

ECONOMIC REFORM AND THE BEHAVIOR OF STATE ENTERPRISES IN CHINA

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INTRODUCTION

MORE than ten years have passed since China adopted its economic reform program and an open-door policy. During these years various measures have been taken to reform enterprise systems in order to give individual enterprises greater decision-making powers. However these market mechanism-oriented reforms have hit snags and run into a number of difficult problems including inflation, increasing unemployment, and growing income gaps. State enterprises, given autonomous powers in the absence of a truly competitive market and rational economic environment, have indulged in behavior that the reform program never expected. This erratic enterprise behavior along with widespread official corruption have extensively undermined the economic reform program itself. It was against this background that the student democratization movement in the spring of 1989 won broad support from citizens and workers.¹

In this article the author traces the course of reform in state enterprises in an effort to identify contradictions inherent in this reform. He will also look at the distorted economic behavior enterprises have exhibited due to ill-prepared and inconsistent reform policies.

I. ACHIEVEMENTS IN ENTERPRISE REFORM

A. *The Three Aspects of Enterprise Reform*

China's enterprise reform program has involved three aspects—reforming the relationship between the government and enterprises, reforming the relationship between enterprises, and reforming intra-enterprise relationships.

Regarding the first, the reforms intended to reduce to a minimum government regulation and control over enterprises, the purpose being to give them discretionary powers over production, marketing, and investment. In 1988 "The law on state industrial enterprises," "The law for the bankruptcy of state enterprises," "Regulations on the contract management responsibility system," and "Regulations on the lease management of state enterprises" were enacted to facilitate enterprise reform.

¹ In my personal view, the students and intellectuals called for further promotion of economic reform and open-door policies through political democratization while workers and other citizens were expressing discontent with the widening income gaps and inflation brought about precisely by the reforms and open-door policy. Their demands thus pointed in diametrically opposite directions. These two groups however shared in their indignation against corruption in government and among party bureaucrats.

The contract management responsibility system is now applied to most of the state enterprises. This system represents a less radical reform than a corporate income tax system that was the objective to be accomplished in the mid-eighties. It does however represent a new approach compared with the pre-1978 enterprise system, and the contract system introduced a new mechanism into Chinese enterprise management [37, pp. III-4-6] [4, p. 12].

Under this system, for instance, the principle of competition began to function, even if only partially, in Chinese enterprises. In 1988, 35.5 per cent of state enterprises contracted for quotas through competitive bidding. In cases where the contracted quotas are not fulfilled, the system calls for the risk to be borne by the top manager, by management as a whole, or by the employees as a collective. This risk-taking system is currently applied to 25 per cent of the Chinese state enterprises.

Regarding reform in inter-enterprise relationships, enterprise mergers have been encouraged. A total of 2,856 enterprises absorbed 3,424 other enterprises in twenty-seven provinces and municipalities. Aside from such enterprise mergers, partnerships and tie-ups are being promoted among enterprises which are compatible in technology, production, and marketing. By the end of 1988, 1,362 enterprise complexes were thus established in eighteen provinces and municipalities. Of them more than 100 are large complexes.

Reform measures have also been taken on a trial basis in intra-enterprise relations. The system of giving responsibility to the factory director was being applied in 95 per cent of the state industrial and commercial enterprises by the end of 1988.

Employee wages have also been linked with the quota system whereby wages are determined by the extent that contracted quotas (norms) are achieved. Quotas (norms) are set in accordance with various factors specific to each enterprise. The kinds of quotas linked with total wage are the profits earned, profits turned in to the state, taxes, output, sales, work volume, and foreign exchange earnings. The system of determining the total wage in this manner was introduced into more than half of the state enterprises by the end of 1988.

Reform in the employment system was also introduced on a full scale in the autumn of 1988. New workers are thus no longer hired as life-time employees but are hired on a contract basis. The number of contract workers in 1988 reached 9,920,000 persons, or 10 per cent of all state-enterprise employees.

Labor-force rationalization was also launched. Thirteen million employees at thirty thousand of the state enterprises, 13 per cent of all state enterprise employees, were transferred to new positions or otherwise reorganized into labor groups which were newly set up to be the basic units of the contract responsibility system.

It should be pointed out that labor-force rationalization is the most difficult part in intra-enterprise reform, for in the presence of large unemployment, dismissed workers can hardly hope to find alternative jobs. There are 11-12 million new job seekers each year. In 1988, government agencies and state enterprises employed 4,920,000, and collective enterprises in the cities employed another 2,630,000, thus giving employment to only 7,550,000 new job seekers. Most of the remaining job seekers found employment as peasants, at small enterprises in rural

districts, or were self-employed. When a state enterprise dismisses workers, the first fired are extra-plan workers (temporary workers). They do dirty, hard, and inferior (*zang, lei, cha*) jobs that regular workers do not want to do.² There is a total of 13 million such workers. If they are dismissed, few regular workers would refuse to take over their jobs.³

B. *Performance of Mining and Manufacturing Enterprises*

The above-mentioned enterprise reforms, coupled with other economic reforms, have contributed greatly to the development of Chinese economy since 1979. Let us take a look at the achievements made by mining and manufacturing enterprises in the ten-year period from 1979 through 1988 [9, p. 10].

In material terms, the output of coal, crude oil, iron and steel, chemical industrial materials, construction materials, machines and equipment, textiles, and twenty-four other items increased 2–4.5 times between 1978 and 1988. In value terms, mining and manufacturing output continued to grow at an average annual rate of 11.1 per cent in the same ten years. The output of state enterprises whose growth was slower than that of the other sectors also achieved an annual growth of 8.2 per cent in the same period. Their sales increased faster at an annual rate of 11.5 per cent. Profits earned by the mining and manufacturing sector also increased 9.7 per cent annually. Profits earned by state enterprises registered an annual increase of 7.6 per cent.

Improvements were also seen in economic efficiency. The norm of materials consumption per unit of product improved between 1978 and 1988 for sixty-six of the ninety-three products produced by major mining and manufacturing enterprises. Labor productivity also climbed 5.1 per cent per annum during the same period.

But not all economic efficiency indicators at the enterprise level improved. The profit-cost ratio, profit-fund ratio, profit-sales ratio, and the rate of cost reduction deteriorated [9, p. 11].⁴ This reflects slow progress in technological innovation.

