Ownership of Enterprises in China
Cost of Ownership and Cost of Contracting

Aarhus School of Business
Department of Management and International Business
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Resume

The thesis analyses three types of ownership of enterprises in China through the last 25 years. The three types of enterprises are private farming, under the Household Responsibility System, collective enterprises in the form of township and village enterprises, and finally state owned enterprises. The thesis aim to answer the following questions:

- What characterises the three types of ownership?
- What are the major costs associated with the ownership types?
- How have the ownership types changed in the reform period?
- Are the changes in ownership justifiable?

To help answering these questions the transaction cost theory is applied. According to the theory, the optimal type of ownership is the one that minimizes the sum of cost of ownership and cost of contracting. Cost of ownership consists of the costs associated with carrying out a transaction within hierarchy. Cost of contracting costs, on the other hand, consists of the costs associated with carrying out a transaction in the market. The information for the thesis is gathered through secondary literature, a field trip and some use of statistical material.

Cost of contracting has overall been reduced during the last 25 years, as markets in China have developed. In the beginning of the reform, it was necessary to have close ties to the authorities, to get access to the needed input. With the development of markets, close relations to the authorities are no longer so important, since it is now possible to rely on the markets for most inputs.

The institutions for a traditional market economy were absent as the reform began in 1978. The development of the markets has had great influence on the ownership forms in China. The development of other institutions, such as a legal system, has also reduced the costs of operated in the market without the support of the local or national governments. The reduced cost of contracting has meant that it has become less attractive to be closely associated with the authorities.
Cost of ownership has been dominated by high costs connected with the monitoring of managers and political interference by the authorities. It has been attempted to reduce the high monitoring cost through the implementation of various responsibility systems. In the beginning, these responsibility systems were often very simple to make them easy to administrate. The cost of political interference is still high for the enterprises that remain closely associated with the authorities. Cost of de facto private ownership has, at the same time, been reduced as legal protection of private property and corporate law have improved.

There were introduced responsibility systems to reduce the agency cost in all three types of enterprises early in the reform era. Especially the responsibility system in agriculture was successful, the success came, as the system was easy to implement and monitor. Each household received a bonus according to the amount of grain handed over to the production team. Actual household farming was introduced in the mid 1980s, the land remained collectively owned, but the individual households bought the needed input, and sold their output on the markets. This was possible because the price reform of 1984-1985 had meant liberation of the markets, and thereby greatly reduced the cost of contracting. In the beginning of the reform, there were widespread problems with households exploiting the land, due to the short duration of the contracts. As the contract period got longer, the problems with short-termism were reduced.

The monitoring of managers in township and village enterprises and state owned enterprises proved more difficult. Continuous monitoring problems in the township and village enterprises, led to the introduction of a system easier to monitor. The individual enterprises were often rented out to the management, the rent was fixed and not influenced by the actually profit in the enterprise. This reduced the monitoring costs. However the contracts had a short duration and this lead to short-termism and defraud, such as managers removing assets, prior to handing back the enterprise to the local government. The contracts between the local government and management later became more advanced to prevent some of the problems with short-termism and
defraud. An increasing number of township and village enterprises became de facto private enterprises during the 1990s, as the advantages of having close ties with the local governments were reduced.

Unlike the situation with the township and village enterprises, the state owned enterprises have not had much flexibility in changing their relations with the central government; instead the state owned enterprises remain closely controlled by the government. In the beginning of the reform, the state owned enterprises benefited from having the best access to resources via government allocations. However, as the markets developed, the benefits from the close relations with the government were reduced.

While the benefits of the close relationship to the state have been reduced, the disadvantages remain high. The state owned enterprises suffer from high agency costs and political interference, which make the objectives of the enterprises unclear. The official target is financial results however the managers are rewarded according to their political achievements, such as over-employment. The official policy is now to sell off the majority of the state owned enterprises. It seems very difficult to change the ownership when the government continues to insist on being able to use the enterprises as political tools. It would simply be too costly to create and enforce contacts between the government and new owners that allow the widespread political interference in the enterprises.

The general changes in the ownership of agriculture, and the township and village enterprises seem justifiable. Both types of ownership have had the freedom to experiment with responsibility systems to find suitable solutions to the problems at hand. The state owned enterprises have suffered from having been imposed many non-financial objectives, and they have not had the same opportunities to experiment with responsibility systems.
There must be farmers to produce food, men to extract the wealth of mountains and marches, artisans to produce these things, and merchants to circulate them. There is no need to wait for government orders: each man will play his part, doing his best to get what he desires. So cheap goods will go where they will fetch more, while expensive goods will make men search for cheap ones. When all work willingly at their trade, just as water flows ceaselessly downhill day and night, things will appear unsought and people will produce them without being asked. For clearly this accords with the Way and is in keeping with nature.

Sima Qian, Han dynasty

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1 The source for the English version is Chow (2002: 13). The Han dynasty lasted from 206 BC to 220 AD.
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Acronyms

CMRS  Contract Management Responsibility System
GCS   Group Company System
HRS   Household Responsibility System
MES   Modern Enterprise System
RMB   Ren min bi (the currency of Mainland China)\(^2\)
SOE   State owned enterprise
TVE   Township and village enterprise

\(^2\) The Chinese currently is also known as the *yuan* and has the ISO code “CNY”. The RMB is locked to the US dollar, and the exchange rate has been constant at 8.28 yuan to the dollar since October 1998 (The Federal Reserve Board 2004).
1 Introduction

Since China’s economic reform started in 1978, the ownership structure of enterprises has undergone significant changes. Three ownership types will be analysed in this thesis: the privately managed farms under the Household Responsibility System (HRS), township and village enterprises (TVEs), and state owned enterprises (SOEs). These three types of ownership have all grown out of the planned economy. Today they dominate the Chinese economy together with private enterprises and foreign investments.

