two questions: how is it actually functioning at each level and how could it be coordinated between two levels? The first question concerns a contractual relationship between the principle and the agent. The second question is about coordination mechanism which is a more fundamental issue of the economic reform. The analysis starts with the first question and deals with the second one in Chapter 9. On the company side, the change of the role of the manager is given in Chapter 8.

7.1.2. The contractual relation between the principal and agent

In terms of delegating managerial tasks to the manager, the CMRS has to build up a kind of principal and agent relation between the government and the manager, based on contracts, in which contractors are in equal positions to negotiate a contract (Jensen and Meckling, 1976). It implies the change in the relationships between the government and the enterprise from administrative coercion which was dominant in the previous hierarchical system to equal partnership (in a broad sense) subject to contracts.

In the course of economic reform, however, such contractual rights are not automatically exerted, even if it is officially put on documents. Several questions arise from the empirical study during the period of formulating a contract:

- Who should be the contractor on the enterprise side, especially related to the role of the director and of the party secretary;

- Whether the government should offer opportunities to the public for applying for the position of the director;
- Whether both sides have equal power to negotiate a contract;
- Who should be contractors on the government side, in terms of the role of owner.

*** the role of the director and the role of the party secretary**

"One centre and one core" was an expression which occurred when the debate on the role of the director and of the party secretary was intensified in 1989 (See Chapter 5.3.1). On the surface it is the issue of who should be the most authorized person in companies; under the surface, it deals with the different approaches of economic development (See Chapter 4.2). The role of the party secretary represents a leading issue of politics and ideology over economic development, while the role of the director represents economic rationality the first priority being given to social and economic development. This debate can be traced back to the beginning of adopting the Soviet-type of economy to China (Child and Xu, 1989). However, in the pre-reform period up to 1984, the party secretary system, to a large extent, had been institutionalized. It means that to subordinate economic criteria to political and ideology principles was a basic rule for administration and management which impacted on every functional area. For example, under the leadership of the party secretary, the motivation was mainly derived from ideology rather than material incentive. The leadership structure in the company is a high order of institutional arrangement which plays a decisive function.

The economic reform aims at giving economic development the first priority. The debate on these two roles reflects such a change and the resistance. It is the first time that the

leading role of the party secretary has been significantly challenged since the CMRS was introduced. This event should be conceived as an important signal for a radical change. It would not be surprising, therefore, to see the debate started again after the Tian An Men event occurred when the political conflicts intensified.

Furthermore, the more important point is how to solve this problem and in which way the transition moves, either going forward to a market economy or back to the previous system. The empirical study shows that the problem was solved in a rather efficient way. First, at macro level, the leaders were determined to stop the debate by using their political and administrative power. Second, at micro level, the party secretary as an individual was transferred other positions in which he still shares a kind of managerial responsibility and power, "their absorption into the functional ambit of management" (Child, and Xu, 1989). These highlight two features of institutional change related to Chinese culture: political, ideological and administrative power as tools are very often used jointly, which might be much less differentiated in China than in other cultures. Second, to reduce the resistance of change, the role of a position is differentiated from the individual himself, especially if job design is less specialized which make changing easier. It can be conceived as a way to seek harmony, influenced by the traditional Chinese culture.

In short, this debate shows that the institutional change is a complicated process which is not only the change of regulation, but sometimes the political or ideological issues as well. Moreover the searching for resolutions of conflicts is often influenced by cultural factors. Finally at this stage, no formal enforcement mechanism, such as a legal system to protect

the change is another feature of reform process. This issue will be further illustrated later on.

*** the selection of the director**

Who has the right to become the director and how to choose the director are not clearly defined in the provision of the CMRS (See Appendix 1). The further delineation of the rights is left to the process of implementation. The case studies and the documentary survey show that the director, to a large extent, are chosen by the government, and individuals have no absolute legitimated rights to become the candidates of the director, but a kind of participation has started (See Chapter 5.3.1.). The constraints on that are very much related to the technology the company employs and the ownership status the company possesses. The more advanced technology the company uses, the more constraints there are for the individual to enter the selection process. And the lower degree of public ownership, the more freedom the individual enjoys in the selection process. For example, the so called "bidding system" is only practised on a very limited scale, mainly in the "higher collective" companies because of its lower degree of public ownership. It implies that if property is owned by "whole people", individuals have less rights to participate, while the government has more power to be representative by directly controlling the assets. It further implies that the higher the degree of public ownership, there is the more difficult, is it to adopt the democratic procedure. By and large, this area is very sensitive to the interests of the government which can be protected by administrative and political forces. It raises the question of how to realize these rights, either by legal systems or by a long period of institutionalization. It relates to the theoretical issue of how to establish rational myths (Meyer and Rowan, 1977). In this sense, the duration of the reform is still

too short to reach a solution.

During the selection process, the case studies show that to some extent the personality of the director has been taken into account with respect to the market structure the company encounters, but also affected by the company's history. The stronger the market competition, the less bureaucratic the director, as shown in the case of BEGPC, BDSC and BLSC (See Chapter 5.3.1). Meanwhile, the historical factors also have an impact on the selection process as shown in the case of BTC, in which the engineering oriented managers are dominated. This can be conceived as a kind of adaptive process to balance between future needs and historical influence of path dependence. Since such limited cases show the complexity of the selective process, any simple generalization is dangerous.

*** the contractor on the government side**

The contractor on the government side is very vaguely specified in the provision of the CMRS (See Appendix 1). It implies that the government has absolute power to decide who should be contractors and no need to disclose information to the public. In practice, shown by the case studies, the local industrial bureau usually acts as the owner to sign a contract with the enterprise and also to look after the enterprise in dealing with other bureaus (See Chapter 5.3.1). This arrangement can be traced back to the previous planning period when the industrial bureau was a general bureau coordinating with other functional bureaus (See Chapter 4.1). But in some cases other regulatory and functional bureaus, for example, tax bureau, labour bureau, financial bureau and even banks, are also involved. The degree of their participation depends on sector, size and the degree of ownership. The more advanced technology the company employs (or the more inclined it is to the heavy industrial sector),

the larger the size of the company, and the higher the degree of the ownership, the more bureaus are involved. It implies that the government's two roles, as owner and administrator, in these sectors are less separate and thus it is more difficult to depart from the previous system.

Here it is worthwhile mentioning the state-assets administrative bureau which is a newly established bureau (See Chapter 5.3 1). It aims at being responsible for state-owned assets responding to the change of separation of management from ownership. But it is very difficult to define its role from the existing bureaus. Up to now, it has played a minor role, because of its overlapped functions and the power struggling with other bureaus, for example with the financial bureau and the industrial bureau. Its future faces enormous uncertainty. It shows that the creation of a new organization not only depends on the needs, but the historical path as well (North, 1989). In this case, it has to find a compromise solution in order not to change the existing structure too much, but enough to cope with the new situation.

*** the rights to negotiate contracts**

As shown in the provision of the CMRS, three contract terms are listed without detailed instruction (See Appendix 1). In the case studies, the structure and content of contracts are further clarified by the government which are varied from sector to sector; the company has no right to bargain on it. In this aspect, the administrative coercive power is still dominated. Besides that, the company has the right to negotiate most of the targets which becomes a dynamic interaction process. More discussion is given in Chapter 8.

7.1.3. Agency problem

According to the agency theory, the agency problem is at the centre of principal and agent relation, due to the fact that the principal and agent have different goals and interests. Thus the agent does not always behave according to the principle's needs which causes the problem of measurement and enforcement. However, the agency problem theoretically is not recognized in Marxism socialist doctrine. It believes that the agency problem would be erased in that system, because the social ownership of the means of production is able to overcome alienation of individuals from the society. People are the owner of the society which would keep them in a perfect working attitude (Brus and Laski, 1989). In the real socialism or a command economy, the agency problem happened, but due to the different reasons. In the hierarchical relationship, individuals played a passive role and had very limited freedom to make their own choice. They behaved as an agent rather than an owner, and it was attempted to solve the problem by political and ideological enforcement.

The agency problem should be applicable to the CMRS, because the managerial tasks, to some extent, are delegated to the managers, and the two parties are unlikely to have exactly the same goals and interests. In this sense, the agency problem would be the main consideration of the CMRS. However, two things derived from this institutional arrangement make agency problem lose its original meaning. First, the CMRS is based on the idea of a contracting system which is different from the classical concept of contract (See Chapter 4.3). For the contracting system, the emphasis is only on the outcome of performance, rather than both on outcome and process. In other words, to some extent it deliberately ignores the issue of monitoring and policing the way the agent behaves. In this

sense, it appears to permit the agent autonomy to perform as he prefers, providing a guarantee of outcome to the principal. It results in a less codified and differentiated institutional arrangement. As Boisot and Child argue that the transaction is at a lower level of codification (Boisot and Child, 1988). Therefore the classical way of analysing the agent problem is not suitable for the CMRS.

Second, the design of the CMRS does not only follow the principle of delegation, but of ownership sharing as well. Under the CMRS, the enterprise is entitled to claim certain profits after the government's first claim of a fixed amount of profits. The enterprise, therefore, enjoys part of ownership rights. To blend two principles together, delegation and ownership sharing, would induce a complicated behavioural pattern. A theoretical analysis focusing on one aspect, either on the agency problem or profit sharing is not sufficient for this system. The CMRS needs to be examined under a more broad framework. The analysis of property rights structure is assumed a necessary step for further study.

7.2. The Property Rights Structure of the CMRS

Property rights structure is the basic structure of an economic system, which is composed of three elements: the right to use asset, the right to appropriate returns from asset, and the right to change asset's form and/or substance (Furubotn and Pejovich, 1974). As Alchian (1965) and Barzel (1989) argue, ownership of commodities and of organizations may be divided. Two or more individuals may own distinct attributes of the same commodity. Incomplete separation makes attributes common property, relinquishing them to the public domain (Barzel 1989).

In a command economy, the property rights structure is highly unified. "The state administration managed the use of enterprises' assets by prescribing all elements of their activity; the state budget appropriated the residual returns; no part of enterprises' assets could be sold or passed over to any other entity without the explicit instruction of the state administration; and destruction of such assets was controlled most meticulously when it was authorized, and was obviously regarded as a severe crime when it was not. It goes without saying that all these rights fully covered entry and exit, that is, the establishment and closing down of enterprises (Brus and Laska, 1989). All these statements are applicable to the Chinese economy in the pre-reform period.

During the economic reform, the property rights structure has been changed, based on the principle of separation of management from ownership. The Enterprise Law for the State-owned Industrial Enterprises (the Enterprise Law for short) and the CMRS are two basic institutional arrangements leading to the changes. The Enterprise Law provides a general framework defining the position of the state-owned enterprise, while the CMRS focuses on certain aspects of property rights subject to specific cases.

*** the Enterprise Law**

According to the Enterprise Law, the state-owned enterprise has the following rights:

- Under the government guidance plans(1), the enterprise has the right to decide which products and services it would like to produce or to provide according to social needs;
- The enterprise has the right to demand a readjustment of the mandatory plans if supply for necessary raw materials and distribution for final products are not arranged; and the enterprise has the right to reject any production assignment from other organizations

beyond the mandatory plans;

- The enterprise has the right to sell

its own products, except those for the government has special arrangements;

- The enterprise has the right to choose suppliers to purchase raw materials and other goods it needs;

- The enterprise has the right to decide the prices of its products, except those for which are controlled by the authority;

- The enterprise has the right to negotiate the business with foreign companies and to sign contracts, and it has the right to draw and to use the proportional foreign exchange earnings, in accordance with the State Council's regulations;

- The enterprise has the right to lease or to transfer the fixed assets in accordance with the State Council's regulations, but the earnings from these must be used for technology improvement;

- The enterprise has the right to decide its own payment scheme for salary and bonus in accordance with its situation;

- The enterprise has the right to employ and to dismiss employees in accordance with the State Council's regulation;

- The enterprise has the right to decide its own organizational structure;

- The enterprise has the right to run its business jointly with other enterprises, and to invest in other enterprise or to hold their shares as well, in accordance with the law and the State Council's regulation; in addition, the enterprise has the right to issue bonds and shares in accordance with the State Council's regulation.

According to this law, the managers have, in principle, the right to use the assets which

are delegated by the government, but subject to regulations; and have limited rights to dispose assets by leasing or transferring. However, the Enterprise Law does not mention who has the right to obtain returns and the rights to establish and to bankrupt a company. In other words, the right to gain and the right to entry and exit into business are assumed not to be the rights of the manager, but of the owner.

The most peculiar feature of this law is that the legal provisions are expressed in a positive way rather than a negative way. This distinction can be traced back to Spencer's idea of militant society versus industrial society (Spencer, 1897). It permits what kinds of things the enterprise can do rather than what kinds of things are forbidden. To take into account all the constraints articulated in the Law, what can be offered in the law is basic principles rather than well defined rules. As a consequence, on the one hand, it might give tremendous explanatory power to the authorities for further specification when the Enterprise Law is executed; on the other hand it might never be specific enough to regulate and handle the situation. Eventually, the actual achievement of the Law is to strengthen the basic principle of the enterprise rights over time, rather than specific rules in practice. In other words, once these rights are confirmed in a law, they would not be readily altered as a set of abstract principles, although it might take time to implement. To a large extent, this is the way of understanding of the meaning of law in China, which would largely reduce the enforcement power of law in each case.

*** the CMRS**

To complement the Enterprise Law, the CMRS is designed as a rather specific rule, enabling it to tackle each specific case. Under the CMRS, part of the property rights are

delineated by contractual terms which includes three main provisions (See Chapter 4.3. and Chapter 5). Among them, the profit sharing scheme is about the right to appropriate returns from the assets, the wage bill control is about the right to use the assets, and the technology investment projects are about the right to change the asset's substance. The relationship between the government and the state-owned enterprise is conceived so that both the government and the enterprise have the right to claim residual: the government's first claim is fixed and guaranteed, whereas the enterprise has the right to share the remaining of profits. The CMRS has some similarities with a fixed rent contract (tenant contract) to ensure the government revenue in a fixed term and to motivate the manager and the employees to share the profits. The original idea of the scheme was to link the managers' and the employees' interests with the government by a profit sharing scheme, especially drawn on the experience of the household responsibility contractual system of farmland (See Chapter 4.3).