Chinese enterprise reform thus has brought about significant improvements in institutional aspects as well as enterprise performance. This should be clearly recognized in evaluating China's reforms and open-door policy. It is also true however that progress has been slow with regard to labor-force rationalization and economic efficiency. As with the reform program as a whole, Chinese enterprise reform now faces serious troubles, forcing a review of what has been done. In the pages that follow, we deal with contradictions in the enterprise-reform program, situating them in the context of the general trend in the China's economic reforms.

² According to [37, p. IV-47], extra-plan employment in 1988 was 10,418,000; beyond this figure there are a lot of temporary workers [34, p. 22].

³ Estimated by the author from *Zhongguo laodong gongzi tangji ziliao* [Statistical data on labor and wages in China] (Beijing: Zhongguo-tongji-chubanshe, 1989) p. 67.

⁴ The wage/profit rate (profit comprises taxes paid) as corroborated by this author was 24.2 per cent for 1978 (in 1970 prices), 13.4 per cent (1980 prices) for 1982, 20.3 per cent (1980 prices) for 1987, and 20.5 per cent (1988 prices) for 1988 [27, p. 49] [28, 1989 edition, p. 333].

II. THE EXTENSION OF ENTERPRISE POWERS

A. *The Two Lines of Reform*

The reform of the Chinese economic system undertaken since the end of the 1970s has followed two main lines [16, pp.299–301]. One is the introduction of the market mechanism. Setting production goals by directives, traditionally the chief method of administrative control, has been reduced and largely replaced by resource allocation through economic means such as prices, interest rates, and taxes. The reform measures taken along this line were intended to liberalize prices from government controls and encourage the formation of markets for production materials, capital goods, finances, and labor. Particularly important were commercial and price reforms. This was the key to the whole reform program that rested on the introduction of the market mechanism.

But it was precisely in this area that the reform program met a number of serious problems and had to be slowed as it entered the implementation stage. Lifting of price controls threatened to cause inflation. Under the multiple-price system under which government-determined, government-guided, and market prices coexisted, the opening of production-goods and capital-goods markets facilitated rampant black-marketeering of government-controlled goods by official brokers. The formation of a labor market has also been difficult given the vast amount of unemployment population including disguised unemployment.

Chinese fiscal and financial reforms involved a shift from coercive administrative control over all types of financial operations to a “window guidance” type of control based on moral suasion [18]. But conditions are not ripe for the formation of a unified financial market. When financial markets exist only locally, it is difficult to fully and effectively apply the orthodox financial control methods composed of official discount rate policy, open market operation, and reserve requirements policy. The recent expansion of credit in China is largely a product of this contradiction specific to a transitional period.

The other line pursued in economic reform is decentralization of decision-making powers to enterprises and local governments. This centers on the expansion of autonomous management powers of enterprises. There being little resistance to decentralization, reform progressed fastest in this area. But sluggishness in market mechanism introduction has influenced the course of decentralization.

B. *The Three Stages of Enterprise Reform*

Expansion of enterprise powers is central to China's decentralization reforms. From 1978 through 1986, enterprise reform was successfully carried out through the following three stages [10, pp.211–15].

The first stage was from October 1978 through 1980 during which an enterprise fund system was experimented with at state enterprises. Under this system, the enterprise would retain 3–5 per cent of the total wage amount in accordance with the degree of fulfillment of production, quality, profit, and cost goals. The enter-

prise fund thus created was to be appropriated for welfare benefits and bonuses for the employees. By the end of 1980, 6,600 enterprises, or 16 per cent of manufacturing enterprises covered by the national budget, were following this system on a trial basis.

The second stage was from the summer of 1981 through early 1983. During this stage a contract profit-delivery responsibility system was introduced into manufacturing enterprises. Those enterprises which had fulfilled the contracted quotas were allowed to withhold part of the profits. This system was adopted by 36,000 enterprises by the end of 1981.

In the third stage that ranged from 1983 through 1986, a corporate tax system was introduced on an experimental basis. In June 1983 state enterprises began to pay corporate income taxes instead of delivering profits to the government. This was the introduction of the first version of the corporate tax system. The tax rate was 55 per cent for large and medium-sized enterprises, and eight categories of progressive rates were set for small enterprises. Of the after-tax profits, portions were paid to the government in the form of contracted profit transfer and adjustment tax, and the remaining portions were withheld as reserve funds. In actual cases, corporate taxes coexisted with the traditional profit transfer at the first version of the third stage.

The second version of the corporate tax system was introduced in October 1984. The new system abolished direct profit transfer in favor of corporate taxes as the single form of profit transfer to the government. The business consolidated tax (levied on the sales revenue gained by each enterprise belonging to the mining, manufacturing, commerce, trading, transportation, or service industries) was abolished and divided into a commodity tax (*chanpin shui*), value-added tax (*zengzhi shui*), salt tax (*yan shui*), and sales tax (*yingye shui*), levied according to business categories. Simultaneously, the land use tax and the city maintenance and construction taxes were introduced.

China's enterprise reform effort was geared to provide incentives to an enterprise by linking the amount of internal reserves it could withhold to its achievements. In this sense the unification of corporate tax systems was understood to be one of the final goals in the reform program, for under this system the enterprise would break free from the administrative controls of government offices there by securing its after-tax profits for use at its own discretion.

C. *Reemergence of the Contract Management Responsibility System*

Though the unification of corporate tax systems was considered one of the final goals of enterprise reform, it was clear that in the Chinese situation the tax system would not play its expected role because its function would be impeded by the skewed price system. Under the existing Chinese economic system, the amount of profit earned by an enterprise is determined not so much by the quality of management as by whether the government-set price of its products is high or not. In fact, the unbalanced price system set by the government is causing raw materials and energy industries to register losses while ensuring high profit rates for processing industries.

When a uniform tax system is applied to all enterprises where prices are irrationally set and a competitive market environment is absent, the inevitable outcome is growing income gaps among enterprises subject to different external conditions. Such income gaps generated by unequal competitive conditions (*ku-le bu jundeng*—the phenomenon of sufferings and blessings not equally shared) must be rectified. For this reason, the idea of uniformly applying the corporate taxes had to be abandoned. Instead, a regulatory income tax was introduced to complement the corporate taxes and to mitigate inter-enterprise differences in after-tax profits. Administrative interference by government offices has thus been called back in at the cost of the original idea of uniform corporate taxes.⁵

The enterprise reform program entered its fourth stage at the end of 1986. This stage was marked by the reintroduction of the contract management responsibility system. In that year the government intended to fully revise the prices of capital goods, but had to give up its price-reform plan as inflation which had started in the previous year began to gallop [30, p. 10]. While efforts to set equal competitive conditions for all enterprises failed, reform measures to increase enterprise powers were still continued. But if all enterprises had the same degree of autonomous powers when their external conditions were unequal, they would certainly suffer from unfair income distribution. In order to prevent this, the government offices in charge would have to regulate the powers of enterprises in accordance with the latter's respective business situation and external circumstances.