As the reform started in 1978 industrial production accounted for almost half of the official measured GDP, despite the fact that much of the workforce remained engaged in agriculture. The secondary industry was dominated by the large SOEs. In the reform era the boom in manufacturing has mainly come from the TVEs. The situation is starting to change so that private entrepreneurs and foreign investors either in wholly owned enterprises or in joint ventures now increasingly lead the ongoing boom in the economy. Economic reforms have not been carried out according to any comprehensive blueprint. Instead the reforms have been experimental, summarised by the Chinese saying “crossing the river by feeling for the stones” (EIU 2004: 32-34).

One obvious reason why the three types of ownerships are interesting to analyse is their importance in Chinese economy, especially as a dominant absorber of labour.

<table>
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<tr>
<th></th>
<th>Agriculture</th>
<th>TVEs</th>
<th>SOEs*</th>
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<tr>
<td>Employed (millions)</td>
<td>325</td>
<td>133</td>
<td>73</td>
</tr>
<tr>
<td>Share of workforce</td>
<td>43%</td>
<td>18%</td>
<td>10%</td>
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There is always a high degree of uncertainty associated with Chinese Statistics. Many other sources estimate the number of workers in the TVEs and especially in the SOEs to be significant higher. According to The Economist (2000: 71) the SOEs represented

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3 The statistics include people working with animal husbandry and fishery.
4 Workers in state owned units including some state organs and institutions.
44% of urban employment, while the share, in year 2000, only was 35% according to the National Bureau of Statistics of China (2003: 123). As it will be discussed later, one reason to these differences might be unclear definitions of the ownership types.

The change in ownership happened in three different ways. Within the agriculture the changes were initiated by the farmers, they could see great advantages in doing things differently and in retrospect they got the government’s blessing. The changes and expansion of the TVEs were encouraged, but not directly controlled, by the government. While the government always have been in direct control over the changes in the SOEs.

1.1 Problem statement

The aim of this thesis is to analyse the existence of three dominant ownership types in China. These are private ownership in agriculture under the Household Responsibility System, township and village enterprises, and finally state owned enterprises.

The theory of transaction costs will be applied in analysing the changes in the ownership structure. The theory’s main point is that the optimal type of ownership is the one that minimizes the transaction costs. Transaction costs can be separated into two main groups, those related to keeping a transaction within the hierarchy (cost of ownership) and those related to carrying out the transaction in the market (cost of contracting). The three ownership types have not been constant over the last 25 years, instead they have undergone great changes. Therefore, this thesis will take a dynamic approach to the changes within these ownerships.

The thesis’ aim is to answer the following questions with the help of the theory of transaction costs:

- What characterises the three types of ownership?
- What are the major costs associated with the ownership types?
- How have the ownership types changed in the reform period?
- Are the changes in ownership justifiable?
1.2 Structure

Chapter 2 gives an introduction to the theoretical framework of the thesis, which mainly consists of the transaction cost theory as used by Hansmann (2000). There follows an introduction to previous research using the transaction cost theory to analyse various aspects of the Chinese business environment.

Chapters 4 to 6 each analyses one of the ownership types covered. Each chapter will be divided into a number of subchapters covering the costs most relevant to the specific types of ownership. Each chapter has its own conclusion. Chapter 6 will be an overall conclusion of the thesis.

1.3 Delimitation

The scope of the thesis means that it is not possible to cover all costs related to the different ownership types. The analyses of the different ownership models are therefore not identical in their structures, as focus in each chapter will be put on the costs most relevant. Especially the HRS chapter is different from the other two, as the enterprises under the HRS all are family farms. This gives the possibility to go more in depth with issues specific farming.

It is not possible within the scope of this thesis to discuss industry specific issues to any great extent as the TVEs and SOEs operate within many different industries and therefore also operate in markets with different competitive conditions such as the degree of market power and general market errors. Focus, when analysing the TVEs and SOEs, will therefore be on non-industry specific costs. However, many of the TVEs are engaged in processing agricultural products, these will be given special attention in chapter 4.2.3 as to follow-up on some issues raised in chapter 3.

This thesis will not try to make a theoretical justification of the transaction cost theory. The goal of this thesis is to see if the transaction cost theory together with the changes in the Chinese society can help justify the changes in ownership structure.
The thesis will not deal with geographical differences within China. It is not the thesis’ goal to determine whether the policies of the Chinese government have been economical optimal or not. Instead it is the goal to see if the ownership structures that have developed can be justifiable when taking into account the society they exist in.

The thesis will only focus on Mainland China, which in this thesis is defined as the People’s Republic of China, excluding Taiwan as well as the special administrative regions of Hong Kong and Macao. The reason for excluding these areas is that they have different business structures, furthermore the society and recent history of these areas differ significantly from the ones of the Mainland. The goal of this thesis is to analyse the changes that have happened after the Mainland introduced the reforms in 1978. It is therefore not considered necessarily to include the other regions, as they have not experienced the same change in ownership structure. Furthermore no special attention will be given to the autonomous regions of China. The autonomous regions are province level regions dominated by a non-Han population, the regions are general underdeveloped and have in some cases been under different regulations.