This arrangement shows how the government conceives of the attributes of the industrial assets. The first consideration is about the distribution of the profits. The government wants to ensure a certain amount of revenue as a fixed target in spite of any uncertainty which might occur in the process. Meanwhile the enterprise is encouraged to share the profits from the amount exceeding the targets. The second is about the right to use the assets in terms of two attributes, one dealing with the incomes of employees and one concerning the potential of the assets. It aims at controlling the managers' behaviour for using assets properly.

For such a property rights structure, there are several consequences. First, who is the owner

of the assets becomes ambiguous, because both parties have rights to appropriate the return of assets. Under the state ownership, assets are supposed to be owned by the whole people which means income distribution has to be decided at national level rather than at enterprise level, otherwise there would be no difference between collectively owned and state owned. Second, other attributes of the assets are not delineated, but assumed to be delegated to the managers. In practice, the implementation of the scheme becomes a process of further delineating the property rights. In other words, it creates opportunities for managers to further explore the assets they are entitled to manage.

Third, the question arises of how to measure and enforce the contract. The structure of the property rights determines the nature of measurement and enforcement instruments, because the design of these instruments depends on what kinds of property rights the managers have and what the government possesses. For the principal and agent relation, the director's financial reward and penalty scheme are supposed to be major enforcement instruments. But under the CMRS, it makes little sense. As mentioned before, measurement and enforcement is not the major point in the contracting system (See Chapter 4.3). Under the CMRS, with a profit sharing scheme, it becomes even more restricted. Drawn on the empirical study, on the one hand, it is difficult to design a rational scheme to reward and penalize the director financially, especially under the debate of how to trade off job responsibility and moral duty (See Chapter 5.3.1); on the other hand, the managers have the rights to reward themselves through a profit sharing scheme which is beyond government control. Moreover, if there is a failure of contract targets, the managers' personal property is incompatible for any meaningful sanction, and even the contract risk fund which occurs in the second period of the contracts, accounting for 2% of remitted

profit and its function is doubtful(See Chapter 5.3.3). Other instruments for monitoring and policing the company performance, such as accounting and reporting schemes are more or less the same as those used in the previous system. They have not been improved for the new system. Among them, the financial resident system, originated in the 1950s, is a kind of direct accounting control system which is widely adopted and performed effectively in some cases, but is criticized by personal influence (See Chapter 6. "the measurement and enforcement" in each case). The socialist emulation campaign is also given great attention and designed even further in each managerial area as shown in the case studies (Ibid.). All in all, these instruments are based on the idea of using either administrative force or relying on ideology. Many of the instruments are impossible to realize rationalization and depersonalization which are assumed to be the basic characteristics of efficient bureaucracy (Weber, 1922), while the market mechanism has not yet attracted enough attention. As a consequence, once the company does not fulfil the contracts, the government would have no instrument for sanction. Instead, the government even has to make a compromise to legitimise the results, as shown in the case studies, especially for a company with more government intervention (See Chapter 6.3.2).

Generally speaking, the CMRS plays two roles, one as an economic rule which defines property rights, concerning a bundle of rights over the use and distribution of assets, and one as a contract which contains specific contractual terms for a particular agreement. In principle they are different rules in an economic system. As North points out, there are three formal rules in the modern society: political (and judicial) rules, economic rules, and contracts (North 1989). Political and economic rules are the rules functioning at macro level, while contracts deal with the micro situations. In contrast, the CMRS becomes a

kind of institutional arrangement to deal with macro and micro rules simultaneously. It can be argued whether it is a temporary solution in the course of institutional change or whether it will be institutionalized as a long term arrangement in a specific economic and cultural environment. It is necessary to study what happens under the system before answering this question. A further discussion is given in Chapter 8 and 9.

*** the development of the Enterprise Law and the CMRS**

In terms of stipulating these two documents, the decision-making can be characterized as a process of trial and error which is a typical policy-making approach in China (Stark and Nee, 1989). As the case studies show that the CMRS started between 1986 and 1988, the provisional regulation of the CMRS was made in February of 1988, and the Enterprise Law was issued in April of 1988 (See Chapter 4 and 5). It first started as a kind of experiment in some enterprises, and then spread to all the state-owned enterprises as a special institutional arrangement, finally the Enterprise Law was made to generalize the overall situation as a rule to ensure the continuation. In addition, nearly all the documents are marked as a draft in order to be able to be further revised. This process is a kind of inductive approach from specific cases to the general situation, and also can be conceived as a kind of adaptive process to learn from the experimental process. Therefore, to establish a new institutional arrangement becomes a process itself which remains flexible to be adaptive in the course of the implementation.

As Barzel argues, "The rights people have over assets (including themselves and other people) are not constant; they are a function of their own direct efforts at protection, of other people's capture attempts, and of government protection. The last condition is

effected primarily through the police and the courts" (Barzel, 1989). In practice, the implementation of the CMRS becomes a very complicated story by the interaction among the actors. The process presents the efforts in further defining and exploring the property rights from both sides which is the topic for the next chapter.

To sum up, the role relationship between the government and the enterprise has been changing under the CMRS. It is inclined to be a kind of contractual relationship in an equal position instead of the previous coercive hierarchical relationship. However, the realization of the contractual rights is a process which is affected by institutional arrangements and other factors, such as ownership status, technology, as well as political and ideological elements. It needs to be further illustrated by the property rights structure. The Enterprise Law and the provision of the CMRS are the formal statements to delineate the property rights structure between the government and the enterprise. The distinct features of these two institutional arrangement are ambiguous and selective in terms of delineating the property rights. They leaves unspecified attributes in the public domain which create opportunities for further interaction in the negotiation and the implementation of the contracts.

Note:

(1). Under the current economic system, the government makes two types of plans, one called the mandatory plan which is a kind of compulsory plan to be fulfilled coercively by the company, and the other called the guidance plan which is to guide the company's business decisions in certain areas.

CHAPTER 8

THE MEANINGFUL INTERACTION PROCESS

The implementation of the CMRS is a dynamic process, with actions taken by the government and the enterprise. Both parties exert their power through administrative or political or economic strength to influence the process. Correspondingly their actions follow different rationales by bureaucratic or political rules or by economic rationality. Such interactions constitute a way of institutionalization. This chapter aims at analysing this process in terms of the following aspects:

- the government exerts its administrative and political power to the process;
- the enterprise demonstrates its managerial strength and entrepreneurship;
- the interaction patterns affected by technology and ownership, and constrained by market structure and ideology;
- the property rights structure further delineated by the interaction

In these aspects, the theoretical issues can be drawn from different rationales of the action and an adaptive process with learning and creativity.

8.1. The Government Actions with its Administrative and

Political Strength

As shown before, the contract terms in the provision of the CMRS are not clarified in enough detail. During the formation of each contracts, the central and local governments

used their administrative power to further define the three main contract terms and left little room for negotiation. In other words, the contract terms are not freely decided by two parties' negotiation.

Moreover, the rights over assets are further delineated in the decisions related to the process of transforming inputs to outputs. The government intervention on the managerial autonomy can be conceived as such efforts to exploit the rights.

*** the determination of contract structure**

The case material shows that technology employed by the enterprise, and the degree of public ownership are the main considerations from the government side to further clarify the structure of contracts, that is to say, the three main contract terms are further specified during the formation of contracts.

In terms of the right to share profits from the assets, three different tax and profit schemes can be identified. The higher the technology the company employs and the higher degree of public ownership the company, the higher proportion of profits the company shares with the government. For example, BEPGC is a key heavy industrial company, using rather sophisticated technology with an oligopoly position in the market. It benefits more from the profit sharing scheme through tax reduction than others (See Chapter 5.3.2). In contrast, BLSC is a consumer product producer using rather lower-level technology and has a lower degree of public ownership, the so-called higher collective company, it is imposed on a clearly defined tax duty and has no profit sharing with the government (Ibid.). BTC's case is, in between that is to separate sales tax from income tax and

remitted profits with profit sharing with the government. In this aspect, the profit sharing scheme can be classified as three types:

- mixture of sales tax, income tax and remitted profits;
- separation of sales tax from income tax and remitted profits;
- separation of sales tax from income tax, with no remitted profits.

It is clearly shown that financial interests between the government and the enterprise is distinguished by the degree of public ownership and of high technology. The larger the company, the higher technology the company employs, and the higher degree of public ownership the company has, the less clearly cut is the boundary between the government and the enterprise. This phenomenon can be explained by the previous dominated development policy, that is "to develop state-owned heavy industry first" (See Chapter 4).

In terms of the right to use assets for labour costs, the higher the degree of the public ownership the company has, and the higher the amount of technology the company employs, the more clearly defined and unified is the income distribution policy the government proposes and there is less scope for negotiation. The empirical study shows that the total wage bill control scheme for the state-owned heavy industrial companies is nearly all the same with a unified rate, designed by the central government. BEPGC and BTC are two examples (See Chapter 5.3.1. *the determination of the wage bill control scheme). For the companies in light industry, the scheme is more flexible, reflected in the specificity of technology the company employees, for example a piece work wage scheme adopted in BDSC (Ibid.). The income distribution decision could be entirely relying on the company itself for the lower degree of public ownership as shown in the case of BLSC

(Ibid.). In fact, this aspect is closely linked to the profit sharing scheme: more profit sharing, more income control. Here the degree of public ownership is conceived as a very important factor. The higher the degree of public ownership the company has, the more control the government imposes. It can be explained by the principle that a higher degree of public ownership implies a larger scope of people sharing ownership which requires more centralized income distributional power.

In terms of the right to change the asset's form and /or substance, the CMRS only provides one way of changing that is to invest continuously in order to increase the value of the assets. During the contract formation, this decision is more decentralized and affected by many factors. The empirical study shows that existing technology is an important factor, but market environment, supply and demand situation is also taken into account by the government. When a company has more advanced technology and a high demand, the government would like to emphasize a clearly defined contract term on its investment projects and to provide easier access to capital as shown in the case of BEPGC. If the company is in a lower demand, even with higher technology, the government would be reluctant to invest as in the case of BTC. For the company with low technology, the investment decision almost entirely relies on the company itself (See Chapter 5.3.2. * the technology up-grading projects). In short, the government's interests in the assets' future value is also subject to technology and ownership pattern, but adapts to the macro economic situation as well. The government's decisions on these three contractual terms can be summarized in Table 8.1.

Table 8.1.

**Comparisons of Technology and the Degree of Public
Ownership in the Government Influence on the Contract Terms**

Contract Terms	* HT&HPO	LT&LPO
Profit sharing	** +	-
Income control	+	-
Investment control	o	-

* HT: higher technology, LT: lower technology,

HPO: higher degree of public ownership,

LPO: lower degree of public ownership,

** + = strong, - = weak, o = dependent.

*** the control on the enterprise autonomy**

During the implementation of the CMRS, the rights to use assets on the government side is further delineated in the control of inputs and outputs, as well as in the control of the process in transferring inputs to outputs. To a larger extent, the government has the power to influence input and output decisions, but to a less extent, to influence the transformation from inputs to outputs. Input control mainly concerns raw material, personnel and monetary supply, and output control concerns price and distribution channels, which can be illustrated in terms of key managerial decisions affected by the government interventions.

The constraints imposed by the government on the key management decisions vary from sector to sector. The higher the technology the company employed, and the higher the demand of the products, the more control the government imposes (See Chapter 6). For example, the degree of liberalizing price control over raw material and final products is increased from heavy industry to light industry and from key capital products to other products. Meanwhile the government's monetary support for the circulation fund and investment is being reducing from heavy industry to light industry and from key companies to other companies. The managerial autonomy in organizational decisions is mainly associated to the degree of public ownership. The lower the degree of public ownership, the more autonomy the company has to change its organizational structure and its personnel decisions. These relations can be summarized in Table 8.2.

Generally speaking, all the major structural aspects, including contractual arrangements and managerial decisions are further differentiated by the technology and ownership pattern, which become two key variables to impact on the relationship between the government and the state-owned enterprises. It can be explained by the fact that the development strategy in the command economy was to give heavy industry a first priority, considered as the base for industrialization and modernization (Brus and Laska, 1989). It needs to be directly controlled by the government, partly because of its strategic position and partly because the value of the assets in terms of investment is usually higher than that in light industry. This strategy also indicates that profitability was not the major concern, because the economy was measured by the growth rate at macro level, not economic efficiency at micro level. During the economic reform, these issues are still taken for granted and work as the basic logic for the policy makers. It shows a kind of path dependence (North, 1991)

which means that the changes of institutional arrangements might coexist with unchanged assumptions.

Table 8.2.

**Comparisons of Technology and the Degree of Public Ownership
on the Government Control of Enterprise Autonomy**

Attributes	*	HT & HPO	LT & LPO
Access to capital	**	-	+
Access to raw material		+	-
Access to labour		+	-
Access to product markets		+	-

* HT: higher technology, LT: lower technology,

HPO: higher degree of public ownership,

LPO: lower degree of public ownership,

** + = strong, - = weak.

*** the change of tax structure**

During the implementation of the CMRS, the change of the tax structure is more proof of how the government exerts its administrative power (See Chapter 6.1). The government increased the weight of sales tax substantially from 1984 to 1990 which means that the importance of the profit remitting and sharing decided by the CMRS is reduced. In other

words, the government uses its administrative power to change the rule of the game, while the enterprise could not do anything about it, because the government still plays two roles simultaneously both as owner and regulator.

*** the government's political power in the negotiation process**

Under the CMRS, the government also exerts its political superiority over the companies, if necessary. The empirical study shows that when the negotiation for the second period of the contract was in a deadlock, the government used its political strength to break it down in order to make things move on. At that time, when most of the companies refused to sign contracts, the government called for abiding by the government policy and following the discipline as the party members. This is a strong enforcement which would involve too much risk for the managers to reject. However, it also means that if the CMRS turns to rest on political enforcement, the responsibility of the managers would be reduced which is against the purpose of the CMRS.