It was to meet this requirement that the contract management responsibility system was reintroduced. This system is basically the same as the contract system practiced during the second stage of reform (1981–83). Indeed it marked the reform's return to the second stage. In 1988 this system was applied to more than 90 per cent of the state industrial and commercial enterprises all over the country, and 95 per cent of the large and medium-sized state industrial enterprises [37, pp. III-1–2].⁶ The new contract management responsibility system is subdivided into several categories: (1) a contract system for increasing profit quotas to be turned over to the government (under which the enterprise assures the government agency in charge of yearly increases in profit quotas to turn over); (2) a contract system for the total wage bill (under which wage bills fluctuate in accordance with profits earned); (3) a contract system for definite amounts of losses or decreasing

⁵ According to D. Granick, there is no correlation between the amount of profit earned by Chinese enterprises and the salaries and wages paid to their employees. This is because Chinese supervisory authorities have no objective criteria for assessing enterprise performance. D. Granick, *Chinese State Enterprise: A Regional Property Rights Analysis* (Chicago: University of Chicago Press, 1990), pp. 187–189; As I pointed out in the text, uniformly applying objective criteria would not accurately reflect excellent or poor enterprise performance when irrationalities in the pricing system prevail. Enterprise performance inevitably has to be assessed in accordance with the individual situations of given enterprises.

⁶ According to this source, transformation of state enterprises into joint-stock companies, while being an important item in the reform program, is still at a primitive stage. According to statistics taken in 20 provinces and cities, experiments were made with more than 3,800 enterprises but 85 per cent of stock shares were held by employees and 13.5 per cent by other enterprises; only 1.5 per cent was opened for public subscription.

TABLE I
ENTERPRISE MANAGEMENT RESPONSIBILITY SYSTEMS IN JILIN PROVINCE, 1987

	(%)
Contracting for quotas of taxes and profits transferred to the government (the above-quota portions are shared in proportion to the contracted distribution ratio)	8.5
Contracting for progressive increase in taxes and profits transferred to the government (same as above)	8.0
Contracting for taxes and profits transfer and technological innovation	0.3
Contracting for transfer to the government of fixed amounts of taxes and profits (the overfulfilled portions are retained by the enterprise)	51.3
Linking the increment in taxes and profits transfer with the total amount of wages	4.1
Contracting for certain amounts of profits in standard years (overfulfillment entitles the enterprise to a lower income tax rate)	2.2
Contracting for a definite amount of output: this applies to enterprises generating little loss or profit (no transfer to the government and no subsidies)	10.5
Contracting for a definite amount of loss or progressively decreasing loss	7.5
Taking full risks for management	2.1
Others	1.5
Total enterprises to which contract management responsibility systems are applied	96.0

Source: [6, p. 10].

Note: Percentage of the total number of centrally and locally controlled enterprises in the province.

losses (under which an enterprise which chronically generates losses guarantees that its annual losses will be held under a definite ceiling); and (4) other various forms of the contract management responsibility system (these vary in detail but all provide that retained profits shall increase if the contract norm of the taxes and profits turned over to the state is overfulfilled and that the enterprise itself shall meet any losses from failure to fulfill the norm).

D. *Vicious Cycle*

In Jilin Province which has developed the contract management system more widely than any other province, ten versions of this system are followed as Table I indicates. The system in Jilin Province suffers from the following problems [6, p. 10].

First, the contract term is too short, only one year for two-thirds of the enterprises. This makes enterprise behavior myopic.

Second, the contract norms are individually agreed upon by each enterprise and the government agency in charge. Consequently, the retained profit amounts vary greatly from enterprise to enterprise, the gap between the largest and smallest even reaching fifteen million yuan or so. The differences moreover do not reflect

the good or bad quality of the management but the good or bad bargaining ability of the enterprise vis-à-vis the government agency.

Third, bonuses are increasing. At profitable enterprises the annual bonus has reached the allowable ceiling of 4.5 months regular pay. Ten major enterprises in the province have accumulated bonus funds totaling 7.5 million yuan, which are waiting for the additional disbursement to be permitted.

Fourth, investment in other industrial areas is barred as each enterprise must confine its activities to the business area defined by the contract it has with the government agency in charge. This practice hampers necessary industrial restructuring.

Fifth, the cost of activities and mechanisms required for intra-enterprise monitoring and bargaining with other bodies and individuals has increased greatly. At the Changchun motor factory, forty units comprising 351 persons had to be organized simply to check whether the contract norm was being fulfilled as planned.

Under the contract management responsibility system, a production norm is set for each individual enterprise in accordance with its business performance and the given price level. In setting the norm, *taojia huanjia* (bargaining) between the enterprise and the government agency in charge carries the greatest weight. A manager's worth is tested in this bargaining: an able manager is one who succeeds in bargaining a low contract norm. Therefore the size of retained profit depends not so much on whether an enterprise's business performance is good as on the bargaining power it can wield [33, pp. 3-4]. The enterprises chronically registering losses have no potential for profits. In their case they contract to reduce their losses to a promised level. If they succeed in overfulfilling this loss reducing norm, the difference is retained by them.

No matter whether in the black or in the red, the enterprise thus can increase internal reserves. Table II shows the shares of retained profits out of the total profits generated by state enterprises. As is clear from the table, the shares began to increase rapidly after reforms were launched in 1978.

The enterprise employees also can partake of the retained profits in the form of wage and bonus increases. For the government agencies in charge of enterprises, they too find the reason for being in bargaining with subsidiary enterprises and negotiating with the agencies of Ministry of Finance for protecting the benefits of subsidiary enterprises. They are adamant in keeping a tight grip on enterprises within their respective jurisdictions. The agencies of the Ministry of Finance can expect to get gradually increasing fiscal revenue every year. None of the four parties involved is fully satisfied because they are obliged to make a definite concession, but none takes the risk of losing everything. The contract management responsibility system is thus a product of compromise amongst all the economic bodies involved.