1.4 Methods

The information for this thesis is mainly gathered from secondary sources that describe the situation and development in China. To get reliable statistics to describe the development has proven very difficult. Different sources often have data that vary greatly, while the general trend in most cases is the same. One reason for the differences in data is likely to be, that the boundaries between the various forms of ownership are often unclear, therefore different sources uses different definitions of the various ownership types. Another reason for the differences in data is likely to be China’s insufficient statistical system that still has many errors, to the extent that it is often difficult to make conclusions on (Laurenceson and Chai 2000: n. pg.). Nevertheless some data from China Statistical Yearbook and other sources are used to illustrate some general trends.

Besides secondary sources the thesis also draw upon the knowledge and impressions I have gained from visiting China. My firsthand experiences will mainly be used in
chapter 3 that consist partly of a case study in a Cantonese village. The information for this case study was gathered from two study tours to the village in the spring of 2004. There are some special concerns regarding the information collected for the case study. These concerns will be discussed in chapter 3.4 as a part of the introduction to the case study.
2 The Transaction Cost Theory

The aim of this chapter is to give a general introduction to the transaction cost theory, as it is the central theoretical framework of the thesis.

*When will a transaction be carried out within a single firm rather than by two separate firms transacting in the market?*

Coase put forward this question in 1937. Coase is normally considered to be the founder of the transaction cost theory (Berlin 2001: 13). The key element in the transaction cost theory is the choice between the market and the hierarchy (Williamson 1979: 235).

The question of the scope of the firm is in itself not unique to the theory of transaction costs but is a part of what in general is known as the *theory of the firm*. Coase was characterised by having the transaction as the unit of economic analysis. While Coase is often seen as the main thinker in the early days of the transaction cost theory there were others such as Commons. Commons (1932) also operated with the transaction as the unit of analysis. Williamson (1971 and 1975), Alchian and Demsetz (1972), and Coase (1972) are some of most quoted works from the 1970s that helped renew the interest in the transaction cost theory.

Traditionally the term *transaction costs* only related to the external costs while the internal costs have been called *control costs* or similar (Hollensen 2001: 53). In contemporary works transaction costs are often expanded to include both the cost involved in conducting a transaction in the market, and the cost involved in internalising a transaction (Winger 1994: n.pg.). The optimal choice of ownership according to the theory is then the choice that minimizes total transaction costs. This thesis uses the term transaction costs as the sum of both cost of ownership and cost of control.
It should be noticed that the transaction cost theory does not include the costs of production. Williamson as a key thinker within the transaction cost theory recognizes this and states that the “most efficient choice of internationalisation mode is one that will help minimize the sum of production and transaction costs” (Williamson 1985, quoted in Hollensen 2001: 59-60).

Collis and Montgomery (1997: 105) argue that it might be a problem that the transaction cost theory assumes that individuals act opportunistically. They admit this is true for most economic theories. However, they still argue it gives some problems in using the transaction cost theory in less individualistic cultures like the ones in East Asia. They also argue that companies might not act opportunistically even if they are culturally and psychologically predisposed to it, as acting opportunistically will hurt their reputation. These arguments put forward by Collis and Montgomery will be incorporated in this thesis as they are of special interest in China, known for its special guanxi networks\(^5\) and attempts of mass mobilisations under Mao Zedong.

Transactions occur as a result of division of labour (Shen 1990: n. pg.). There lacks a general accepted textbook definition of what transaction costs are. A general definition could be “the costs of running the system” (Standfird and Marchall 2000: 25). Foss (2002: 16) explains transaction costs as being the “costs of exchanging and enforcing property rights, or, less abstractly, cost of bargaining and cost of monitoring and enforcing agreements.” A more specific introduction to the different kinds of transaction costs will be given in the presentation of Hansmann’s book. Different scholars often use different terms to categorize the transaction costs. An example of different use of terms and slightly different categories is given in the introduction to Chen’s work in chapter 2.2.

The theory is most often used to analyse the scope of enterprises regarding vertical integration. The type of ownership has often being taken as given, and whether the widespread use of investor owned enterprises in much of the world is optimal has only

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\(^5\) *Guanxi* (关系) can be translated as *relation, relationship, ties or connections* (Manser 1999: 194). It refers to the special connections and networks that play an important in the Chinese society.
attracted limited attention from a transaction cost perspective. One of the scholars who have dealt with this issue is Hansmann (2000). Hansmann looks into industries in the United States that have a tradition of non-investor owned enterprises such as certain service industries and agriculture.

The traditional way of using the theory only analyses if a transaction should be carried out within the hierarchy or in the market. Hansmann take the analysis one steep further as he tries to determine which patron(s) should be the owner(s). Different owners result in different transaction costs. The ideal owner is the patron that minimizes the total transaction costs.

2.1 Hansmann’s Study

Hansmann’s *The Ownership of the Enterprise* (2000) has been an important source of inspiration for this thesis and the thesis also apply some of the same framework as Hansmann. A separate introduction to the book is therefore given. Hansmann analyses the existence of various ownership types with a focus on the United States. Instead of merely asking where the scope of the firm should go, Hansmann uses the theory of transaction costs to analyse who is the optimal owner of the enterprise. He analyses a number of industries with various types of ownership. Hansmann generally manages to justify the existence of the different ownership types across industries in the United States. The aim of this thesis is to see whether the same theoretical framework can help justify the existence of three dominant types of ownership in China.