Nevertheless, it shows that the government can use multiple instruments based on its administrative and political power to enforce a new institutional arrangement. To some extent it indicates a characteristic of the economic reform at this stage which is an up-down approach still depending on strong leadership, ideology and politics to implement the reform policy. All in all, in course of the economic reform, the government has taken the strength of a less differentiated system in terms of politics, ideology and economics.

As a consequence, the boundaries between the government and the state-owned enterprise are varied with respect to technology and ownership. The higher the technology and the

degree of public ownership the company has, the less clearly defined are boundaries between them. The empirical study shows that psychologically, the managers in light industry, especially in a smaller company feel more distant to the government than managers in the large sized heavy industry (See Chapter 6, the case of BEPGC and BLSC).

8.2. The Managers' Response to Constraints and Opportunities

During the implementation of the CMRS, on the one hand, managers are restricted by the contract terms and economic structure, on the other hand, they also face opportunities of being able to further exploit their rights. The case studies show that all the companies make their own choices for their own sakes. Their actions can be characterized as short term or long term behaviour, and as activities taken within the CMRS's boundary, or moving away from it. All these involve the further delineation of property rights. By considering the countless decisions taken by the company, the following shows the areas which clearly present some regularities in the case studies.

8.2.1. The short term behaviour versus the long term behaviour

Whether the managers behave in a short term view, for instance, higher labour cost, poor maintenance and lower investment, is always at the centre of the debate on the evaluation of the CMRS. It becomes a major argument for people not to support the CMRS, while most managers deny such criticism. This research aims not at providing an answer to it, but attempts to show some facts which have been recognized by the managers themselves, and with their interpretations.

In this aspect, income distribution is an important issue. The managers have to pay a great deal of attention to it, because the employees' income is so essential to the people's expectation on the new system and on the managers decisions as well. In spite of the constraints imposed by the government, there are always public domains for further delineating the right to use assets. All the case studies show that on the one hand the managers attempt to link employees' incomes to their performance in one way or another, but on the other hand the average income has to reach certain levels in order to match social norms, no matter what performance the company achieves (See Chapter 6). This can be explained by a dilemma of economic rule and social convention. As a rule of the CMRS, that the employees' income should be associated to their performance is widely accepted. It is also in line with the socialist distribution principle: distribution according to work. However the notion of equalitarian is so deeply rooted in the reality that the manager has to make adjustment in order to match it. It can be conceived as a way of making compromise in order to cope with this complexity. Many managers believe that the new rule is right, but it takes time to be implemented. The best way of achieving it is to make a temporary compromise to reduce conflicts, providing the whole system is still moving in a new direction. In this aspect, the government shows a realistic attitude to leave the decision power to the managers and to accept the manager's solutions. It is a way of reducing risk and keeping flexibility by decentralizing decision power to individuals. It opens possibilities for further modification. It can be conceived as an adaptive process to meet future needs and to reduce resistance.

Another short term behaviour shown in the case studies is that the workers have a tendency to leave production lines for clerical jobs which has a short term effect on the

company's performance (See Chapter 6.2.2). The action is mainly driven by the less efficient measurement instruments in clerical jobs than in production lines which create conflicts between the managers and workers. The workers' action is a reaction to a kind of free rider problem (Clarke and McGuinness, 1987). In contrast, challenged by workers' efforts, there is not much action taken by the managers. This is because under the CMRS the government no longer imposes personnel control at micro level, but the managers have no power to control it seriously, either through management or ideology, especially when they have no authority to dismiss employees as an enforcement mechanism. Moreover, the disparity in monitoring and measuring jobs is widely accepted which gives rationality to workers' behaviour. As a consequence, the workers have more mobility inside the company to seek an easier job. It shows that delineating property rights is a complicated process: the institutional change often provides opportunities for more parties to join the process in delineating property rights, especially when original structure and mechanism no longer functioning. Correspondingly, it needs new measurement and control mechanisms for a new property rights structure.

The third possibility to pursue the short term behaviour is on investment decisions which has been discussed before. In this area, it is rather difficult to identify whether the managers' interests are short term or long term, because the managers' perceptions vary so much, attributable to many factors. It is mainly dependent on the manager's views of the company's further development. Three types of managers can be specified as:

- Traditional bureaucratic managers who know the bureaucratic machine well and are used to exploiting opportunities provided by the government policy as shown in the case of the director of BEPGC (See Chapter 6.2.).

- Technical oriented managers who have a strong belief in the strength of higher technology as shown in the case of the director of BTC (See Chapter 6.3.).

- Market oriented manager who has a good sense of market demand and would like to formulate his own strategy as shown in the case of the directors of BDSC and BLSC (See Chapter 6.4. and 6.5.).

The limited empirical study has shown the diversified styles of the managers which highlight the complexity of the economic system. Even in the same ownership sector, people could have rather different perceptions and behaviours. It is, therefore, dangerous to stereotype the managers simply according to one or two criteria which is very easy from an outsider's view (Nee, 1992). Furthermore this issue should also be conceived as a learning process which is associated with time effects. To a large extent, the change of the managers' attitude and behaviour depends on their capacity of learning.

In addition, market demand has been taken into account, no matter what request comes from the CMRS. When demand for its products is low and its future development faces a lot of uncertainty, both the government and the company are hesitant to put new investment as in the case of BTC. It shows both sides are not following the bureaucratic rules, but economic rationality as well, which can be interpreted as the behaviour of decoupling (Meyer and Rowan, 1977). For the companies like BDSC and BLSC, the investment decisions are even inclined to the company's individual choices, depending on their long term strategy referring to the market competition.

Broadly speaking, many decisions which the managers made are difficult to be classified

as either long term or short term behaviour, because in some cases the long term interests do not conflict with the short term interests, for example, the horizontal connection with other types of companies which has both short term and long term advantages. Furthermore even a kind of short term behaviour is affected by many factors and it is possible to interpret in different ways, for example, a higher income policy can be argued as a tool to keep higher moral in a difficult situation (See Chapter 5.3.3.). Therefore other ways are necessary to classify management decisions in order to describe the interaction process.

8.2.2. The decisions in boundary dynamics

The CMRS aims at defining property rights and responsibilities between the government and the state-owned enterprise. It implies two types of boundaries: between the government and the state-owned company as well as between the state-owned enterprise and non-state-owned enterprise. Meanwhile the company is also facing bureaucratic control and certain market freedom which creates different boundaries. The actions taken by the managers can be illustrated according to these boundaries.

*** the attitude towards the boundary between the government and the state-owned enterprise**

The notion of a boundary between the government and the state-owned enterprise can be defined by the property rights structure and the obligations between these two. Under the CMRS, the three contract terms are designed as the major obligations. The remitted profit is a key element of defining the property rights boundary between the government and the enterprise. In principle, the company is obliged to fulfil the targets, but in practice, the

managers' attitudes towards them are divergent. With a lower degree of public ownership, the company respects profit targets less. Some companies, like BLSC (See Chapter 6.5.2.) even attempted to hide its real profit figures, which demonstrates a kind of moral hazard (Strong and Waterson, 1987). The companies perceive more divergent interests with the government. The boundary between them is so clear that it needs strong enforcement for implementing contracts. For other state-owned companies, the obligation to fulfil the profit targets are taken more seriously concerned, unless the targets are far beyond rational (See chapter 6.2, 6.3, and 6.4.). There are less conflicting views on the interests between the government and the enterprise. The limited empirical study shows that how to perceive the tax duty is a key question of how to deal with the boundary of property rights between the government and the enterprise. A more clear defined boundary might mean the need for more efficient measurement and enforcement.

*** the efforts within bureaucratic control and seeking market freedom**

Many companies in heavy industry attempt to exploit the opportunities provided both by inside the bureaucratic system and by the limited markets. For example, a company with more advanced technology and a higher degree of public ownership, would continue its bargaining and lobbying efforts (Walder, 1991, and Nee 1992) to negotiate with the government in order to get better prices for its products and more financial support for investment and other funds as shown in the case of BEPGC (See chapter 6.2). Meanwhile, companies also attempt to seek other market opportunities, for example, to diversify its product mix and to set up joint ventures with foreign companies (See Chapter 6.2.). Broadly speaking, all the companies show a kind of blending of tendencies in boundary dynamics between the government and market controls (Hannan and Freeman, 1989). But

the companies' initiatives in heavy industry are largely restricted by government control and by the difficulty in spreading higher technology to other types of companies than those in light industry.

The companies in light industry demonstrate their high initiatives to exploit market opportunities. Some companies, as in the case of BDSC, started to adopt a long term strategy in order to achieve competitive advantage. Both BDSC and BLSC made a great effort to establish all sorts of links with collective township companies as subcontractors and to set up joint ventures with foreign companies. In this way companies create approaches to enter and exit a business which were the most restrictive areas in the previous system. As a consequence, the ownership pattern of the state-owned company becomes less clearly defined and becomes a kind of hybrid form (Borys and Jemison 1989, Nee, 1992) between the state-owned enterprise and non-state-owned enterprise in terms of blending production and revenue source (See Chapter 6.4 and 6.5). In this way the basic property rights structure of the CMRS, has been altered. The right to use and the right to gain have been shared with other parties, and the right to change asset's form/substance has been extended.

This blending process can be explained by the fact that the institutional arrangements, both in the CMRS and the Enterprise Law, permit the state-owned enterprise to set up horizontal links with other types of companies, but without clearly defined boundaries. From the government's point of view, it is still a kind of trial-and-error process, the so-called "crossing a river by touching stones". Since the institutional arrangement is flexible, it creates opportunities for those managers who responded rationally by exploring

opportunities in boundary dynamics to reduce transaction costs. Meanwhile it also implies a political risk. Once the government changes the policy, the managers, to some extent, will bear the responsibility of their decisions. Obviously if things continue, as pioneers, they will be highly rewarded in one way or another. Therefore the managers' action can be explained as a kind of behaviour of combining rational choice and political risk-taking.

Furthermore, another explanation could be to refer to transaction costs. But this thesis argues that it may not be suitable to explain institutional change, because it is difficult to define the meaning of transaction costs. In some cases, in terms of the short term view, transaction costs might be high, but in terms of the long term, it might be low. Therefore it is difficult to conclude that an institutional change is always towards lower transaction costs (Cheung, 1982). At least it is difficult to explain the process itself.

To sum up, the action taken by the managers has gone beyond the existing boundaries issued by the unclearly differentiated institutional arrangements. Managers in light industry have more opportunities and show more initiative than managers in heavy industry, but both are very active to achieve as much as they can. As a result, the interaction has altered the existing boundaries between the government and the state-owned enterprise in terms of property rights structure, especially expanding the right to dispose of assets in the light industrial sector. In comparison, the company with higher technology and higher degree of ownership has closer links with the government than the company with lower technology and lower degree of ownership. For the former type of company, the relationship between them has not yet changed very much from its previous situation, while the latter is much more inclined to a marketized firm. This result implies that the

CMRS as an institutional arrangement can not be institutionalized as a stable system, instead its original structure has been incrementally altered.

8.3. The Adaptive Process

The interaction between the government and the state-owned enterprise under the CMRS can be conceived as an adaptive process in terms of adaptive efficiency to the economic transition. As advanced by Pelikan, adaptive efficiency concerns "the kinds of rules that shape the way an economy evolves through time" and "the willingness of a society to acquire knowledge and learning, to induce innovation, to undertake risk and creative activity" (North, 1991, and Pelikan, 1987). In other words, this process involves learning and creativity which are restricted by their past experience and environmental factors.

To apply for the CMRS, the adaptive ability is shown in learning new concepts and rules developed in market economy, which might involve changing the way of thinking and assumptions. And it is also shown in creating new institutional arrangements on the government side and seeking business opportunities on the company side in order to match market needs and adapt to some conditions which are difficult to change, for instance some cultural factors. Some issues which have been mentioned before will be given further analysis in terms of adaptive process.

*** the learning process**

Broadly speaking, in course of the reform, learning has been involved in every stage and aspect. The CMRS can be conceived as a process of learning how to set up a new institutional arrangement by delineating property rights between the government and the

state-owned enterprise. It involves learning concrete knowledge as well as abstract concepts. Several points can be illustrated below.

First, to learn the concept of property rights is the critical step for the CMRS, which did not exist in the previous system. After several years practice, it has been changed a great deal. A good example is a comparison of the different attitudes shown in the two negotiation periods over the five year period. In the first period, both parties' behaviour still largely followed the rule of the previous system. The case studies show that the negotiation was easy going in which the government was inclined to use the administrative rule to solve the contractual problems instead of negotiation, while the enterprise had high expectation as to the outcome of the CMRS without tough bargaining for each contract term (See Chapter 5.3.2.). During the second period of the CMRS, the negotiation became very tough, because the attitudes of the enterprises have changed a great deal (See Chapter 5.3.3). Both sides have clearer ideas about the meaning of the property rights which did not exist in the previous system. They emphasize the consistency between responsibility, authority and benefits which the system contains. The managers argue that "if you want me to be responsible for profits, I need the right or authority to use these assets, and to obtain the proper return as well." It implies setting up rationalized targets, allowing for managerial autonomy and designing proper reward and penalty schemes.

Second, learning new concepts usually evolves in the change of behavioural assumptions which is a difficult part of the adaptive process. For example, the managers have quite different views on the new financial reward system (See Chapter 5.3.1. the director's

income: the reward and penalty scheme). Some stick to the ideological view, while some are inclined to introduce market mechanism. It is not clear what kind of motivation can promote such changes and the interactive relationship between the institutional change and assumptional change.

Third, the major aspect of learning concrete knowledge is about making strategic decisions on the manager's side and formulating institutional arrangements on the government's side in order to meet the needs of market mechanism, which has been discussed before.

*** adaptive strategy**

As explained before, the needs for making adaptive strategy are caused by the incoherence of future needs and existing unchangeable (or difficult to change) conditions. Under the CMRS, such incoherence can be characterized as different institutional logics due to economic, political and ideological considerations, as well as the incoherent needs for institutional stability and flexibility.