From the point of view of thorough economic reform, this system is far from satisfactory as it does not modify the fundamentals of the traditional system [29, p. 56]. The enterprise remains subjugated to administrative agencies. Even if an enterprise continues to suffer losses over years, it not only does not go bankrupt

TABLE II
 PROFIT RETENTION RATES AT STATE ENTERPRISES (AMOUNT OF PROFIT
 RETAINED / TOTAL PROFIT EARNED)

	1952-57	1958-61	1978	1979	1980	1982	1983	1984	1985	1986	1987	1988
State mining, manufacturing, and transport enterprises (A)		10.3	2.0	7.6		21.1	26.3	30.1	37.9			
State mining and manufacturing enterprises (B)			3.7							42.4		
State mining and manufacturing enterprises (C)					10							
State mining and manufacturing enterprises (D)										33.1	33.7	36.3
State enterprises (E)	3.6				22.27 ^a					38.9		

Sources: For (A), Dangdai-Zhongguo-shuangshu-bianjibu ed., *Dangdai Zhongguo zaizhong* [China today: finance (II)], (Beijing: China Social Sciences Publishing House, 1988), pp. 9-15; for (B), Xu Feiqing ed., *Zhongguo jingji tizhi gaige* [China's economic structure reforms], (Beijing: China Financial and Economic Publishing House, 1988), p. 158; for (C), Yuan Shouqi, *Zhongbao jingying zerenzhi* [Contract management responsibility system], (Beijing: China Economic Publishing House, 1988), p. 13; for (D), [27] [28, 1986-89 editions]; and for (E), [4, p. 12].

Notes: (Total profit earned) = (crude enterprise income) - (cost) - (transaction tax) - (appropriated fund repayed to the state finance) = (profit turned over and income tax) + (loan repayment) + (retained profit).

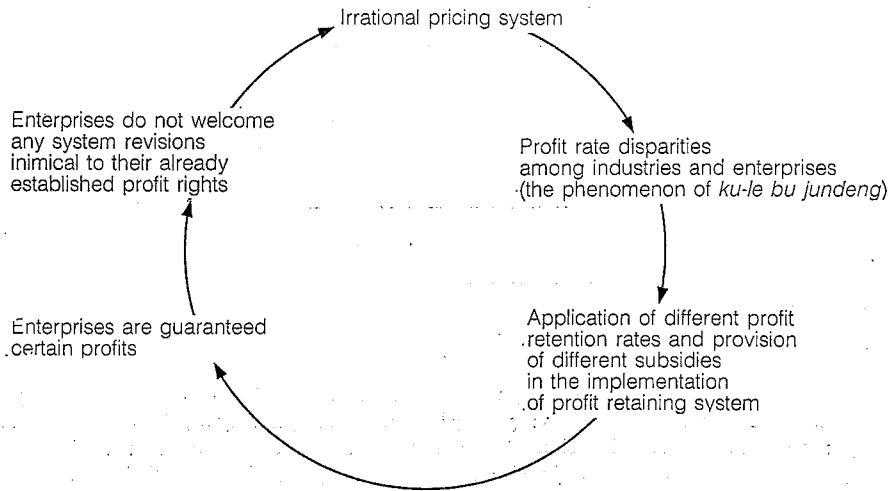
^a (Retained profit) / (total profit after settlement).

but can continue to pay the same wages and even bonuses. People are still eating "a big pot of rice" (*daguo-fan*) from the "iron rice bowl" (*tie-fanwan*), having no fear of losing privileges. Budget constraints on enterprises still remain soft. This is why the contract management responsibility system is often characterized as a "reform that has not modified the benefit allocations under the traditional system" [6, p. 18].

Already in 1980, Xue Muqiao pointed this out in his treatise on the "vicious cycle" [31, pp. 9-11]. According to him, the complicated formula giving government agencies in charge powers to determine the profit retention rates for individual enterprises presupposed irrational relative prices of commodities and thus in the end impeded progress in price reform (Figure 1).

As government activity reports have repeatedly admitted since the early eighties, introduction of the market mechanism centering on price reform is the key to economic reform. Nevertheless, it would be premature to carry out price reform across the board when gross demand still largely exceeds gross supply. To carry out such reform now would kick off inflation and invite social turmoil. On the

Fig. 1. Vicious Cycle Plaguing Reforms in Distribution



Source: By the author.

other hand, preserving the present irrational price system will keep the decentralization reforms in the strait jacket of the traditional system.

III. THE MARKET MECHANISM DOES NOT FUNCTION

A. Market-oriented Reform

When the market mechanism functions normally, prices go down if supply exceeds demand and go up if demand exceeds supply. Reacting to price fluctuations, individual enterprises and households adjust their supply and demand volumes. Market equilibrium is attained through these barometer and parameter functions of price, and the patterns of resource and income distribution are also determined accordingly.

As was earlier said, Chinese economic reforms since the end of 1978 purport expansion of enterprise autonomy and introduction of the market mechanism. In other words, the reforms aim at creating a situation where macroeconomic equilibrium is attained as the result of competition among individual enterprises acting to maximize their respective profits. The wages and fringe benefits of the employees are to be linked with the amount of profits their enterprise obtains. But for such a system to function more or less smoothly, a fair competitive environment should first be provided to enterprises. It is therefore logical that price reform to adjust relative prices and abolish the officially determined prices should have emerged as a crucial policy task. Obviously under an irrational and inconsistent price system, profit-rate gaps are bound to develop among industries and enterprises

TABLE
COMPOSITION OF

	National							
	Peasants' Agricultural Products Sales			Sales of Major Producer Goods			Sales of Industrial Products (Consumer Goods)	
	1978	1986	1988	1978	1986	1987	1978	1986
Government-determined price	92.4	37	24	100	64	60	97	45
Government-guided price	} 7.6	23	19		23			23
Market-adjusted price		40	57		13	40	3	32

Sources: Tian Yuan, "Jiage gaige yu chanquan zhidu zhuanhuan" [Reforming the price jiangzuo] [Lectures on enterprise pricing], *Jiage lilun yu shijian*, 1988, No. 1, p. 58; gaige: chenggong, wenti he chulul" [Price reform in the past decade: achievements, yanjiusuo-ketizu, "Zhongguo wujia sishinian" [The forty-year prices in China], *Zhongguo*

irrespective of their performance. Fair competition cannot take place under such circumstances.

To be sure the reform efforts to decentralize the economy and introduce the market mechanism have marketized the Chinese economy to a remarkable degree. Table III indicates that the weight of government-determined prices in the sales of various goods is rapidly diminishing, giving way to government-guided prices (fluctuating within government-designated margins) as well as market-adjusted prices. Reflecting different degrees of government intervention and market adjustment, the same commodity thus has come to have more than one price, a phenomenon known as multiple prices [17].