Hansmann divides the transaction costs into costs of contracting and costs of ownership. An introduction to both types of costs will be given in the following. This introduction to his division of transaction costs works as an introduction to Hansmann’s framework that is being applied in this thesis.

There will not be given a general introduction to Hansmann’s findings as most of them are of little direct relevance for this thesis due to his focus on the United States.
2.1.1 Cost of Contracting

The cost of contracting includes the classic costs due to imperfect markets and contracts as well as opportunistic behaviour. Below is given a brief introduction to the main categories Hansmann (2000: 24-34) divides cost of contracting into.

Simple market power

Simple market power arises when companies hold some degree of monopoly power when dealing with their customers. An alternative version of simple market power arises from monopsony power. Monopsony power exists when a firm does not have market power in dealing with its customers but instead in dealing with the suppliers. Simple market power results in two costs: the customer paying too high a price for the goods, and in under-consumption of the goods due to the high price. From the customer’s point of view the first cost is likely to be far the largest while the second cost, under-consumption, results in a reduction of the total welfare in the society (Hansmann 2000: 24).

Ex post market power

Monopolistic exploitation that can happen despite the market as a whole is not monopolistic (Hansmann 2000: 25). Ex post market power is also known as *lock-in* or *hold-up* (Holmström and Roberts 1998: 92). The lock-in can happen if two circumstances are present. Firstly when entering into the relationship a substantial transaction-specific investment has to be made by the patron, an investment that is at least a partial sunk cost. That is to say an investment that cannot fully be recouped if the relationship is terminated. Secondly the contracts controlling the relationship have to be imperfect. This can be because the relationship will extend over a long period of time, so that future aspects cannot be all dealt with in the contract. In this way the patron can become locked-in and risk that the firm seeks to exploit the relationship in the future on issues not covered in the contract. To prevent one party being exposed to opportunistic behaviour as a result of transaction-specific invests it is a possibility to have long-term contracting for as many issues as possible. This in itself posses a risk due to changes in the society during the term of the contract (Hansmann 2000: 27).
Furthermore the cost of trying to create a contract covering as many possible scenarios of the future as possible can be very costly in itself.

**Asymmetric information**

Asymmetric information also increases the costs of contracting. For example if the seller knows more about the quality of the product than the buyer, this gives the seller an incentive to sell a lower quality product than promised and the buyer in turn wants to pay less, this leads to inefficient transactions (Hansmann 2000: 27-28). Wang (1999) offers an interesting case study on a different case of asymmetric information relating to China, this will be discussed in chapter 2.2. Asymmetric information also leads to strategic bargaining, meaning that there is no free flow of information between the firm and its patrons about the two parties’ individual preferences and opportunities. This results in the negotiations to drag on in an attempt to apply pressure on other party (Hansmann 2000: 29).

If there is no free flow of information this means that the patrons’ preferences are likely not to be known to the firm, this means that the firm might offer products that do not give optimal satisfaction (Hansmann 2000: 30). At the same time contracting often mean that a firm has to deal with a group of patrons on the same terms even though they might have different preferences. This will normally lead to the satisfaction of the marginal patron that might have different preferences than the individual or average patron (Hansmann 2000: 31).

**Enforcing contracts**

Hansmann discuss the costs associated with imperfect contracts but does not pay special attention to the costs of enforcing the contracts. Hansmann does not give any reasons for this delimitation, but it might be because he does not find the enforcement costs as important as the other major costs of contracting. The costs of enforcing contract are likely to be significantly larger in China than in the United States due to China’s ineffective legal system. The costs of enforcing contracts will therefore be included in this thesis.
2.1.2 Cost of Ownership

Ownership itself can be seen as a nexus of contracts. This thesis will nevertheless follow Hansmann’s example and only use the term cost of contracting to describe costs relating to market-based contracts. The costs relating to the nexus of contracts making up the ownership of an enterprise will instead be named cost of ownership.

Controlling managers

These are costs associated with the inefficiencies resulting from employing an agent to carry out a task. Often the agency costs relate to the fact that the agent does not act purely in the interest of the principal but also in his own interest. There are also costs associated with monitoring and controlling the agents. Agency costs tend to increase with the numbers of owners because the individual owner’s incentives to monitor are being reduced, since the potential gains from effective monitoring decreases (Hansmann 2000: 36).

Collective decision-making

The decision making process tends to get more costly when more individuals take part in it. The most obvious costs might be the costs of the process itself and resolving conflicts among the owners. However, there are also other costs involved in decision-making; majority voting tends to select the outcome preferred by the median voter, while efficiency generally calls for the outcome preferred by the average voter (Hansmann 2000: 40). An increased number of people involved in the decision making process might also have some positive aspects, such as making sure that all sides of the issue are being considered.

Risk bearing and entrepreneurship

The costs discussed so far have been closely related to one aspect of ownership; control. But the other part of ownership; rights to residual earning, also imposes costs in the form of risk bearing. Not all patrons have the same ability to bear risk. Furthermore there are costs involved in establishing a firm to begin with or to change ownership. An increased size of the hierarchy tends to reduce the degree of entrepreneurial activity, all other things equal. (Hansmann 2000: 44-45).
**Political interference**

Hansmann does not analyse the cost of political interference. The types of ownership he analyses are all private enterprises, independent of the state. The three types of ownership analysed in this thesis on the other hand all had close links to the authorities at the beginning of the reforms, and the SOEs keep having a close relationship to the government. Special attention is therefore given to the costs associated with political interference and production of what can be termed political goods.