For institutional logics, economic rationality is assumed to be a leading issue for the reform, but in practice other considerations, for example political and ideological, have to be taken into account which do not always correspond to rational thinking. Furthermore, market and bureaucratic mechanisms still co-exist to deal with the relationship between the government and the enterprise which is not easy to eliminate at once, although in the future, it aims at setting up a free enterprise system subject to market mechanism.

The major adaptive strategy in reflecting these logics can be summarized as:

- First, institutional arrangements are made by combining market rules and socialist principles, that is to say, the CMRS is designed around the idea of separation management from the ownership. On the one hand it is a rule derived from the market system, on the other hand it is still possible to persist in public ownership which is assumed to be the basic principle of socialist economy. The CMRS is a product of such a mixture.

- Second, the managers intend to seek all the opportunities provided by the bureaucratic mechanism and markets, which means moving around inside and outside institutional boundaries. This is a peculiar feature of the strategic decisions made by the managers both in heavy and light industry under the CMRS. It is partly due to the flexible institutional arrangement and partly due to the managers' initiatives to perceive opportunities and willingness to take risk.

To consider the needs for stability and flexibility of institutional arrangements, the government is facing a dilemma in the reform. On the one hand, it intends to establish a new order incrementally, in order to stabilize achievements; on the other hand, it cannot be sure how efficient the new order is. Usually it requires further adjustment or modification. In this aspect, it is inclined to be more flexible than stable. Such a dynamic view of the world is very much influenced by Chinese culture and Chinese contemporary history which tend to view the world in a relative sense and to seek changes.

As a consequence, the adaptive strategy adopted for the CMRS is to design institutional arrangements with a lower degree of codification in order to provide flexibility for further adaptation. Boisot and Child argue bureaucratic failure and the problem of governance (Boisot and Child, 1988) which could be explained by such an adaptive strategy to deal

with the transition. It is a kind of trial-and-error approach in the decision making which provides room for the government to make further clarification on the institutional arrangement and space for the managers to make strategic decisions on their own business. As Hayek pointed out, "The society permits the maximum generation of trials will be most likely to solve problems through time" (Hayek, 1960).

To sum up, the implementation of the CMRS is a dynamic picture of an adaptive process to the economic needs and other social constraints in the economic transition. It involves learning and creative activities. The flexibility of the institutional arrangement and the dynamism of the managers' behaviour open up more opportunities for further adaptations rather than stabilizing the existing system.

CHAPTER 9

THE COORDINATION MECHANISM

Having conducted the analysis of the CMRS in terms of structural feature and the process of interaction, the remaining question is why this institutional arrangement cannot be institutionalized and what reasons or causes can be used to explain this phenomena. It can be conceived as the question of how to assess an institutional arrangement in particular, and the economic system in general. In theory, this is the question of the researcher's taste and choice, for example it can be explained by functional analysis, transaction costs, or populational ecology etc. Each one has its own limitation. In reality, it results in the interaction among political, social, cultural factors and technology. As a consequence, in some societies, economic rationality is a dominant value, while in other societies, it is the trade-off between economic rationality and other social values.

In China, even since the beginning of the planned economy, the assessment of the economic system has always been around the question of how to solve the dilemma between dynamic and control functions within a system (See Chapter 4). These two functions are considered as YIN and YANG, two sides of one system according to Chinese traditional philosophy, and a principle contradiction of an economic system in contemporary thoughts (Mao, 1957). In the pre-reform period, a proper solution for this dilemma had never been found, although several changes had been made. Sometimes it emphasised the dynamic side, for instance during the period of the Great Leap Forward;

and sometimes the control side, for instance during the highly centralized periods. The issues derived from these practices have been highlighted in the reform which aims at finding a better solution. As an institutional arrangement, the CMRS is inevitably to be examined by its dynamic and control functions.

Dynamic means the system should be able to give rein to the people's initiatives. In the past, one question was about who should be given more freedom, workers, professional staff or managers. During the reform, the manager's role becomes critical which raised the question of how much entrepreneurship could be permitted under the new arrangement.

Control is basically conceived as a function of keeping economic order. Under the command economy it was measured by pursuing the central plans and development strategies. Since the reform, the efficiency of allocating economic resources has become a fundamental criteria for the new economic order. In this sense, the function of the CMRS is an important structural factor to impact on it. The main argument is about its rigidity towards industrial structure.

Drawn on some theoretical debates, for example, between Lange and Hayek, these two functions can be seen as the basic elements of coordination mechanism in an economic system. A lack of dynamic function is conceived as the main disadvantage of a central planned economy over a market economy. How to cope with rapid structural changes and the function of entrepreneurship, even Lange himself admitted, he had never succeeded in confronting the Austrian challenge in this aspect (Lange, 1936; Brus and Laski, 1989). The following is a more detailed discussion of these issues.

9.1. The Entrepreneurship under the CMRS

The dynamic function of the CMRS can be discussed in many ways. As explained before, in terms of the management decisions, the CMRS has changed the role of the state-owned company from a cost centre to a profit centre but not an investment centre yet. From the property rights point of view, three rights are restricted in the contract. Meanwhile, the CMRS emphasises the value of fixed assets which are required to be continuously increased or kept the same as that when the contract started (See Chapter 5.3.3). But it totally ignores the market value of the enterprise as a whole. This implies to ignore the value of entrepreneurship as well.

As advanced by Schumpeter, the dynamic of an economic system can be interpreted by the notion of entrepreneurship which is composed of three elements: new combinations in terms of the way of making managerial decisions, procuring means of production in terms of the access of obtaining financial sources, and entrepreneurship in terms of the people who are involved (Schumpeter, 1991).

Under the CMRS and the Enterprise Law, none of these three areas can be fully exploited. The managerial autonomy is imposed by all sorts of constraints through the CMRS, the Enterprise Law and other regulations. Because of the ambiguity of the institutional arrangements, part of the property rights are left in public domain in which they are further delineated during the implementation process through the two parties' efforts.

The first element of entrepreneurship is about the new combinations which are defined as the introduction of a new good, the introduction of a new method of production, the

opening of a new market, the conquest of a new source of supply of raw materials and the carrying out of the new organization of any industry. In principle, the enterprise assumes to have this autonomy, but in practice, it varies a great deal, with respect to technology and ownership pattern (See Chapter 6 and 7). It can be argued that the problem could be eliminated by changing government policy, instead of changing institutional arrangements. This problem leads to the last part of the chapter, that is to say, how the coordination mechanism works in an economic system.

The second element is about procuring the means of production. Originally, it mainly concerns the external financial source for entrepreneurs, namely the role of the banking system. But under the CMRS, it needs to consider financial constraints in a broader sense, due to an unclearly defined financial system, especially during the transition between two economic systems. According to the three contractual terms, the profit sharing scheme is a core and a leading issue by which the company is not free to make their own financial decisions. Instead, the company has to guarantee a fixed amount of profits to the government with a positive annual growth rate. In this way, the CMRS seems to assume all companies are able to be more profitable without concerning itself with the fluctuation of profit and loss. It makes certain strategic choices, such as changing the product mix or closing down a business, very difficult. It is even more difficult than in the previous period, because bureaucratic mechanism has been weakened. As a consequence, the industrial structure is rigidified by such unified financial strategy, and the government revenue is still directly linked to each enterprise performance which makes the divorce between the government and the enterprise difficult. Meanwhile the company's financial resources still come from two accesses: government grants and bank loans. And the

latter is still in its primary stage of setting up new institutions, which even lag behind the enterprise reform. In short, the freedom to procure a means of production for the entrepreneur is still heavily restricted.

The third element is about who has the right to become an entrepreneur. It is critical and sensitive issue in transferring a command economy to a market economy, because it relates to the notion of class structure which is assumed to be the foundation of a communist society. In the pre-reform period, the command economic system attempted to eliminate the possibility to become Western style managers and entrepreneurs. This is because the behavioural assumptions derived from this group, such as profit seeking and individual achievement, were conceived against socialist ideology. Moreover the value of management and entrepreneurship was assumed to be possibly replaced by a planning system. As a consequence, the government attempted to suppress individual initiatives associated with setting up a new business in the past.

The reform has changed such an assumption. The importance of the manager and entrepreneur is at the centre of the enterprise reform. But the problem is tackled mainly through practical solutions in order to avoid too much ideological debate. The way of dealing with the debate about the roles of director and party secretary is an example which is conceived as a very important step (See Chapter 5.3.1.). But for individuals to have rights to become entrepreneurs is another challenge. It implies more fundamental changes. The problems shown in implementing the bidding system reflect such difficulties (See Chapter 5.3.1.). Essentially the main obstacle is not only to recognize the value of management and entrepreneurship at micro level, but to recognize these individual efforts

making resource allocation more efficient at macro level. In other words, the whole economic system could build on manager's and entrepreneur's initiatives and decisions, coordinated by market competition, while the government influence can only be through indirect macro instruments. At present, the so-called " socialist planned commodity economy" has caused controversy, but is inclined to the interpretation "to combine planning with market, and to liberalize at the micro level and control at the macro level" (Zheng Xinli, 1992). In this sense, the evaluation of the CMRS has to be associated with the coordination mechanism of the economic system as a whole.

To sum up, the CMRS does not provide a dynamic structure for exerting entrepreneurship in terms of managerial autonomy, access to financial resources and freedom of being entrepreneurs. This can be explained by the restriction from the institutional arrangements, government intervention and even the value conflicts in the transition period.

9.2. The Control Function of the CMRS

In the previous chapters, the control and enforcement instruments have been discussed. The empirical material shows that for the company with higher technology and a higher degree of public ownership the control mechanism is more inclined to the direct administrative control, while for others the direct control is loosened. Meanwhile the CMRS has not yet formed non-administrative instruments to enforce the contract, especially by the legal instruments. In terms of the dynamic part of the system, the former has less managerial autonomy than the latter. It raises the question of whether these two functions can be integrated into one system, in other words, whether it is possible to make the system both

dynamic and efficiently controlled. It leads to the fundamental question of coordination mechanism to see how these two functions are integrated in an economic system. Eventually the survival of the CMRS depends on such functional effectiveness.

9.3. The Coordinative Mechanism of the CMRS

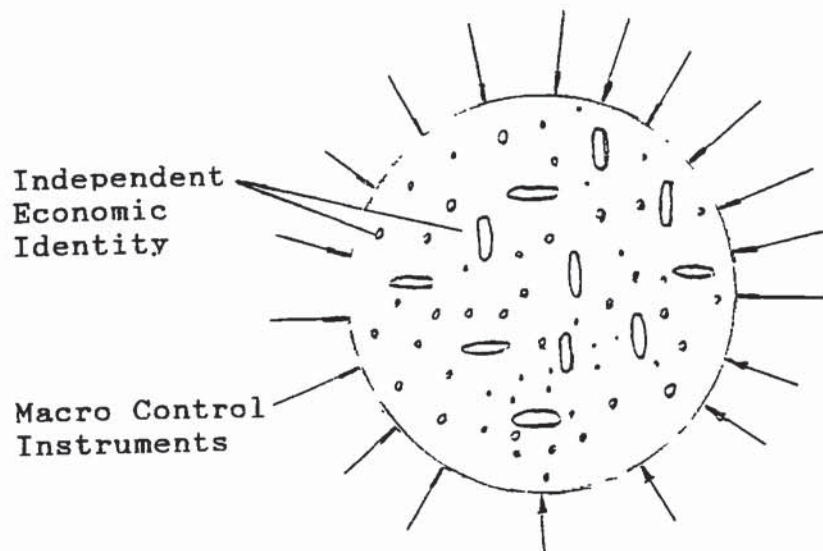
As people widely accepted, there are only two types of coordinative mechanism --- market coordination and administrative coordination in the contemporary world (Spencer, 1897, Hayek 1944, Kornai, 1986). They are derived from entirely different principles. In market coordination, the basic principle is to rely on the individual's choice which means that individuals and the firm have rights to offer and to choose, meanwhile as a superior power, the state is able to affect their choices by using indirect instruments, for instance. monetary control and other economic policies. In other words, it is a kind of voluntary coordination in which the system is supposed to permit individuals and other economic identities as much freedom as possible. Effectively such freedom play a coordinational role to make each one respect the other's decisions, the so-called competition mechanism. In this system, the boundaries among economic identities, both individuals and the firm, are clearly cut off by their financial interests. By nature, the system is decentralized. The mechanism of this coordination can be simplified as the model shows in Figure 9.1.A. Meanwhile certain instruments, for instance the legal system and other informal rules, are designed as an enforcement mechanism to guarantee freedom of choice. For this purpose, the instruments are required to be designed in a negative way. As a whole, the control and dynamic functions can co-exist and even reinforce each other.

In administrative coordination, the basic principle is compulsory coordination. Individuals

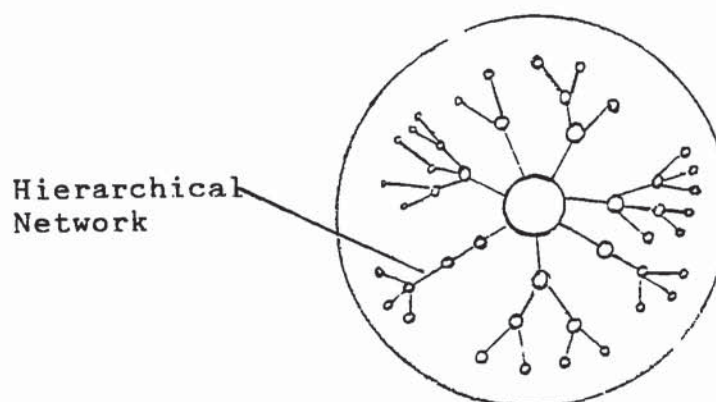
and economic organizations are positioned in a big network of the economic system, in which bureaucracy is the leading force to exert its coordinative function. Within the system, there is always some kind of delegation from one level to another which permits certain autonomy and freedom to individuals and organizations. As a whole, the system is highly centralized and each unit cannot perform as an independent economic identity. The boundaries can only be cut by functions, but not in the sense of independent economic identity. This system can be simplified as shown in Figure 9.1.B. Meanwhile, the administrative system also plays an enforcement mechanism due to its nature of compulsory orders. Moreover in some cases, it can be exerted by political and ideological enforcement through the administrative system. It is not too difficult to see that it might be possible this system to exert its control function effectively, but it is impossible to endow freedom as much as that in the market system. Furthermore, control and dynamic functions in this system hold a contradictory relation, that is to say, more control, less freedom. In other words this system cannot compete with the market coordination economically. As a historical consequence, economic reform has swept over the communist block.