B. *Expansion of the Non-commodity Economy*

The diminishing weight of government-determined prices does not immediately mean full functioning of a market economy. Multiple prices obstruct fair market competition. The market-oriented reforms have on the one hand reduced the degree of government control, but on the other hand have not weakened and even strengthened trends in the non-commodity economy.

One trend is the increasing activity in the bartering of goods. China has been for years an economy suffering from shortages of goods. The introduction of the market mechanism of course has not eliminated this imbalance between supply and demand. Under these circumstances commodities whose demand is larger than supply sometimes function similar to hard currency. Table IV gives exchange rates of various commodities against coal. These rates were set through consultations by the State Bureau of Materials and Equipment, the State Administration of Commodity Prices, the State Economic Commission, and the State Planning Commission. These rates are applied when a supply-side enterprise directly deals

III
PRICE FORMS

Guandong Province			Jiangsu Province		
Peasants' Agricultural Products Sales	Sales of Major Producer Goods	Sales of Industrial Products (Consumer Goods)	Peasants' Agricultural Products Sales	Sales of Major Producer Goods	Sales of Industrial Products (Consumer Goods)
1988	1988	1988	1988	1988	1988
20	30	13.5	28	30	38
80	70	86.5	72	70	62

and transferring the property right system], *Jingji yanjiu*, 1988, No. 2, p. 12; "Qiye dingjia Zhongguo-shehui-kexueyuan-caimao-wuzi-jingji-yanjiusuo, "Jiage gaige"-ketizu, "Shinian jiage problems and way out], *Caimao jingji*, 1989, No. 11, pp. 3-4; and Guojia-wujiaju-wujia-wujia, 1989, No. 6, p. 8.

TABLE IV
COAL EXCHANGE RATES WITH OTHER COMMODITIES

	Coal (Ton)		Coal (Ton)
Steel (1 ton)	11-20	Rubber (1 ton)	55-70
Zinc / alminum (1 ton)	30-50	Urea (1 ton)	10-15
Lumber (1 cubic meter)	11-20	Barley (1 ton)	15-25
Sheet glass (1 standard box)	1.2-1.5	Rice / wheat flour (1 ton)	15-25
Refined soda / caustic soda (1 ton)	12-20	Bicycles (1 unit)	3.5-4
		Sewing machines (1 unit)	3.5-4

Source: *Jingji ribao*, November 19, 1983.

with a demand-side enterprise outside of the scope of planned distribution. Here commodity prices hardly function as a value indicator.

Even when there are market prices, bartering not based on money value is frequently carried out with commodities in short supply. Steel and aluminum are a case in point. The market price of steel is two thousand yuan per ton and that of aluminum ten thousand yuan per ton. But in actual practice, five tons of steel is bartered directly for one ton of aluminum. Money here fails to play its role as the general means of exchange [3, p. 15].

Central government control has been curtailed, but this does not mean the diminishing of control itself. The State Planning Commission now gives mandatory production directives for only 60 kinds of mining and manufacturing products compared with 120 in 1984, and the share of goods under state control also declined from 40 per cent to 17 per cent of total mining and manufacturing output. However, in lieu of the State Planning Commission, other government agencies,

TABLE V
SHARE OF PLANNING IN THE PRODUCTION

	Centrally Planned	Provincially Planned	Municipality Planned
Share of mandatory planning	12.44	21.51	23.97
Share of guided planning	9.48	29.12	26.91

Source: Zhongguo-jingji-tizhi-gaige-yanjiusuo-diaochazu ed., *Gaige: women mianlin de tiaozhan yu xuanze* (Beijing: Zhongguo-jingji-chubanshe, 1986), p. 53.

Note: One hundred for total production volume; the provincially planned volume includes the centrally planned volume; and the municipality planned volume includes the provincially planned volume.

TABLE VI
AUTONOMOUS POWERS DELEGATED TO STATE ENTERPRISES IN SHANGHAI

	All Powers		Partial Powers		No Powers	
	Number of Replies	%	Number of Replies	%	Number of Replies	%
Planning	67	21.9	198	64.6	41	13.4
Control over production	202	66.2	100	32.8	3	1.0
Personnel matters						
Cadre appointment rights	53	17.3	215	70.2	38	12.4
Worker dismissing rights	36	12.3	114	37.7	155	50.8
Financial	37	11.9	239	77.1	34	11.0
Price decisions	34	11.0	151	57.6	77	29.4
Sales	114	44.5	127	49.6	15	5.7

Source: Tao Youzhi et al., "Shanghai quanmin qiye jingyingzhe ze, quan, li diaocha" [An investigation on responsibility, authority and interest of managers in the state-owned enterprises of Shanghai], *Jingji yanjiu*, 1988, No. 4, p. 69.

Note: Survey questionnaire sent to 322 enterprises.

both central and local, are now giving the directives for norms to enterprises in their respective jurisdictions [5, p. 29]. A survey made in 1984 (Table V) showed that the share of mandatory planning increased as echelons went down from central to provincial and from provincial to municipal.

The State Council regulations promulgated in May 1984 imparted limited autonomy to enterprises in ten business categories including production, marketing, pricing, material purchasing, investment, personnel assignment, and wages. But the enterprises feel that they have been given but limited powers of management. Table VI contains replies to a questionnaire on this matter sent to state-enterprise managers in Shanghai. As the replies show, few enterprises have full autonomous powers on planning, personnel assignments, finance, and pricing.

There are similar other data. The directives for norms the State Planning Commission gives to Shanghai cover only 18 per cent of the local mining and

manufacturing output value. But a different picture appears if the situation is probed from the enterprise side. It is found that almost 100 per cent of the major products in the metallurgical industry and in cotton spinning and weaving as well as some sectors of the machinery industry are bound by mandatory plans. In some cases, output above the norms is incorporated into the mandatory planning [25, May 14, 1987].⁷

A second trend is the development of non-commodity relations in goods distribution [36, pp. 4–5]. Commodity rationing coupons exchangeable for specific goods were in use for 102 items in Beijing and 92 items in Shanghai in the sixties. Even in the seventies coupons covered 72 items. After the economic reforms were launched, coupons were gradually phased out so that in the first half of the eighties only grains, edible oils, and cotton cloth remained as coupon-exchangeable goods. But rationing coupons were revived one after another when inflation began in the summer of 1988. Rationing has thus been introduced for eggs, meat, sugar, bean jelly sticks, toilet paper, soap, detergents, and other daily necessities. Under the adjustment policy in 1989 and 1990, 85–95 per cent of grains, edible oils, eggs, and meat for home consumption were rationed by local governments.