**2.2 Previous Research Covering China**

Much of what have been written about ownership in China uses the thoughts of the transaction cost theory without actually using the term *transaction cost theory*. One example is Eastman (1988: 146) he argues that the market mechanism worked so well in the late Qing dynasty⁶ that there were no reasons for Chinese brokers and wholesale merchants to become involved in the process of production. Just as he analyses the great agency costs that were involved in the *guandu shangban* enterprises of the late Qing. The name of the enterprise system means *official-supervision, merchant management*. The merchants supplied the capital and were the official owners of the enterprises but they had little, if any, control over the enterprises (Eastman 1988: 173). Therefore they had no chance to punish opportunistic behaviour from their agents.

Much of the previous research covering contemporary China that has used the transaction cost theory directly has had the focus on urban industry and especially the state owned sector.

Lin (1987; 1988) studies agricultural production and has the focus on the costs of monitoring since these tend to be high within agriculture (Lin 1988: 199-200). The reason for this is that it is difficult to monitor the quality of the individual tasks that have to be done during the year. Lin conducts empirical testing of a set of hypotheses. Lin finds that there are two factors that have influenced the likelihood, and speed, of

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⁶ The Qing dynasty lasted from 1760 to 1911.
collectives turning into household farming. These are the size of the collective and the amount of machinery used. The number of households in a production team has a positive influence on the likelihood of breaking up, Lin (1988: 212) argues this is due to increasing monitoring costs as the team gets bigger. On the other hand the amount of machinery has a negative influence on the likelihood of converting into private farming, as machinery is not suitable for small scale farming, the cost of changing the ownership thereby increases (Lin 1987: 413).

Wang (1999) studies the fish markets in the Long Lake area in Hubei province. He found that asymmetric information significantly increases the transaction costs. The situation is that a village is visited by a middleman who buys up fish to sell them at a central fish market, but the local fishermen do not have any knowledge about today’s prices of fish and therefore do not trust the middleman’s offer and, instead, most fishermen take the fish to the market themselves as the cost of contracting the task to the middleman would be too high (Wang 1999: 799-802). This is a case of vertical integration, as the fishermen expand their activities into transporting the fish to the market, as the cost of this is lower than the cost of the asymmetric information in a bargaining situation with the middleman.

Chen (2000) studies transaction costs in relation to the success of TVEs. Chen (2000: 11) finds that TVEs are a possible solution in transitional economies when the market does not work well and government, as a direct owner, also proves to be highly imperfect as owner. The TVEs have changed much over the last 25 years with a general move towards increasing autonomy for enterprise managers. Through empirical testing Chen manages to show a link between the contractual form chosen and a series of factors, especially the development of markets (Chen 2000: 170, 205).

As stated before there are basically two kinds of costs: cost of contracting and cost of ownership. Chen (2000) uses a slightly different categorization: internal and external costs. This is one example of how the costs often are slightly differently grouped by different researchers. Internal costs cover most of the cost of ownership, but not all. An example is that government imposed costs on a certain ownership type are
considered a cost of ownership, but is an external cost, and not an internal cost, as internal costs only include costs which arise within the hierarchy, such as monitoring costs.

Chen’s study shows that political influence on the management of the TVEs in general tends to increase the cost of ownership due to different kinds of agency costs. These costs were not very important in the beginning, as the political management helped reducing the cost of contracting significantly, in an environment where it would often be impossible to get the needed input without political support. This included land, capital, technology, raw materials, energy and often human resources (Chen 2000: 57-70). But as the markets develop the political leadership is no longer needed to keep external transaction costs low. So as the markets improve the importance of the cost of inefficient internal leadership due to the political connections increases, and it becomes less attractive to have close links with the local government (Chen 2000: 141, 208).

Zhou and Wang (2000) analyse how the SOEs suffer from high agency costs such as the plundering of assets and general collusion among agents. This is made possible due to minimal control of the agents, because of the unclear ownership and lack of efficient accounting and auditing systems. Most SOE managers are still appointed by a superior government official and judged mainly by their political performance, and paid according to their rank as government officials. This means that many SOE managers focus on production of political goods.

White and Liu (2001) studied the Beijing No. 6 Pharmaceutical Factory, a SOE, and found that the cost of monitoring certain contracts was very high due to asymmetric information. They found that the cost were likely to be reduced through vertical integration so that the transactions would happen within the hierarchy instead of on the market. Or, alternatively, the relationship between the two parties could be turned in to some kind of hybrid relationship (White and Liu 2001: 119).
Hybrid relationships are often seen as a third way, between the market and the hierarchy. Hybrid relationships are often used for long-term agreements where hold-up situations could happen. The hybrid relationship includes renegotiations of the original agreement as the circumstances change (Noorderhaven 1994: 21). The hybrid relationship, therefore, has some similarities to the typical Chinese business relationship, which also builds on long-term relations as well as renegotiation agreements (Shi and Wright 2001: 382; Pye 1992: 89; Blackman 1997: 165). There is one significant difference between the two types of relationships. Hybrid relations revolve around the existence of contractual laws while the guanxi based business practise revolves around codified social rules and values (Standifird and Marshall 2000: 29).