**Figure 9.1. The Coordinational Mechanisms of Two
Economic Systems**

A. Market Coordination

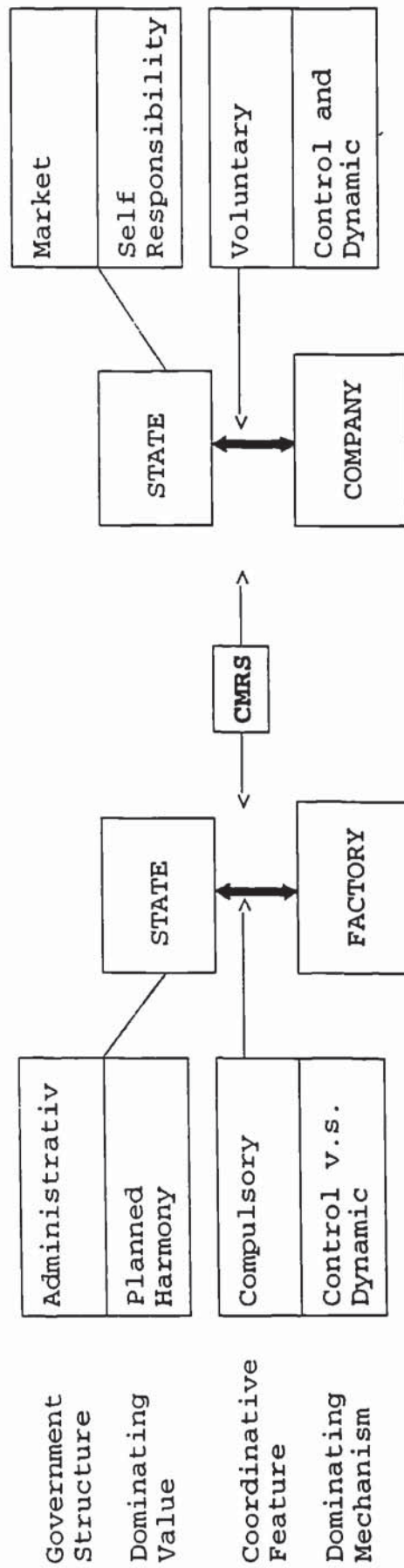


B. Bureaucratic Coordination



To apply these two coordinational mechanisms, the relationship between the government and the enterprise can be summarized in the Figure 9.2. First, the government and the enterprise can be conceived as either state and factory, or state and company. That is to say, the factory is not an independent economic identity, but the company is. Second, the governance structure imposed by the state can be either administrative or market. An administrative structure is functionally featured and hierarchically divided, while a market structure is differentiated by independent economic identities and is horizontally connected. Third, the dominating value of the two systems are either inclined to planned harmony or to self responsibility. For the former, the economic system is viewed as a whole, enabling an achievement of a balanced pre-planned economic development. As a result, it supposes no basic conflict between two parties. For the latter, each independent identity has to be responsible for its profit and loss, and they are constantly in competitive positions. Fourth, the two systems adopt different coordinational principles to the two parties, either by compulsory or by voluntary, as mentioned above. Finally, the two systems result in different functional mechanisms, either putting dynamic and control functions in a contradictory position or integrating these two together which would determine the nature of institutional arrangements.

Figure 9.2. The Relationships between the Government and the Firm
in Two Economic Systems



Given that, the CMRS has to be examined by the functional mechanism, especially by dynamic and control functions. In other words, as an institutional arrangement to link macro to micro levels, it needs to answer these functional questions. Having conducted the analysis of the property rights structure, the CMRS could be conceived as a kind of institutional arrangements which is a compromise between the two types of coordinative mechanism, neither totally breaking down the administrative ties between the government and the enterprise, nor permitting a free market competition. As a result, the two types of coordinative functions cannot perform effectively. It creates an unstable situation and leads to further changes. The empirical study shows that if the government attempts to reinforce the control function, the system is moving back to the previous system; if the government is willing to allow more freedom to the enterprise, the system becomes more marketized. In either way, the CMRS is difficult to function as a stable institutional arrangement. If we assume it is impossible to go back to the previous system due to political and economic reasons, the only solution is to carry out further market reform for the CMRS.

CHAPTER 10

CONCLUSION

As an important part of the enterprise reform, the CMRS has provided rich material for the understanding of economic reform in particular and institutional change in general. The study of the CMRS may yield some insights for further research on these two aspects. This section attempts to draw some conclusions on the basis of an institutional interpretation of the economic reform.

In comparison with other studies, the major feature of this research is that the subject has been examined with an institutional perspective. This means that the research has attempted to understand the whole process rather than specific features of the system. The area of inquiring taken in the research has not only been to compare reform programmes with market or planned systems, but to study the general tendency of the reform movement. This thesis argues that the critical question of the reform is not whether each step is right or wrong referring to a standardized market system, but whether there are regularities appearing in the process which determine the tendency of movement.

In order to answer this question, it needs to inquire into all sorts of actions taken by people and to understand the logics behind their actions. These constitute the main theme of the research. As a conclusion, the research can be seen as drawing some theoretical and policy

implications. From the theoretical point of view, to analyze institutional structure and institutional logic are two aspects of understanding the process of institutional change. The former is related to actions taken by participants, and the latter to the meaning of actions. From the policy making point of view, creating enough opportunities for adaptive process and pursuing the principle of market mechanism are two critical considerations.

10.1. Theoretical Implication

As given in Chapter 2, the institutional perspective has been developed in rather divergent ways. The major distinctions can be drawn between economic and sociology, and between old and new institutional sociology. This research mainly adopts a sociological approach, but uses some economic concepts as tools, especially property rights, to analyze the institutional feature of the system. It assumes that these approaches, to some extent, are not contradictory, but compensate each other, or depending on the needs occurring in the different stages of institutionalization. Correspondingly, the two aspects mentioned above can be related to three key questions of institutional change addressed by sociological approach (See Chapter 2.4):

- Through an understanding of action, it attempts to answer the question of what actions can be taken to lead to the establishment of new institutional orders;
- Through an understanding of the meaning of action, it attempts to answer the question of why and how some beliefs and institutional logics are relatively immune to challenge, while others are easily delegitimated;
- To put these two questions together, thus these may be seen to provide some insights to the question of what kinds of social processes have irreversible tendencies.

10.1.1. The understanding of action in institutional change

Actions taken in the process of institutional change can be characterized by several features. First, this process must be considered as a process of interaction by all the participants, rather than one party making decisions and others following. Referring to the fundamental change in the economic system, this research argues that interaction should be studied through role relationships rather than group relationships, because research can discover all sorts of action taken at individual level, instead of relying on the grouped and stereotyped activities. Moreover interaction takes place over time and is composed of repeated, reproductive actions. Through time, interaction becomes institutionalized. These points can explain the difference in defining an institution in the economic and sociological approaches, one viewed as the product of human design and one as the result of human activities (See Chapter 2.3.2).

Second, to create opportunities for action and to respond to challenge are two sides of the problem. For the former, what kind of constraints and opportunities institutions imposes would largely influence the whole process. They relates to the structural feature of institutional arrangements and enforcement mechanism. The more clearly defined and codified is the structure the easier to stabilize the existing institutions and to strengthen the existing boundaries, but the fewer the opportunities there are to experiment with other possibilities. As Arthur points out there are lock-in and path dependence effects (Arthur, 1988). In terms of reform, by nature, it is a process of continuous changes which needs dynamic institutional arrangements. As Hayek pointed out, the society that permits the maximum generation of trials will be most likely to solve problems through time (Hayek, 1960). This research shows that the policy-making in China is a kind of trial-and-error

process which might provide opportunities for multiple equilibria (Arthur, 1988). The advantage of this process is allowed ex ante and ex post adjustments.

In addition, it raises the question of the role of legal system in the process of institutional change, which is always less favourable in China. One reason for that is its rigidity to adapt to changes, especially for economic affairs. But on the other hand, modernization, by all means, needs a legal system. This is another theoretical and practical question which has to be answered in the process of economic reform.

With respect to interaction process, it is necessary to study how actors respond to opportunities created by institutional change. In other words, how people exert their initiatives through their actions. The general picture shown in the research is that people have been motivated to very active in the reform. For example, the managers and employees are keen and able to exploit new business possibilities rather than stick to the previous system. There has therefore been a strong underlying support for reform. Basically this process has involved strongly motivated learning and creativity in new options. Why it happens in this way is an important and complicated question, influenced by many factors, which needs more comparative studies in different economic and cultural settings.

Third, the notion of boundary is critical to an understanding of action. Institutional change can be conceived as actions moving beyond boundaries. It is particularly useful to understand a kind of gradual institutional change through continuous marginal adjustments. Economic reform is such a type of change. In this sense, institutional change takes a form

of boundary dynamics in which repeated actions break down existing boundaries and re-shape new institutional boundaries. In the case of the CMRS, both the government and the enterprise attempt to redesign the boundary, either through administrative force or through business decisions. Eventually the boundary between them is re-shaped.

To describe a boundary needs tools which clear specification of the concept. In the economic sphere, the property rights structure has been shown to be a powerful tool to analyze boundary dynamics. This is because on the one hand, the property rights structure contains basic elements of economic system; on the other hand, it is directly associated with economic activities of transaction. Therefore, it builds up a link between structural factors and actions, which is essential to describe boundary dynamics. As a consequence, the change of structural factors in the process of institutionalization is clearly presented in boundary dynamics.

Furthermore the remaining question is about the relationship between the boundary dynamic and the establishment of a new institutional order. The key question is about how the dismantlement of existing boundaries related to the establishment of new institutions: whether these two steps go together or whether one involves destruction first and construction the next. What are difference between incremental change and discontinuous change? The continuity of economic reform provides opportunities for future research which have been mapped out in the previous chapters.

In short, the notion of action in institutional change is a dynamic concept. First it should be conceived as an interaction process among participants. Second the action needs to

be understood from two sides: opportunities and constraints provided by institutional arrangements and creative responses from the receivers. Third, the notion of boundary is critical to understand the impact of action on institutional change, especially for incremental changes.

10.1.2. Understanding the meaning of action in institutional change

An understanding of the meaning of action is the main focus of the institutional theory, inspired by ethnomethodology and phenomenology. However the meaning of action in institutional change is the most controversial issue in the discussion. Nearly all the debate between economics and sociology can be simplified as a divergence in their understandings of the meaning of action. For example, economists conceive rational choice and self-interests seeking as the basic behavioural assumptions to understand institutional change, while sociologists tend to take social and cultural factors into account (See Chapter 2.3.2). Furthermore the tendency of institutional change could be viewed as an adaptive solution towards economic rationality and efficiency in economic approach, or viewed as modern secular rituals and myths which constitute and contain legitimate actions as in the sociology approach (Ibid.). These two types of views reflect in the understanding of the process of institutional change.

Drawing on this research, several points could be further specified. First, the meaning of action in institutional change implies the logics involved in the process of institutionalization. Institutional logic is based on behavioural assumptions and values (or beliefs). To understand the meaning of action implies an understanding of an institutional logic. If we consider institutionalization as a process of creating reality, this process could

be conceived as a set of developing institutional logics through time and space. These logics might be developed in divergent ways over a long process which characterizes the complexity of institutionalization. During the economic reform, several different institutional logics are presented in the process: economic rationality versus political and ideology priority, administrative mechanism versus market mechanism, rational choice versus cultural and ideology consideration. To establish a new full-fledged economic system theory implies the further understanding of these logics.

Second, in many cases, institutional change means to create new institutional logics, as well as to delegitimize or to re-balance other logics. For fundamental changes, such as the economic transition from command economy to market economy, the change of institutional logic is inevitable, because they are built on different mechanisms. But this process does not mean other values and institutional logics would disappear. Therefore it is vital to understand the process of change and the way of re-shaping other logics.

The research shows that institutional change implies (1) the delegitimation of the previous dominated institutional logic, (2) the establishment of a new one. For example, the dominant logic in a market economy is driven by economic force, while in a command economy, political and ideological consideration is given a first priority. Therefore, the change of economic system means first to change dominant value and institutional logic. Any significant reverse of this tendency also means the possibility of a failure of economic reform. Sometimes the change of value and logic might start before the actual changes of institutional arrangements. For example, when the economic reform started in China, to a large extent, economic development as an leading issue had already been legitimated,

instead of the previous ideology of class struggle. Actually, the possibility of starting the reform can be conceived as the success of this transformation.

Moreover, the change in dominant values or institutional logics do not mean the disappear of other values and logics. The process of establishing new institutions can be conceived of as the process of changing and re-shaping different values and logics into a new routinized system, for example, under the CMRS, The persistence of a dominant institutional logic as well as the trade-off with other values and logics constitute the main theme of the institutional change. Some ideology and social considerations, for example, spiritual motivation versus financial reward, an equalitarian ethic versus efficiency criteria, are in the process of re-balancing.

Furthermore the way of dealing with the re-shaping of institutional logics can be interpreted as the process to seek for strategic decisions and tactical solutions. The former is defined as action taken towards an existing direction and the latter aims at balancing other institutional logics. For example, the debate on the roles of party secretary and the director, on the one hand is considered as being associated with the basic principle of the reform, that is, either by economic driven or political driven forces which can not to be compromised; on the other hand, it attempts to find a practical solution for individual motivation, which could be learned from cultural inheritance. From this aspect, the long Chinese history provides rich material to conflict resolutions. Nevertheless, this is a complicated and dynamic process, composed of learning and creativity. The more the participant and the trials, the more possible to find out optimal solutions.