Non-commodity economy is carrying in determining the fringe benefits provided by enterprises and other units. The share taken by house rent in an urban household's living expenses per head was 2.32 per cent in 1957 and 2.61 per cent in 1964. This share slipped to 1.52 per cent in 1983 and further to 0.71 per cent in 1988. This is because rent is frozen in the range of 7.7–7.8 yuan [28, 1989 edition]. This means that housing subsidies have been increasing. It is reported that public subsidies for housing, food rationing, medical services, and education amount to 80 per cent of the average wages and salaries of staff and workers [19] [21, pp. 39–41].

High-ranking cadres are paid a monthly salary of 250 yuan which is only two times higher than the national average. But such cadres can avail themselves of a personal chauffeured car, telephone, cadre house, special medical services, government-paid maid servants, and specially rationed goods. Such cadres thus receive benefits equivalent to three thousand yuan a year, and their real income is easily four times as high as the national average wage. Leading cadres at or above the vice-bureau director level are said to number only 90,000 nationwide, but those who enjoy this level of privileges are estimated at 210,000 or more [20].

Many commodities are rationed within the enterprise and other units exclusively to their constituent members. Of the high-grade rice consumed by staff and worker families in Beijing in October–December 1987, 40 per cent came from the units they belonged to in the form of special rationing. They received rice at a price 70 per cent lower than the market price. A survey conducted of 200 households in Shanghai, 70 per cent of them purchased New Year goods from the units they belonged to at a 30 per cent discount. If half of the 100 million urban households throughout the country purchased New Year goods at a price discounted 30 yuan per household, this would be equivalent to their receiving 1.5 billion yuan worth

⁷ A similar situation exists with the six enterprises in Beijing surveyed in 1985 [1, pp. 58–67].

of free foods every year [8, p. 32], about the same as the value of canned foods sold across the country in 1987. A survey taken in 1988 in Sichuan said that the "concealed wage" per capita not appearing in wage statistics nor on the bank books amounted to 36.46 per cent of the average wage in the province. The concealed wage according to the survey consisted of various cash-paid benefits, provision of benefits in kind, and diverted administrative funds [11, p. 26].

Enterprises distribute to their employees their own products as well as products they purchase from other enterprises. For this purpose large volumes of goods are exchanged between enterprises. For instance, steel products are bartered for passenger cars, gasoline for color TV sets, and chemical fertilizer for grain, fish, and meat. Grain rationing coupons are exchanged for eggs. Those in power can use inside tracks to favor petitioners, and in return they can expect to receive such items as refrigerators or color TV sets. On every festivity day enterprises give special rations. Banquets and outings at public expense have become rampant. Such spending flourished to such a degree that the State Statistical Bureau in its official bulletin in 1988 deplored it saying that "collective consumption at enterprises has increased remarkably" [25, February 24, 1988].

Fair competition on the market can hardly occur when provision of goods in kind carries an enormous weight and personal favor and corruption are widespread. Hua Sheng et al. in their article analyzed why the lifting of price controls did not lead to the formation of market prices [15, pp. 19-20]. First, they pointed out that most government agencies, using their authority, force enterprises under their control to sell their products at low prices. In some areas, local governments even close the local market to create multiple prices.

Second, they said a situation exists where priorities are given to "small interests of private individuals" rather than to "big interests of large bodies." Individuals and small units belonging to the branches of the Bureau of Materials and Equipment often sell at low prices in exchange for kickbacks. Bureaucrats having norm allocating powers face temptations to take bribes. For the enterprises on the buying side, whether they can obtain production materials at the official price or only at the market price makes a great cost difference. The norm license thus can serve as an instrument connecting administrative powers to money.

Third, in China the goal of enterprise behavior is not profit maximization but enterprise-welfare maximization. Thus an enterprise can still be considered to be acting rationally even if it sells its products at a lower price, or even for no price, provided that by doing so it can expect to draw benefits for itself and its employees in the form of preferential taxes and financial treatment.

Fourth, the Chinese economy is subject largely to administrative authority and personal connections and not yet fully based on a money economy. Even if one has money, one cannot always expect to be able to buy commodities. In this situation everybody has to depend on the personal favor of, or ties to, those in positions of power.

Fifth, state enterprises still hold monopoly positions. In 1985 the dual government purchase price of grains (state listed prices and higher prices for above-quota purchases) was abolished and replaced by a unified purchase option price. But that eventually turned out to be another official price.

As all these cases illustrate, the weakening of administrative control on the economy at the national government level has not necessarily led to the expansion of autonomous powers at the enterprise level. Nor has the abolition of price controls helped the price factor to perform its expected barometer-like functions. Thus it cannot be said that the price mechanism is functioning normally at China's present stage of reform.

IV. REFORM INCONSISTENCIES AND ENTERPRISE BEHAVIOR

A. "*Honest Men Are Losers*"

China's economic reform program at present is at a dead end. The abolition of central government economic control has not generated fair market competition. Instead the structure of the economy has become more complicated and multifarious; contradictions and conflicts have become aggravated. In this socioeconomic environment, Chinese enterprises have developed peculiar adaptive behavior generated by the pattern of economic reform during the past decade [32, pp. 10-11].

The first characteristic of enterprise behavior is linked to the inconsistencies between the reform measures which have been carried out at the macro and micro levels. While the market-oriented aspect of the reforms was initiated but later stalled, the traditional macro-control system has remained intact. At the same time, however, the micro-level enterprise reforms transferring powers to enterprises has continued to be promoted. Consequently two diametrically opposed economic mechanisms have come to exist side by side in a single national economy. On the one hand, enterprises which have been placed outside of government control are completely free, subject to no government control, direct or indirect. On the other hand, those enterprises which have remained under the old system are still unable to act on their own discretion.

The second feature determining enterprise behavior has been that the transfer of power to enterprises has not been in conjunction with them taking responsibilities and risks for their action. For this reason enterprises have generally taken the attitude that they will follow the reforms if and only if these bring explicit and direct benefits to them. Otherwise they will not accept reform.

The third feature is that reforms which promised direct benefits to the enterprises could not be applied simultaneously all over the country, but had to be confined to specific areas and industries, such as special economic zones, coastal open cities, *jihua danlie chengshi* (cities given the power to plan independently of their provinces), and industries that introduced the contract management responsibility systems. The areas and industries singled out for preferential treatment have become special areas where macro control practically does not function. Taking advantage of such disjunctive systems, shrewd enterprises and individuals play their games. This is a circumstance in which honest people lose. The "dishonest" use this opportunity to promote their self-interests committing all kinds of irregularities, and these phenomena are spreading.