Standifird and Marshall (2000) study how the use of guanxi based business practises can be an alternative to the hierarchy or pure market based transactions. The main advantage of guanxi-based business is how it can control opportunistic behaviour. Opportunistic behaviour is attractive when the expected payout from the opportunistic behaviour is greater than the expected costs. A key benefit from guanxi is how it increases the expected costs of opportunistic behaviour. The whole network soon knows of any opportunistic behaviour, thereby increasing the costs of any such behaviour. In guanxi terms a person that conduct opportunistic behaviour loses face and will find it more difficult to do business in the future (Standifird and Marshall 2000: 24, 29-30).

Guanxi helps give some assurance of the exchange partner’s behaviour and reduces the problems with imperfect contracts and lack of an effective legal system. Standifird and Marshall (2000: 31) findings give some support to this as they find that private firms use guanxi more than the institutional secured state owned enterprises. Standifird and Marshall (2000: 39) point out that relying strictly on guanxi-based exchanges creates its own problems. The main problem is a lack of ability of respond

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7 The Chinese concept of face is divided into two parts: lian (臉) and mianzi (面子). Lian is closely related to your behaviour and moral character, lian will be lost if you do not fulfil your obligations. Mianzi is closer related to your social status and degree of success in life (Chen 1995: 54; Earley 1997: 46).
to specific cases of opportunistic behaviour. The same problem is analysed by Shen (1990). Opportunistic behaviour is less likely to pose problems in a village than in an urban area, as any opportunistic behaviour will have not only economic consequences in a rural community but also very strong social consequences (Pei 1998: 90). Pei (1998: 91) states that transaction costs generally are lower in rural areas with informal rules than in an industrialised urban economy with formal rules. This might be partly a result of the high social cost in a rural community; therefore it does not mean that an urban economy could achieve the same low transaction cost if it is built on informal rather than formal rules.
The introduction of the HRS was among the first initiatives in China’s reform process, and the success of the HRS was central in helping to increase support for reforms outside agriculture (Naughton 1995: 142), this alone helps to justify analysing the HRS. Farming is an important part of the Chinese society with 43% of China’s active workforce engaged in agriculture in 2002 down from 71% in 1978\(^8\) (National Bureau of Statistics of China 2003: 128).

China’s agriculture was collectivised during the 1950s. Prior to 1978 the structure in rural China consisted of 20-30 households grouped together to create a production team. Around 10 production teams were grouped together into a brigade, and 10-15 brigades made up a commune (Carter et al. 1996: 8).

A group of farmers secretly created a responsibility system in Anhui province in 1978 and this is considered to be the beginning of the nationwide move towards decollectivisation. However, the first responsibility systems had already been introduced in the mid1950s. In the years after the failure of the Great Leap Forward (1958-1961) the use of various responsibility systems became more widespread (Charter et al. 1996: 9; Huang 1998: 38). This might indicate that responsibility systems have some advantages over the planned economy in turbulent periods. Maybe because it was easier for the individual household and production team to secure sufficient food, than it was possible via the planned economy. The planned economy had great difficulties in adjusting to the rapid changes in the society.

The reforms of the late 1970s went far beyond what had been seen before, due to the fact that Mao had died in 1976 and Deng Xiaoping gained power in 1978, leaving more room for reforms (Ash 1993: 13-14). The rural policy became relaxed in 1978 and gave increased local autonomy. Despite this general relaxation, the government

\(^8\) The statistics include people working with animal husbandry and fishery.
specifically banned household farming. But the farmers soon went beyond the reform boundaries created by the government. The political leaders responded firstly by allowing household farming in poor mountainous regions in 1980 as these were considered backward areas and not yet ready for collective farming. The government gave the HRS its formal blessing in retrospect after the HRS had become widespread in 1981 and 1982. This further increased the speed of reforms and by the end of 1983 the HRS was nearly universally adopted covering some 98 percent of all households engaged in farming, while it in 1979 had covered one percent or less (Huang 1998: 41; Naughton 1995: 141).

In four years the ownership structure within agriculture was completely changed. The change did not happen as a result of official policy or by orders of the government. Instead the farmers changed it out of their own free will. This indicates that the household farming system has some significant advantages for the farmers, compared with the previous collective system. This chapter will look at what these advantages could be, and what the disadvantages are seen from a transaction cost perspective.

Prior to the reforms the production teams officially owned the land in most cases. However the team had no rights to sell, transfer or rent out the land, furthermore the production teams did not control what to plant, and all output was sold to the state. It is therefore arguable if the collective ownership prior to 1978 was real (Puttermann 1995: 1052). The reforms transferred the ownership of the land to the villages but still with no clear definition of the ownership rights (Selden and Lu 1993: 189). While the ownership in this way officially has remained collective, management became private at the household level. There also developed an increased private ownership of tools and machinery (Selden and Lu 1993: 204; Charter et al. 1996: 9)

3.1 Responsibility Systems

There have been two main forms of contractual systems: contracting output to the household and contracting everything to the household. There are some differences over time and across regions, but a general presentation of the two systems will be given here.
Contracting output to the household was the dominating system in the beginning of the reform. It lets the household organise the everyday work on the land while inputs are provided by the production team who also distribute the final income on basic of the number of work points earned. Work points were distributed as a result of the amount of grain handed over to the team by each household.

After the price and market reforms of 1984-85 the system of contracting everything to the household became the dominating system. It goes a step further and gives each family some land of which it can cultivate, under the condition of paying taxes and handing over fixed quotas of grain. Under this system animals, farm tools and other equipment were normally divided among the households (Ash 1993: 16-18; Chen et al. 1991: 195).