Finally, the notion of adaptive efficiency is another controversial issue related to the meaning of action. An economic approach is inclined to efficient solutions and rest on transaction costs explanation; the sociological approach emphasises the process of institutionalization with respect to cognitive issue. (See Chapter 2.3.2). This thesis argues that the transaction costs approach does not possess a time dimension to explain institutional change, because these costs cannot be measured in terms of both long term and short term views (See Chapter 9). Unlike the sociological approach it is too abstract to explain actual the process.

This thesis uses functional arguments to explain institutional change, referring to two basic economic functions: dynamic and control. It argues that to achieve these two functions simultaneously has irreversible tendency in modern societies. The debate on the mechanism of interaction between these two functions in a command economy over last decades has focused on a failure in economic performance. Instead, economic reform aims at establishing market institutions to exert these two functions effectively. Therefore it is important to understand the coordinative mechanisms of these two functions in two different economic systems: market and administrative coordinations. General speaking, in the former system, control and dynamic are self contained, while in the latter, these two repel one to another (See chapter 9). For economic reform, all the efforts occurred in institutional change will be eventually assessed by the degree of realizing these two functions together.

10.2. Policy Implications

Drawing on the theoretical issues from institutional change, many policy issues have been

implicitly mentioned, for example the design of regulation, the establishment of the legal system, the strategic decision and tactical solution etc. Here these issues will not be repeated, but the value of the institutional approach in incorporating these issues can be seen. From a practical point of view, therefore, the institutional approach can be considered as a powerful way to understand the reform, especially when the reform process in China has been moving so fast. By the time of this dissertation is finished, the CMRS is likely to have been changed a great deal. Therefore the thesis has not aimed at only providing material to understand the CMRS in a rigid way, but has attempted to map out a way of understanding the economic reform as a process. The most important issue is to have a clear understanding of targets and to keep more options to reach the targets.

Difference between the theoretical implications at the study and the policy implications in reality is that the former are based on an attempt at objectively viewing the phenomenon, while the latter derives from a social-political process. The former attempts objectively to understand regularities occurred in the process, while the latter involves an understanding of reality which gives significance to pursuing natural laws and regularities.

In terms of the relationship between the government and the state-owned enterprise, the understanding of the coordinative mechanisms of two economic systems would push reform minded policy-makers to establish a free enterprise system as a target. Meanwhile the way of reaching this target could be flexible in order to create more opportunities for better adaption to ideology and cultural issues. In this sense, the purpose of the CMRS diverges from the reform targets, but it provides some flexibility for the managers to make their own adjustments which constitutes the unstable nature of the system and the

complicated interaction as well.

To sum up, both economic reform and institutional change are complicated and novel subjects. This research is an attempt to link two things together by analysing the CMRS as an example. From theoretical point of view, an understanding of institutional change can be drawn from an understanding of action and the meaning of action occurred in the process. From practical point of view it places emphasis on the relation between clearly defined targets and a flexible process to reach the targets. The author hopes the value of the research is not only to provide some material to understand the CMRS itself, but to yield some insights for understanding the economic reform as a whole. Therefore the research which has been done here is considered as a beginning of an understanding of the process of the economic reform rather than as the end.

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APPENDICES

APPENDIX 1.

The Provisional Regulation of the Contract Management Responsibility System for the State-owned Industrial Enterprise (issued in the 27th, February, 1988 by the State Council)

Chapter 1. General Rules

Article 1. The purpose of this regulation is to improve the state-owned industrial enterprise (the enterprise in short), and to increase efficiency and profitability.

Article 2. The principle of the CMRS is the separation ownership from management on the basis of socialist public ownership. The CMRS is aimed to set up the contractual relationship to clarify the responsibilities, rights and benefits between the state and the enterprise, enabling the enterprise responsible for its own profits and loss.

Article 3. Under the CMRS the interests of the state, the enterprise, the manager and the employees must be given consideration, in order to motivate the people and to guarantee the revenue of the state.

Article 4. The CMRS must give a managerial autonomy to the enterprise and to protect the legal rights of the enterprise.

Article 5. The principle in the distribution of income between the state and the enterprise is to guarantee the fixed remitted profits to the state, to allow the enterprise to retain the exceeding amount of the profits and to compensate the loss by its own funds.

Article 6. Both sides of the contractors must abide by law, regulations, and policies under the authority's supervision.

Article 7. The authorized auditing organization has the rights to audit the implementation of the contract.

Chapter 2. The Content and Forms of the CMRS

Article 8. The basic items of the CMRS are: to contract the remitted profits to the state, to contract the fulfilment of technology up-grading projects and to link total wage bill with the enterprise performance. Besides these, each enterprise could decide its own contractual terms depending on their needs.

Article 9. The remitted profits to the state can be contracted in the following forms:

- to increase progressively,
- to contract the fixed amount of remitted profit, and
to share proportionally above the amount,
- to contract the fixed amount of remitted profits for
the enterprises with a very low profits rate,
- to contract the fixed amount of loss reduction for the
enterprise with a loss,
- other forms ratified the authority.

Article 10. As a general rule, the fixed amount of remitted profits is decided on the basis of the remitted profits of the previous year. For the enterprise in which its performance is affected a great deal by external factors, its remitted profit targets can be decided on the basis of the average remitted profits over the last two or three years. The final targets can be adjusted by the local average rate of profits on capital. The rate of progressive increase

or the proportion of the profits sharing above the targets must consider the real potential of the enterprise and the needs for technology improvement.

Article 11. The procedure to turn over the profits to the state is that: the enterprise pays taxes according to the law, every three months the 80% of the profits which exceeds the contract targets returns to the enterprise from the financial bureau, and by the end of each year, the final account is settled between the state and the enterprise.

Article 12. The technology up-grading projects must be decided in accordance with the sector development policy, market needs, and the economic situation in the enterprise.

Article 13. The way of linking total wage bill with performance can be made on the basis of the government regulation and on the situation of the enterprise.

Chapter 3. The Contract Terms

Article 14. To conduct the CMRS, the manager who is responsible for the management of the enterprise is entitled to sign a contract with the government.

Article 15. To negotiate a contract, both sides must be in an equal position.

Article 16. The main contract terms are as follows:

- the form of the contract,
- the duration of the contract,
- the amount of the remitted profits or of the loss reduction,
- any mandatory plans for supply and production,
- the quality control and other main indicators,
- the technology up-grading projects, and the protection and increase of the value of the state

- assets,
- the usage of the retained profits, the payback of
loans and other debts,
- the rights and obligation for both sides,
- to break a contract,
- the rewards for the managers,
- others.

Article 17. The minimum duration of the contract is three years.

Article 18. The contract is protected by law, and can not be altered and terminated at will by each side.

Article 19. If the tax system and the mandatory prices are largely changed by the government, the contract can be readjusted according to regulations. The contract can be altered or terminated due to force majeure.

Article 20. If the management is poor or the contract can not be achieved, the contractor on the government side has the right to terminate the contract. If the contractor on the government side breaks the contract, the contractor on the enterprise has the right to terminate the contract.

Article 21. If a dispute occurs, it could be solved either by consultation, or by arbitration, or by suit to the court.

Chapter 4. The Rights and Obligations for the Contractors

Article 22. The contractor on the government side has the right to investigate and monitor the performance of the enterprise, to protect the legal rights of the managers

and to help to solve the problem facing by the managers.

Article 23. The contractor on the enterprise side has the managerial rights defined in the law, regulation, policy and the contract. The contractor must fulfil the task defined in the contract.

Article 24. If the contractor on the government side breaks the contract, the administrative and economic responsibilities must be taken by them.

Article 25. If the contractor on the enterprise side does not fulfil the contract, the managers must take the administrative and economic responsibilities.

Chapter 5. The Manager

Article 26. To implement the CMRS, usually the bidding system should be adopted to choose the manager(s), or other ways which are approved by the government. The bidding can be conducted within the enterprise, or in the sector, or to the publics if possible. Individuals, groups or the legal person of the enterprise can be the candidate of the bidding, but eventually a person must be appointed to take the responsibility. The government encourages an legal person of the enterprise to bid for other enterprises, in order to restructure industries.

Article 27. The local government should be encouraged to set up the bidding markets to provide information and opportunities for the future contractors.

Article 28. The contractor on the government side should organize a bidding committee composed by the representatives of the employees to evaluate the candidates.

Article 29. The manager who is responsible for the enterprise must be qualified as follows:

- the qualifications of the director defined by the government,
- other requirements made by the bidding system,

Article 30. The manager who is responsible for the enterprise must be the director of the enterprise who is the legal person of the enterprise.

Article 31. The director can choose his own management group during the contractual period.

Article 32. The director must report to the enterprise employee congress about the performance of the enterprise.

Article 33. The income of the director can be one or three times more than the average income of the employees, or slightly higher if his contribution is higher. The income of other managers should be lower than the director. If the contract does not fulfilled, the income of the director must be deducted until the half of his basic salary.

Chapter 6. The Management

Article 34. Under the CMRS, the assets of the enterprise are divided into two parts, the state assets and the enterprise assets. The fixed assets and circulation funds possessed before the CMRS is belonged to the state assets. The retained profits during the period of the CMRS and the fixed assets gained by the retained profits is the enterprise assets. The fixed assets gained by loans during the period of the CMRS depends on the way of paying back... The depreciation funds depends on the proportion of the fixed assets between the state assets and the enterprise assets. The enterprise assets is public owned.

Article 35. The current enterprise funds is also the risk fund for the current period of the CMRS, and it will transfer into the enterprise fund in the following contractual period.

If the enterprise can not achieve the contract targets, it is compensated by the enterprise funds.

Article 36. The enterprise must divide the retained funds into three parts: the production fund which should be the main part, the welfare fund and the reward fund. And the part of the last two funds should be invested into the employees' houses.

Article 37. The loans the enterprise borrowed before adopted the CMRS should be defined in the contract in terms of the payback period and the amount of payment. The loans borrowed during the period of the CMRS should be payback by the enterprise funds.

Article 38. The enterprise must abide by the price policy, not allowed to raise prices arbitrarily. The enterprise must be responsible for illegal activities in the determination of prices.

Article 39. The enterprise should be responsible for managing the organizational structure inside the enterprise under the director responsibility system.

Article 40. The enterprise should strengthen the democratic management including the function of the employee representative congress and the trade union.

Article 41. The enterprise should build up a managerial responsibility system in the principle of the unity of responsibilities, rights and interests.

Article 42. The enterprise should adopt the principle of the distribution according to work, and decide its own payment scheme, for example, a piece rate wage or a fixed salary.

Chapter 7. Supplementary Articles

Article 43. Other sectors, for example, transportation, construction, forestry, commerce, international trade can work out their own contract management responsibility systems

referring to this. The sectors which adopt the sector contractual system and the enterprises which are on the special list are not suitable for this regulation.

Article 44. The local government could make their own operational regulations in order to implement the CMRS.

Article 45. This regulation goes into effect from the 1st, March of 1988.

APPENDIX 2.

The Summaries of the Four Contracts

The Summary of the Contract of BEGPC in 1991-1995

Article 1. The contracting remitted profit targets are:

	1991	1992	1993	1994	1995
MY	1.289	1.325	1.363	1.401	1.440

The 90% of the retained profits has to be used in technology improvements and 10% is used for the employees.

Article 2. The total increase of the value of the fixed assets is 5.5 MY.

Article 3. The increase of the total wage bill is associated to the realized profits with the rate of 1: 0.75.

Article 4. The merge of the business is according to the regulations.

Article 5. The company should pay a risk fund accordingly.

Article 6. Other terms are the same as the previous one.

Article 7. The terms of validity is in 1.1.1991 - 31.12.1995.

The Summary of the Contract of BTC
in 1991 - 1995

Article 1. The remitted profits targets are:

	1991	1992	1993	1994	1995
MY	3.74	4.08	4.20	4.42	4.72

Article 2. The total investment in Eight-year plan is 1.3 M Yuan. The value of the total fixed assets should be at least the same as it now. The total circulation fund owned by the company should be increasing by 1.5% annually.

Article 3. The total wage bill is associated with the total realized profits. The reduction of the profits will lead to the decrease of total wage bill until 20% of the previous bill.

Article 4. Other measurement targets.

Article 5. The rights and obligations of the two sides.

Article 6. The change and termination of the contracts.

Article 7. Supplement articles

**The Summary of the Contract of BDSC
in 1991-1995**

1. The Key Contract Terms

Article 1. The targets of the realized profits and remitted profits are 4.5 MY and 2.55 MY respectively, with 2% annual growth.

Article 2. The net value of the fixed assets should be increased by 6.4% annually.

Article 3. The total wage bill is associated to the performance with the same scheme as before.

2. The Performance Targets

Article 4. Quality

Article 5. The rate of export

Article 6. The consumption of raw material

Article 7. The maintenance

Article 8. The production safety

3. The Key Tasks in the Eight-Five Year Plan

4. The responsibility of the director

5. The change of the contract

6. The rights and obligation of the two parties

7. The auditing of the contract

8. The validity of the contract is in 1.1.1991-31.12.1995.

**The Summary of the Contract of BLSC
in 1991-1995**

1. General terms

Article 1.

Article 2.

Article 3.

Article 4.

2. The targets and validity of the contract

Article 5. The validity of the contract is five years.

Article 6. The targets:

- the profit bases are:

	1991	1992	1993
MY	1.40	1.54	1.69

- the quality targets

3. The rights and obligation of the government

Article 7. The role of coordination

Article 8.

Article 9.

Article 10. The inspection

Article 11. The auditing

4. The rights of the company

Article 12. The management autonomy

Article 13. The right to use the profits after taxes

5. The obligation of the company

Article 14 - 24

6. The reward and penalty

Article 25 -30

7. Supplementary articles

APPENDIX 3.

The sub-case 1. An Entrepreneur in 1950s

The Beijing DA HUA Shirt Company (BDSC) was originally established in 1954, just after the success of the economic recovery period of 1950-1952. At that time the further prosperity was expected in the society. The new communist regime perceived a way of development was to launch the socialist transformation which is a kind of movement of nationalization. As the first step, the government encouraged to merge small private companies into a larger ones. The Beijing DA HUA Shirt Company was the result of this policy.