The geographically uneven preferential treatment generates regional disparities.

TABLE
TYPES OF

	Personal Corruption		Corruption in Lowest and Party
	For Protection	Not for Protection	Through Relatives
Management	Patriarchal domination, corruption, and bribing (to protect relatives and acquaintances)	Bribing and other irregularities (on behalf of employee collectives or in economic action)	Nepotism and other underhanded dealings (through relatives)
Law	Protecting relatives or acquaintances having committed economic crimes	Speculation and other economic crimes	Securing licensing rights and favorable distribution shares for the sake of relatives
Production	Setting up sub-contract enterprises to profit relatives and acquaintances	Contracting with specific selling enterprises on preferential conditions	Provision of modern equipment for relatives
Distribution	Special favors for relatives and acquaintances	Bribes and gifts to obtain preferential treatment	Provision of preferential treatment in housing for relatives

Source: Li Nanxiong, "Guanyu Zhongguo fubai xianxiang de yanjiu," *Jingji shehui tizhi money and power*] (Beijing: Zhongguo-zhangwang-chubanshe, 1989), p. 13.

The regions not favored become discontented. Raw materials produced in inland regions where prices are kept low naturally flow to coastal areas where the prices for the same products are high. The inland regions thus suffer from shortages of materials and the local governments have had to close their borders. What is called *zhuhou jingji* (parochialism) appears in some provinces and regions where the local governments and local industries are united in pursuit of their exclusive interests [26, pp. 15-16].

The fourth feature is that administrative powers are commodified. As the commodity economy expanded, the government agencies and bureaucrats monopolizing material allocation rights and business licensing powers have developed the art of translating their powers into business transactions and maximizing their particular economic interests. In the absence of market mechanisms, bribery, nepotism, and personal favor are the only means of influencing the economic processes. Bureaucrat brokers (*guandao*) have taken over, and paper companies established by the government agencies and the party organizations have become fashionable. Shops and other commercial units increased from 1,260,000 in 1978

VII
CORRUPTION

Echelon Administrative Organizations	Corruption in Enterprises	
	Through Not Relatives	Making Use of Personal Ties
Gifts and excess favor for certain persons	Nepotistic hiring	Conceding position to subordinates prior to retirement
Bribing and other intervention to evade law enforcement	Crimes in commercial transactions committed by employees on the strength of the prestige of their enterprises	Tax evasion and illegal retention of profits
Intervention and bribing to obtain preferential treatment	Special subsidies provided by personnel to factories and workshops controlled by their subordinates	Obtaining permission for production outside of planning and other privileges
Mutual assistance to obtain material benefits	Bonus payments in kind, collective consumption at the workshop level, extravagant gifts, preferential treatment in fringe benefits and housing allocation	"Unit chauvinism" (<i>danwei zhuyi</i>) whereby provision of subsidies, allowances, and houses is made limitlessly

bijiao bianjibu ed., *Fubai: huobi yu quanli de jiaohuan* [Corruption: exchange between

to 12,670,000 in 1988. The number of *gongsi* (companies partially characterized as government agencies) grew from 270,000 in 1985 to 477,000 in 1988, 39 per cent of them established in the second half of 1986 [24; p. 33] [25, August 30, 1989].

The inconsistency in the reform program and the delay in the formation of institutionalized markets have created major pockets in the economy where no control is practiced. These pockets have created opportunities of windfall profits. Official and private bodies are frantically running after such profits. This situation has resulted from contradictions arising from the reforms. Table VII provides an extensive list of the forms of corruption by individuals, party organizations, administrative offices, and enterprises, in the areas of organizational management, law enforcement, production, and distribution.

B. *The Struggle over Quasi Rent*

How are the "pockets" created by the reforms explained in economic terms? The pocket is most graphically explained by the emergence of "quasi rent" due to

Under the dual pricing system where the market and official prices coexist, there is the possibility of goods which are supposed to be sold at the official price being sold at the market equilibrium price P_1 . Therefore, for the enterprises between O and M , P_1P_0RQ , which is the differential between the market price P_1 and official price P_0 , emerges as quasi rent. Also, QRA , the differential between the sales price and production cost, is another portion of quasi rent. Thus fierce struggles occur to win the lion's share quasi rent, P_0RAQP_1 . In this struggle enterprises do all they can to sell products through illegal channels and buy goods for resale. Meanwhile government agencies and their bureaucrats try to make fortunes using their power to issue goods distribution permits.

How large are quasi rents? Hu Heli calculated the amount of quasi rent arising from the dual pricing system using the following formula [13, pp. 34–35]:

$$R = \sum_{i=1}^n (P_{fi} - P_{oi}) Q_i,$$

where R : quasi rent, P_{fi} : market price of i th item, P_{oi} : official price of i th item, and Q_i : volume of extra-plan sales of i th item.

According to his calculations, quasi rent totaled 356.9 billion yuan. He broke this down into 150 billion for the differential between the official and market prices of government-controlled commodities, 113.88 billion yuan for the differential between the official and market interest rates, and 93.04 billion yuan for the differential between the exchange rate applied to imports and the market exchange rate [14, pp. 10–15].⁸ The quasi rent total was equal to 25.5 per cent of China's GNP in 1988. If the nation's high ranking bureaucrats skimmed off 5 per cent of the total, they may have easily pocketed 17.8 billion yuan. If so, they would have embezzled far more money than the total wages and salaries of 8.17 million public servants in government service and party functionaries which totaled 13.6 billion yuan in 1988.

C. *Distorted Enterprise Behavior*

Given the above-mentioned immaturity of the market mechanism, lack of consistency between reform measures, and resultant presence of pockets, the behavior of Chinese enterprises at the present reform stage still deviates from that of an "orthodox enterprise." By "orthodox enterprise" is meant an enterprise which, in its pursuit to maximize profits, actively promotes research and development, makes investments, extends marketing, and procure financing, thus endeavoring to increase productivity and achieve technological progress and finally to accumulate a significant volume of profits for its further growth and development [22, pp. 80–81].

In the Chinese economic reform program, priorities were given to the decentralization of power to enterprises. This was intended to create orthodox enterprises. In the area of laws and regulations, Chinese enterprises have acquired greater autonomy over production, research and development, marketing, employment,

⁸ Quoted from Zhao Renwei, "Dui dangqian shouru fenpei bu gongkai wenti de jidian kanfa" [Some views on the unfair income distribution at present], *Jingji yanjiu*, 1989, No. 12, pp. 8–9.