Both of the responsibility systems are in Western literature general referred as freeing China’s farmers and it is argued that by implementing the systems the household becomes an independent organisational hierarchy with contractual relations to the village and other patrons (Zweig 1997). It is often difficult in China to determine when a transaction is market based and when it is based within the hierarchy. Especially with the early system of contracting output to the household it is arguable that the household remained a part of the hierarchy, since the village was responsible for much of the decision making as well as the risk bearing. The early system therefore mainly was a way to reduce monitoring costs and introducing simple ways of rewarding and punishing wanted and unwanted behaviour respectively.

3.2 Cost of Contracting

Prior to the reform it was difficult to talk about the cost of contracting versus cost of ownership in a tradition sense due to the central role that the state played as purchaser and supplier of most products. The planned economy created a nationwide hierarchy in which the majority of transactions were made. While relations generally were based on contracts, it was contracts that were influenced by the fact that two parties, at different levels of the same administrative hierarchy, created the contracts. There were
a few free markets prior to the reforms for agricultural products including meat, vegetables and fruits (Carter et al 1996: 40). The shift from collective farming to household based farming in general meant an increased use of contractual relations.

Contracting everything to the household got close to what is known as household farming in the West, with the individual household responsible for buying the input needed and market the output. This system, furthermore, meant that the individual farmer had to supply tools and machinery. All of this meant a change in the contractual relationships and thereby in the cost of contracting (Chen et al. 1991: 195).

3.2.1 Land
The cost of contracting the land under the HRS is widely discussed in Western literature. The earliest system, where the household only had the responsibility of organising the work on the land, often worked with one-year leases with no certainty of how the situation would be the following year. This clearly limited the individual household’s incentives to improve the land; instead the farmers had an incentive to exploit the land as much as they could. The individual household’s opportunities for exploiting the land might have been reduced by the collective control over input and what to plant, for example that the collective this way could make sure that enough chemical fertilizer was used, for the long term good of the soil quality. However this was not enough to completely eliminate the exploitation of the land.

In 1982 the government, following its recognition of the HRS, introduced leases of 3-5 years duration, however, this still only gave little incentive to improve the land. From the 1984 land leases had to have a minimum duration of 15 years with no upper limits (Kojima 1993: 100). This meant that the problems with short-termism were reduced. Now the right to land is guaranteed on a permanent basis and has become transferable, the difference between renting and actual ownership is thereby becoming unclear (Chow 2002: 48).

With the introduction of the 15-year minimum duration of the contracts in 1984 the government also introduced a system under which a household could receive
compensation for investments made on the land (Selden and Lu 1993: 194). It is unclear how well the compensation system worked but it is likely to have been able to reduce some of the costs associated with contracting the land. As we will see in chapter 3.4 knowledge of this system has not reached all villages that naturally reduce the chances of it reducing any costs.

With the increased length of the leases the costs associated with long term contracting started to increase. The longer the contracts became the more difficult it also got to predict the future development within the duration of the contract. It is not possible to create contracts that deal with all possible future developments, these problems become more urgent in China due to the rapid changes in the society in the last 25 years.

It should be emphasized that the land contracts are not between two private individuals or enterprises. Instead the household sign the contracts with the township or village9 (Charter et al. 1996: 10). That the land leases were made permanent meant that they started to work like ownership of the land, with the rent paid to the local authorities working as a tax on the land. This does not imply that there are no costs of long term contracting but it is likely to be reduced if the village management, and the local government, is stable and therefore indicate a stable rent situation. If the future seems uncertain this is likely to reduce the farmers willingness to make any investments that could work as sunk cost. The situation is the same in the West if farmers are uncertain about the future policies on taxation or other issues.

The vast majority of the farmland was distributed according to the number of the family members in each household. Following the distribution of the land an increasing number of farmers got jobs in the fast growing TVEs. Many of these farmers kept their land despite working in the TVEs. Despite the fact that farmers employed in TVEs often could not cultivate the land effectively, they were generally unwilling to lease the land to others (Kojima 1993: 115, 117). Kojima does not give

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9 The terms, township and village, were used after the communal system was abandoned in the mid 1980s.
any reasons for this. One could be a fear of being seen as landlord.\textsuperscript{10} The lack of clear property rights could also create a fear of losing the land permanently if renting it out. If this behaviour should be justifiable from a transaction cost point of view, the cost of contracting must have been greater than the potential gain from renting it out. The fear of losing the land, as a result of renting it out, is one such cost of contracting.

The collective farming also had some advantages, which were lost during the shift to household farming. The collective farming benefited from a minimum loss of land to field boundaries. When the HRS was introduced the land was often divided in many small plots to give each household some land of good soil quality and some of bad quality. This was done to make the allocation of land as fair as possible but it also resulted in a significant loss of land to boundaries (Putterman 1993: 20).

### 3.2.2 Other Means of Production

Under contracting output to the household the collective kept the ownership of all machinery and owned most of the tools as well. This is likely to have meant that some farmers saw no need to take good care of the tools and machinery. As the households effectively still were a part of the collective, these costs were in fact agency costs, but will be briefly discussed here. The relatively small size of the individual production team might have helped reducing the problem. But as we saw in 3.2.1 the small size of the production teams had not been sufficient to eliminate the free-rider problem in the era of collective farming, while the small size might have reduced the problem. Lin (1988: 212) argues that the free-rider problem tends to increase, as teams become bigger.