The local government launched a campaign to called on such a merge in order to cope with the needs of industrialization, while the actual merges was carried out by the willing of the owners. At that time many owners of the small companies were conceived of this policy as an opportunity for the further development. The 19 small private companies, including 3 department stores, 1 grain shop, 13 cloth shops and 2 small shirt companies, which were just moved into Beijing from Shanghai, were decided to merge into one company, called the Beijing DA HUA Shirt Clothing Manufacturing Limited-liability Company. The establishment was formally announced in the 24th of August, 1954. The company had started with 157 employee, 40 equipments and the circulation fund of 200,000 Yuan.

The chairman of the board of directors Mr.Zhao, was a rather local well-known person who was the owner of the previous DA HUA department store and the deputy secretary-

general of the chambers of commerce. As the founder, he made several contributions to the DA HUA. First he suggested that man's shirts would be a quite good product for the company, because at that time there was no local company specialized in making man's shirts and the market for this product was huge, even locally. Second the name of DA HUA, which means great China, originally used by his previous company, became the name of the new company. He also suggested to use Tian Tan as a brand name. Tian Tan is the Chinese name of the temple of heaven, located in Beijing, one of the most famous temple in China, with very strong symbolic meaning. All these three decisions have been remained for nearly 40 years.

His contributions were recognized by the company, and even more appreciated since the economic reform. They found that the strategy of concentrating on man's shirts with a sound brand name gave them many competitive advantages such as quality control, economic scale, and marketing. Such a strategy of specialization was differed from many companies who usually preferred to produce products as diverse as possible under the planning system. The DA HUA benefited this uniqueness, especially when the situation changed. The other benefit came from the name of the company, the DA HUA. Because it does not have meanings limited in a special region as many Chinese companies did, such as the Beijing No.1 Clothing Manufacturing Company. Since the economic reform when the company had a chance to expand its markets, the managers found it was much easier to enlarge its company into the national scale by using an established company name and the brand name than the others.

APPENDIX 4.

Sub-case 2. The Change of the Organizational Structure in BDSC

In 1956, during the movement of nationalization, so called the socialist transformation, the Beijing DA HUA Shirt and Clothing Manufacturing Limited-liability Company transferred into the joint-owned (the state and the private) company, which was in fact a kind of the state-owned company.

*** the transformation to the state-owned company**

Since then, the company was named as the Beijing DA HUA Shirt Factory, under the direct leadership of the Beijing No.1 Local Industrial Bureau. The structure of the company was reorganized according to the normal state-owned company. A more detail is given below. The new director Mr.Wu was appointed by the municipal bureau, while the ex-director became the depute director. Obviously the board of directors was abolished.

*** the merge with other companies by the administrative order**

In 1956, a hundred of workers from another local clothing company merged into the DA HUA through the municipal bureaus' arrangement. In 1960, another small local clothing company with 140 employee was required by the municipal bureaus to merge into the DA HUA. When Mr.Niu the director looked back that period, "All? these decisions were decided by the bureaus without many discussions. Even we did not think to bargain with the superiors."

*** the recruitment according to the municipal bureau's plan**

In 1958, a group of new workers was recruited based on the municipal bureaus' plan. In 1962 it was the first time the DA HUA was allowed to recruit young workers graduated from the middle school. Before the employee working in the clothing manufacturing sector usually had very low education background which means that the employee in the DA HUA would have higher education background than the others. The DA HUA was proud of such a change. In 1966 before the Cultural Revolution the DA HUA had total employee of 406. At the beginning of 1970s, two group of new workers were recruited again. In 1976 when the DA HUA moved to the new place, the total employee reached 626. By the end of 1970s, the DA HUA had more than 1000 employee which became a large-scale clothing manufacturing company in China. In the process of recruitment, the managers did make some efforts to pursuit the bureaus to increase as much as possible.

*** a little autonomy on the personnel decisions**

Before the economic reform, Mr.Niu, the director of the DA HUA, said, the power for the personnel decisions were highly centralized in the hands of the municipal bureaus. The appointments of the managers from the middle level to the director were directly decided in the bureau, although the decisions were consulted with the company before it was made. "They had veto power, while we attempted to influence the process by giving information." The technical people including engineers and technicians was allocated by the bureau. The recruitment of workers was based on the bureaus' plans, and then carried out jointly by the DA HUA and the local community. There was no right to fire employee, unless in the extreme case in which dismissal was used as a kind of punishment against bad behaviour. The wages for all the employee were subject to the regulations made by the central government.

*** the changes of the supervisory bodies due to the re-structuring of the macro economic system**

In 1956 when the DA HUA transformed into the state-owned company, the Beijing No.1 Local Industrial Bureau was its supervisory bureau. In 1958 during the period of the Great Leap Forward, the Beijing Clothing Manufacturing Industrial Company was established under the Beijing No.2 Light Industry Bureau. It became the supervisory bureau for the DA HUA. In 1970s during the Cultural Revolution, the structure of the bureaus was streamlined by that all the clothing manufacturing companies were under the supervision of the Beijing Commercial Bureau, and the Beijing No.2 Light Industrial Bureau was abolished. In 1979 when the economic reform started, the system changed again by which the local No.2 Light Industrial Bureau was re-established and became the supervisory bureau of the DA HUA. The general feeling the managers had was that once the changes of economic policy took place, either left deviation or right deviation, it would result the change of re-structuring its supervisory body. The impact of such changes on the DA HUA was not tremendous. " Since we are not a big company and producing very simple products, who is our boss is not matter very much. If you are a large company, you would like to be under the ministry in order to get more support."

*** the continuation of functional structure for 40 years with the change of its content**

Since the company founded, the functional structure has been adopted for nearly 40 years, although the content of the structure was changed a great deal. The major changes were due to the change of defining functional units and the change of the leadership, either the party secretary, or the director. Appendix 1 shows all the organizational structures of the company adopted over the past 38 years. The company itself had no authority to make

such organizational decisions. It was a kind of general patterns occurred in each period, to be followed by most of the enterprises in China.

*** the simple structure without party system in the period of the private-owned company**

The Figure 1 shows the structure of the DA HUA when the company was just founded. It looks like a structure of a share holding company. At that time the post of the party secretary had not yet been created because the company was private owned, but the trade union had been set up. General speaking, the structure of the company was quite simple with a few of the departments and one workshop in order to cope with a small-scale business.

*** the new leadership structure after being the state-owned company**

In 1956 when the DA HUA transformed into the state-owned company, the crucial change is the structure of the leadership. The Figure 2 shows the new structure of the DA HUA. The party secretary became the leading figure who had the general responsibility in the company, and the director was mainly responsible for production. This kind of leadership system had been carried out until the CMRS was introduced. Two new departments, personnel and political work office, were created, by which the management of human resources was emphasized. The production line was also further differentiated into three workshops, cutting-out, sewing and ironing which represented the development of the company.

*** the attempt of changing the role of the director and some other political related**

issues at the beginning of the Cultural Revolution

The Figure 3 shows the structure of the company appeared at the beginning of the Cultural Revolution. The major change was the title of the director. The idea was to change the title of the factory director into the director of the revolutionary committee by which the director supposed to have a new relationship with the employee. The position of the party secretary was still remained, but the previous party secretary and director were under the examination. A new propaganda department which would be concentrated on the political education was established, while the political work office became a kind of personnel department to deal with promotion and recruitment, but only for "cadres". The labour wage department was created dealing with the workers, mainly on the matter of recruitment and wages. The other important change was that the Trade Union was abolished, because the different interests between managers and workers were supposed to be eliminated by the Cultural Revolution.

The Figure 4 which is not very much different from the previous one, except that the party secretary was re-established, was the structure of the following 4 years.

*** the major change of the structure in the middle of 1970s due to the expansion of the DA HUA**

The Figure 5 shows that two new departments, the energy supply and the construction departments, were set up, due to the needs of the development of the company, because the DA HUA moved to a new place. A more detail of this movement is given below. Meanwhile the name of the workshop were re-named referring to numbers instead of the professional names. It sounded more formal and represented a large scale production,

which was based on the convention of terminology used in the Chinese industry.

*** the re-establish the Trade Union**

The Trade Union was re-established in the middle of 1970s, nearly the end of the Cultural Revolution. The purpose for such a re-establishment was the need of an organization to deal with welfare and other leisure activities in the company, rather than the serious concern of the different interests between workers and managers or other groups. For example, the Trade Union had amount of money, called relieve fund, to help the employee with financial difficulties. If you asked some one in the company about the function of the Trade Union, s/he very often said, "they give me two tickets to go to cinema every month."

*** the slow move by the end of the Cultural Revolution**

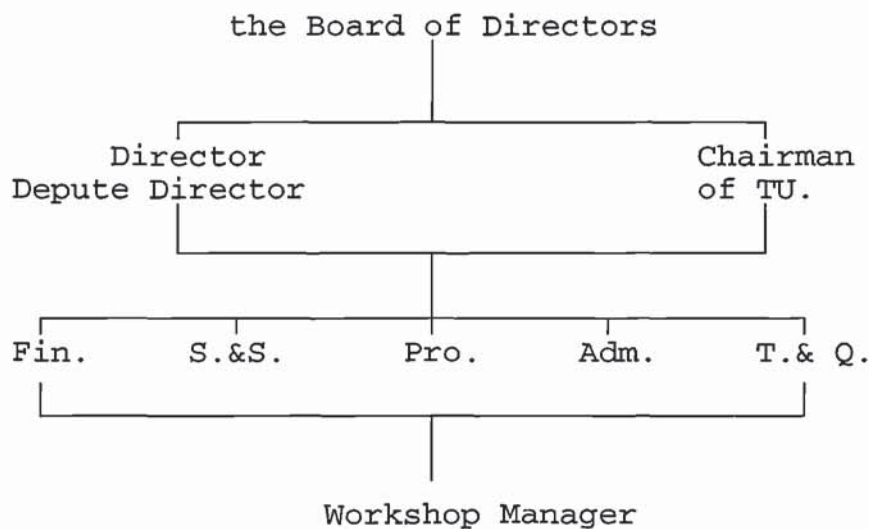
The Cultural Revolution was ended up in 1976, but the impact on the organizational structure in the company took time. The Figure 6 shows the picture at transition period from the Cultural Revolution to the economic reform in which the political working office transferred into the general office responsible for the general management issues, but another two political departments, the security office and the military office, were set up. Those were required by the central government to respond to the overall political situation, mainly the threat from USSR<5>. The revolutionary committee was still remained, until 1978 the eve of the Economic Reform.

*** no radical change at the beginning of the economic reform**

The Figure 7 shows that the revolutionary committee was abolished and the factory

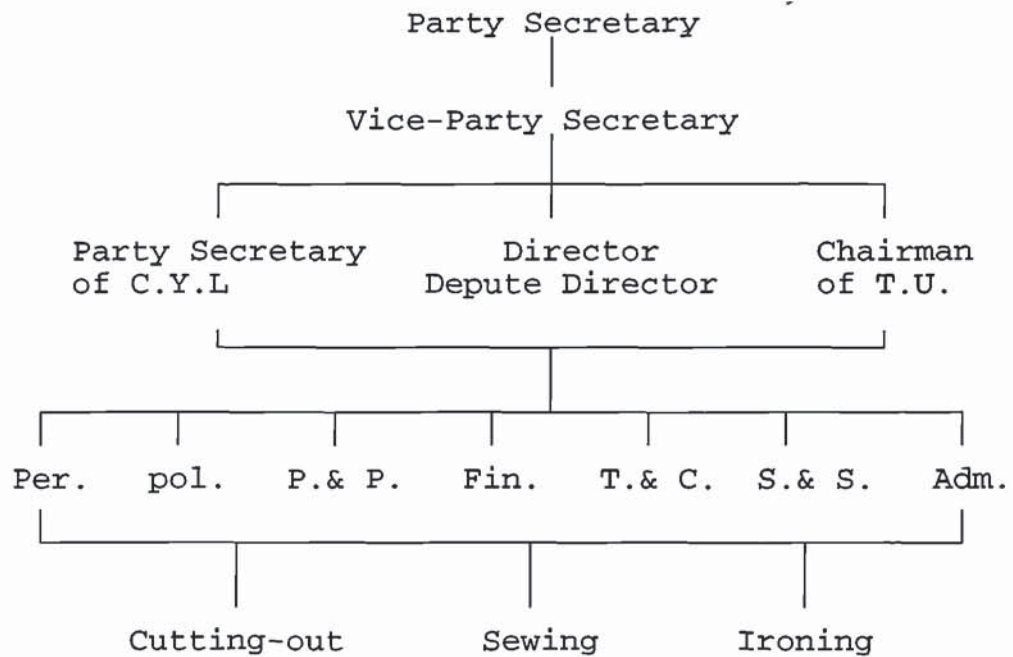
director was re-established by the end of 1978, which are the symbolic of the end of the Cultural Revolution. Another move was to set up a special office for the campaign, so called "learning from the DA QING". The DA QING was a model company for the Chinese industry in 1960s, but declined in the Cultural Revolution. This campaign supposed to be one step forward to recover the industry from the disorder of the Cultural Revolution. The Figure 7 also shows that the company was expanded into four workshops, instead of previous three.