TABLE VIII
USES OF RETAINED PROFITS (HEERVIN MUNICIPAL DISTRICT; 149 ENTERPRISES, 1988)

	Total (Thousand Yuan)	Share in Retained Profits (%)			
		Average	Large Enterprises	Medium-sized Enterprises	Small Enterprises
Production development fund	56,056.7	34.0	34.5	37.6	25.0
Bonus fund	10,581.2	6.5	9.6	1.2	6.2
Welfare fund	98,112.1	59.5	55.9	61.2	68.8

Source: [23, p. 26].

wages, internal reserves, equipment expansion, and merger with other enterprises. Even so, more than ten years after the reforms were launched, the corporate behavior of the vast majority of Chinese enterprises remains far different from that of orthodox enterprises. They do not fully exercise legally recognized powers regarding research and development, technological innovation, and the expansion of internal reserves. Rather than winning new customers through active marketing, they seek to profiteer by dint of the differential between the official and market prices. Instead of increasing internal reserves, they prefer to appropriate profits for bonuses and fringe benefits to their employees.⁹

A survey conducted of 149 state manufacturing enterprises in Heerbin City revealed the uses of retained profits as shown in Table VIII. There is a regulation that the share of the production development fund should be 50 per cent or more of the total retained profits, but this regulation is not honored. Enterprise welfare costs are above 50 per cent in all cases [23, p. 26].

Organizationally the enterprise has been revamped as an body operating to maximize profits. But the actual behavior of the now largely autonomous enterprise has not fulfilled the expectations of the reforms. Case studies on distorted enterprise behavior have been conducted by the Institute of Economics of the Chinese Academy of Social Sciences. The studies covered forty state enterprises located in cities and counties in Wuhan, Changsha, Zhenjiang, and Lin-an [7, pp. 41-47]. According to the studies, the behavior of these enterprises deviates from that originally expected to arise from the economic reform program in that they pursue their individual self-interests in the procurement of funds, product marketing, inventory formation, and decision making. Below are examples of enterprise behavior taken from the institute's case studies.

1. *Fund procurement*

Inflation spiraled in 1988. The price of zinc, the mainstay raw material of the Zhenjian City storage battery factory, soared 2.6 times on the open market

⁹ In fact, the factory director is the champion of the employees' interest; 80 per cent of the retained profits are appropriated for bonuses and fringe benefits and only 20 per cent for productive investment [2, p. 8].

between January and September of that year. But the amount of zinc procurable under the economic plan, which accounted for 43 per cent of the total zinc consumed at the factory in 1987, was reduced to only 20 per cent in 1988, only half of which was actually allocated. Finding funds to buy the raw material became a life-or-death matter for this enterprise.

In this context, the Chinese enterprise's capacity to pay for raw materials depends on its ability to obtain bank loans. An enterprise at Wuhan City, having fixed assets worth only 500,000 yuan, was able to draw a 25 million yuan bank loan because its director had strong personal connections with bank officials.

2. *Product marketing*

Commodities in short supply are now a more powerful means of exchange than money. Because of this, local governments are anxious to keep scarce and precious local commodities under their direct control in order to utilizing their exchange value for the benefit of the local economy and specific individuals. By accepting such control, enterprises have to deliver their products at low prices, but they are compensated by preferential treatment in the forms of low or no taxes, better access to loans, easy permission to investment, and higher ceilings for bonus funds. To receive the title of "excellent entrepreneurship" also benefits enterprise managers. These all serve as incentives for the enterprise. A steel mill at Hunan Province thus is delivering 95 per cent of its products to the government at low official prices, which are one-tenth of the market prices.

3. *Inventory formation*

Wuhan radio and telecommunication equipment factory usually needs a two-month inventory of plastics for video tape-recorders. But a survey made in September 1988 showed that the factory had a plastics inventory that would keep it running for one year.

There is also a tendency for enterprises to stock raw materials which are irrelevant in kind, standard, and quality, to their actual production. They keep such materials in the hope that they can exchange them for materials they need for production. In other cases, large stocks of unrelated goods are held just for resale and profiteering. An enterprise in Lin-an County bought ten thousand tons of coal and resold it three months later. This brought it a profit of one million yuan.

As bonuses are often paid in kind, a factory's inventory includes daily necessities for this purpose. There is even an enterprise which built a refrigerated warehouse simply to stock chickens for distribution to employees on festival days.

4. *Price determination*

Fifty-six enterprises in Zhenjiang City were forced to spend 42 million yuan extra following raw material price hikes between January and June 1988. These enterprises increased their revenues by 48 million yuan by raising the prices of their products. Their cost increases were thus 114.3 per cent shifted onto their

product prices. Few enterprises strive to absorb raw material cost increases by rationalization and other means of cost reduction.¹⁰

These examples of distorted enterprise behavior resulting from insufficient operation of the market mechanism characterizes not only state enterprises but also *xiangzhen qiye* (village and township enterprises). They pursue temporary interests by utilizing connections with local government officials, or even by selling fake drugs, fake wines, and the like. In coastal cities like Wenzhou, local self-employed merchants and private enterprise owners openly exchange bundles of small banknotes valued at 103, 104, or even 105 yuan, for a single 100 yuan note, taking advantage of the fact that a larger note is more convenient for carrying to distant places and for bribing. Cash transactions make sense for tax evasion as well as for the black-marketeering of scarce commodities [12, pp. 59–60].

CONCLUSIONS

China's economic reforms have reached a point where they can go neither forward nor backward. Conditions are not ripe to carry out a drastic economic and price reform in a single step. Considering the social chaos that could arise, China has to proceed extremely, prudently, and circumspectly in its economic reforms, trying in this process to mitigate the various contradictions and obstacles.

The market economy has its own principles that need to be followed and an order that needs to be respected. Just removing controls and liberalizing everything does not create a market economy. How to build and control a market economy is still a difficult task facing China today. It will be a long time before China can institutionalize new economic reform measures and get them to work normally. Until such a time, the distortions in enterprise behavior will not be corrected.

¹⁰ According to Zhang Zhuoyuan, "Woguo wujia shangzhang de yuanyin yu duice" [The cause of China's inflation and the counter plan], *Guangming ribao*, April 23, 1988, enterprises generally shifted 70 per cent of the material and energy cost increments onto product prices. And 90 per cent of the material cost increment is shifted onto the product prices [35, p. 10].

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