**FIG.1. The Organizational Structure of the Beijing DA HUA
Shirt and Clothing Manufacturing Limited-liability Co.
(8.1954-4.1956)**



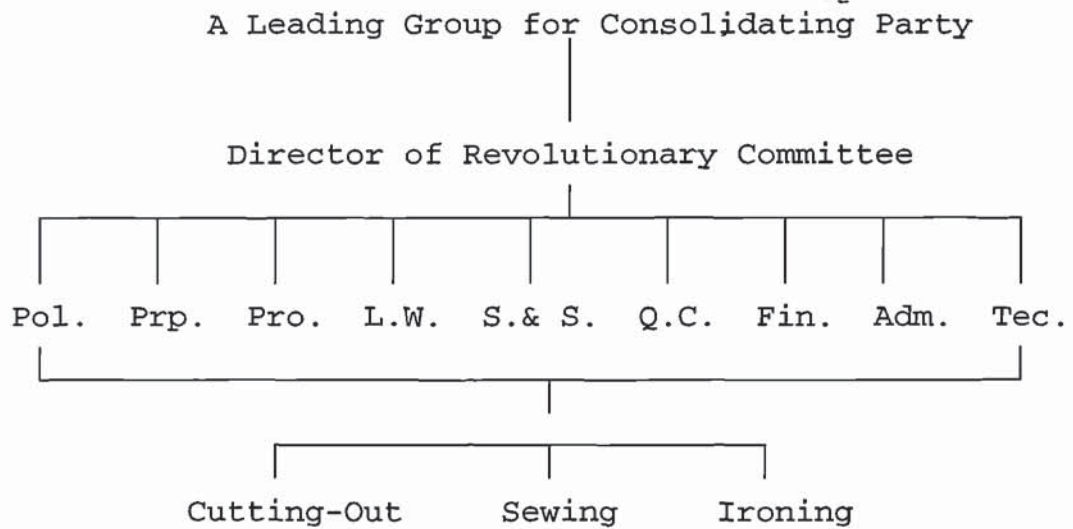
(Note: T.U. stands for the Trade Union,
Fin. stands for the financial department,
S. & S. stands for the supply and sale department,
Pro. stands for the production department,
Adm. stands for the administrative department,
T. & Q. stands for the technology and quality
control department.)

FIG.2. The Organizational Structure of the Da Hua Co.
(4.1956- 6.1966)



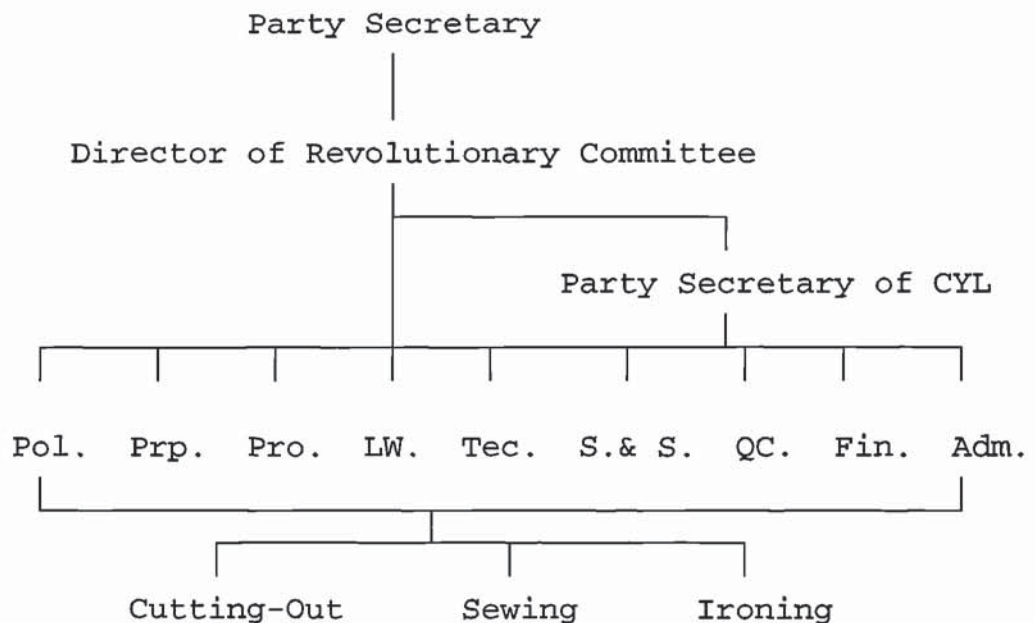
(Note: C.Y.L. stands for the Communist Youth League,
Per. stands for the personnel department,
Pol. stands for the political work office,
P. & P. stands for the production and planning
department.)

**FIG.3. The Organizational Structure of the Da Hua Co.
(6.1966 - 12.1969)**

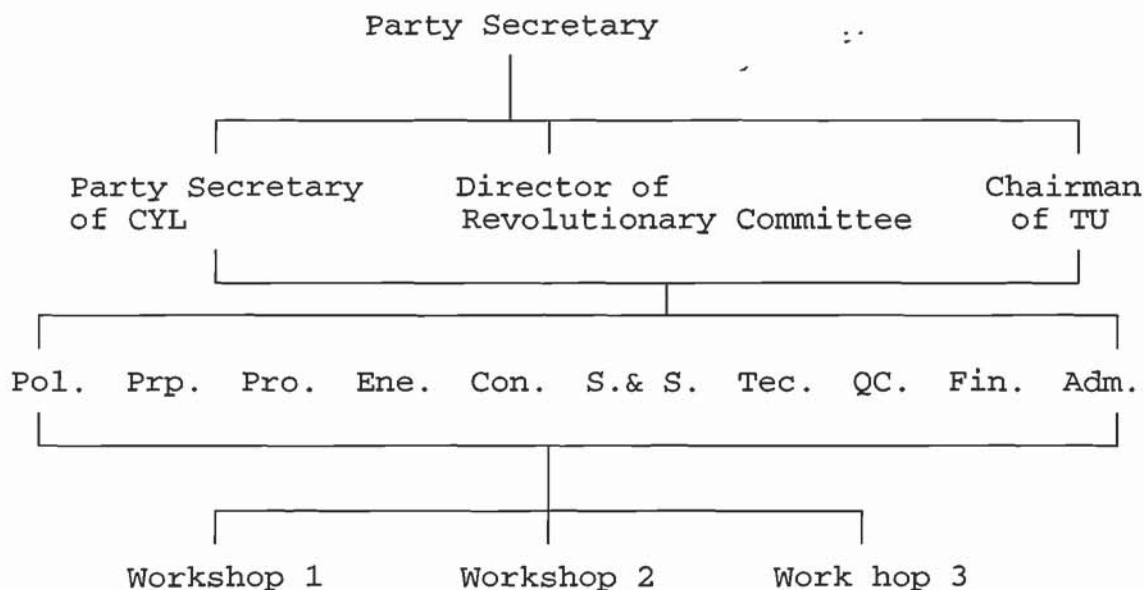


(Note: Prp. stands for the propaganda department,
L.W. stands for the labour wage department.)

**FIG.4. The Organizational Structure of the Da Hua Co.
(1.1970- 3.1973)**

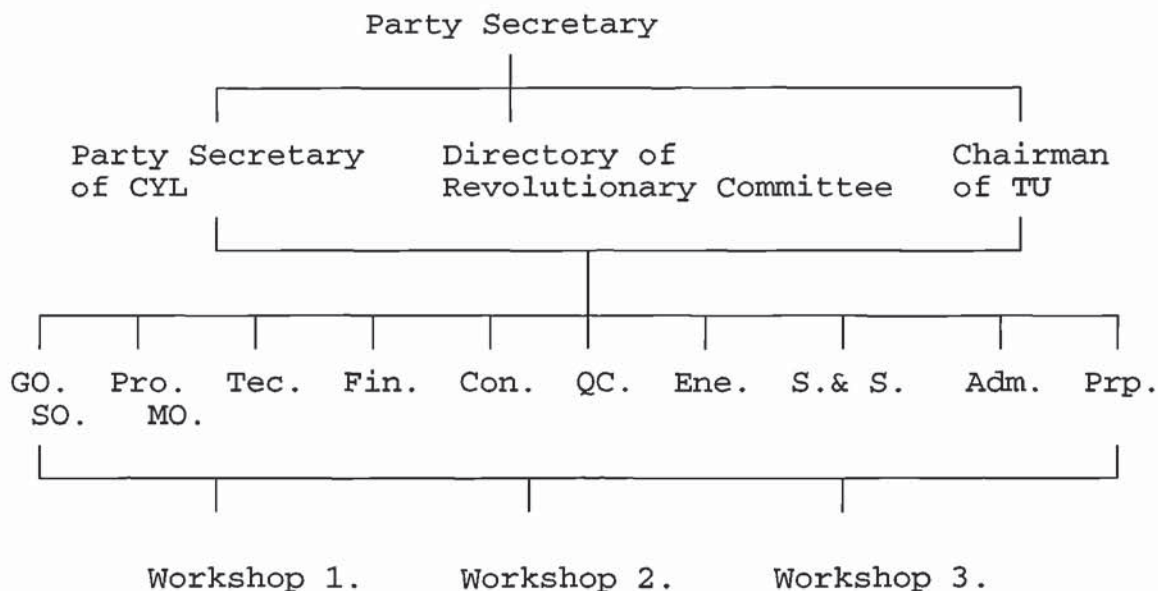


**FIG.5. The Organizational Structure of the Da Hua Co.
(3.1973- 6.1976)**



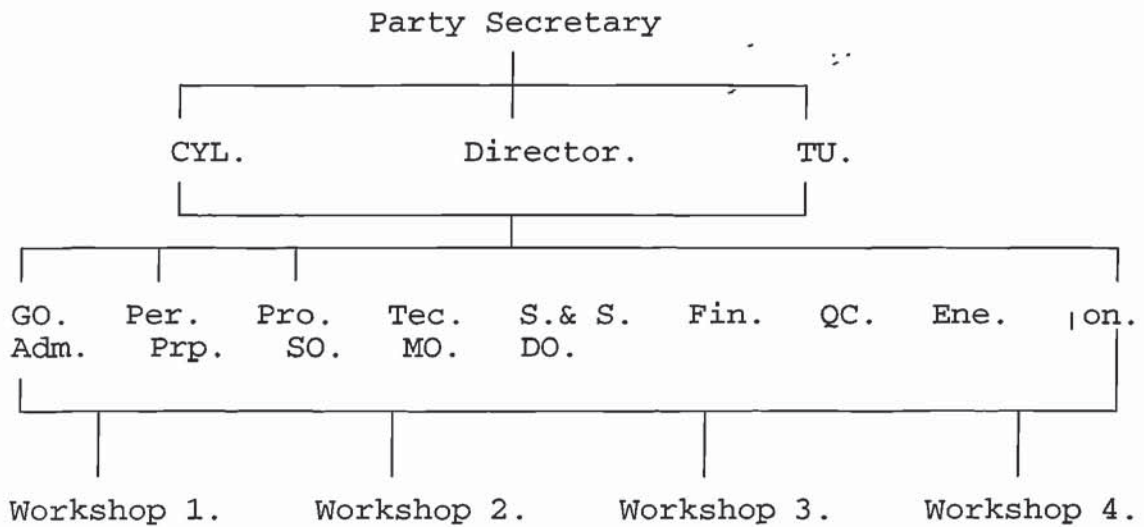
(Note: Ene. stands for the energy supply department,
Con. stands for the construction department.)

**FIG.6. The Organizational Structure of the Da Hua Co.
(6.1976- 12.1978.)**



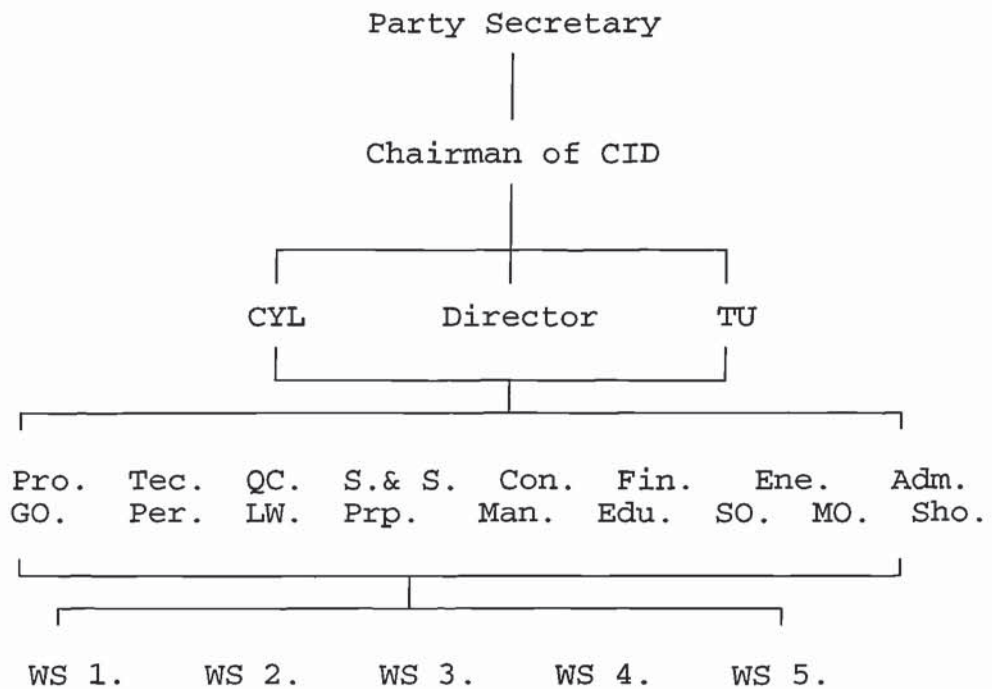
(Note: GO. stands for the general office,
SO. stands for the security office,
MO. stands for the military office.)

**FIG 7. The Organizational Structure of the DA HUA Co.
(12. 1978- 4.1982)**



(Note: DO. stands for the special office for learning from DA QING Company.)

**FIG 8. The Organizational Structure of the DA HUA Co.
(4.1982- 1.1985)**



(Note: Chairman of CID stands for the chairman of the committee for inspecting discipline,
Man. stands for the management office,
Edu. stands for the education department,
Sho. stands for the shop run by the company.)

Appendix 5. The Original Documents of the Four Contracts

(See attached papers)

THE UNIVERSITY OF ASTON IN BIRMINGHAM
THE CONTRACT MANAGEMENT RESPONSIBILITY SYSTEM IN CHINA
An Institutional Interpretation

DERONG CHEN
Doctor of Philosophy
1993

Appendix 5. The Original Documents of the Contracts

- 5.1. The Contracts of BEPGC
- 5.2. The Contracts of BTC
- 5.3. The Contracts of BDSC
- 5.4. The Contracts of BLSC

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