As farmers joined the system of contracting everything to the household they had to enter into a contractual relationship regarding machinery and some tools. There are

\textsuperscript{10} Landlords have been considered a prime enemy of the communist society in China. China Communist Party traditionally considers anyone who uses labour from outside the family to cultivate its land a landlord. Most rural Chinese still consider the concept of landlords as a dark chapter of China’s history closely linked with exploitation of poorer peasants. Being seen as landlord could therefore result in great social costs.
reasons for this; first of all there was the legal aspect since households were not
allowed for households to possess machinery until November 1982, and tractors until
February 1984, however most households did not adopt the system of contracting
everything to the household until after this restrictions had be removed. Secondly, and
most importantly, after it was made legal to possess your own machinery only few
households were able to do so. This is illustrated by the following statistics from 1984.
For every 100 farms in China there were in average 47 draught animals, three mini-
tractors, and one pump. Ownership of machinery was different across regions, in some
areas they remained mainly public owned, while in other places they were more
commonly owned by a group of farmers or by a tractor station that rented out the
machinery (Kojoma 1993: 104-105).

If the costs related to renting machinery were low enough one could expect that the
types of machines used in agriculture would have remained fairly unchanged. In the
first five years of the reforms the tractor-ploughed area in China declined, this trend
ended in 1983. The rest of the 1980s were dominated by investments in mini-tractors
and horse-powered machinery suitable for cultivating small land spots. There were a
constant number of larger tractors and a decline in the number of combined harvesters
(Putterman 1993: 45). In the entire reform period the growth in mini-tractors has far
outnumbered the increase in larger tractors. This could indicate that it is cheaper to
have small-scale machinery within the hierarchy than to have access to large
machinery via joint ownership or renting. Another reason could be that the
industrialisation that had occurred in China’s agriculture in the period leading up to
the reform had focused too much on large machinery. Furthermore the households had
divided the individual fields as the land was redistributed, and the field sizes might
therefore no longer be suitable for large machinery.

Table 2: Number of agricultural tractors in China

<table>
<thead>
<tr>
<th></th>
<th>1978</th>
<th>2002</th>
<th>Annual increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large and medium tractors</td>
<td>557,000</td>
<td>912,000</td>
<td>2.1%</td>
</tr>
<tr>
<td>Mini-tractors</td>
<td>1,373,000</td>
<td>13,394,000</td>
<td>10.0%</td>
</tr>
</tbody>
</table>

Kojima (1993: 105) reports that 20% of draught animals and 42% of all machinery were jointly owned. According to Unger (2002: 112-115) the Chinese press in the 1980s also reported that there was widespread use of shared ownership of animals and machinery. Unger however, found that while two or three families often owned draught animals jointly, there was normally no joint ownership of farm machinery, instead this was owned by tractor stations.

The access to means of production thereby tends to be divided between private ownership of tools that could be owned by the individual family, shared ownership among a small group of families for draught animals, and finally market contracting for machinery. That large machinery was owned by tractor stations might be due to the fact that machinery often are so expensive that a large group of families had to share the ownership, thereby increasing the costs, both in regard to people not taking good care of the machinery as well as collective decision-making. By renting the machinery the tractor station supplies both machinery and personnel to operate the machinery, thereby removing the monitoring costs regarding if people take good care of the machinery.

Irrigation systems are of great importance for agriculture in southern China, as the communes were dissolved many irrigation systems were no longer maintained. In 1982 the government declared that water conservation facilities were owned by the state, except those dug by individual households. The government introduced different contractual systems to outsource the daily responsibility to either individuals or groups. These contracting systems often did not work well and the irrigation systems were not maintained sufficiently (Kojima 1993: 103).

There might be a couple of transaction cost reasons why the contractual system did not work well. One could be a general free-rider problem that some farmers did not want to pay for the irrigation system but they benefited from it anyway. It was difficult for anyone who was given the daily responsibility to get enough capital from the farmers to maintain the system. Selden and Lu (1993: 205) can report how conflicts over water resources have been common.
The contracts for maintaining the irrigation systems were often short-term just as the early land contracts. This is likely to have resulted in the same problems as it did with the land, as there was little incentive to maintain the systems. The result has often been to give TVEs the responsibility of the irrigation systems. Thereby moving the control of the irrigation system back into the collective system, this reduced many of the problems with getting money to maintain the system as farmers could better be forced to pay for the irrigation system by the village than by a private enterprise (Charter et al. 1996: 10). The local government also had incentives to maintain the system for the long term good of the community and they could to some degree secure this via their influence on the management of the TVEs.

### 3.2.3 Markets

The system of contracting output to the household meant that the individual household did not have to deal with buying input or market its output. Instead the collective was responsible for buying input and selling the output. In the beginning most products were sold to the state with the state as price setter, and there were only few free markets.

A general lack of free markets made it difficult for an individual household to get the required input without the help of the collective. Any individual household who broke out of the collective system would therefore not only risk legal problems but also face high costs obtaining the needed input. A direct jump to the system of contracting everything to the household would therefore have been problematic as long as there were no markets for the farmers to operate in. A dual price system was introduced with the price reform in 1984-1985, this meant that inputs such as diesel, chemical fertilizer were sold under two different prices, one for the planned economy and one, normally higher price, for the free market economy. The collectives in general had the best assess to the cheap inputs. Chemical fertilizer was important in Chinese agriculture but it was also one of the products of which only a small share was traded on the free markets to begin with (Chow 2002: 51; Huang 1998: 97; Guo 1992: 113, 117).
Following the price reform the free markets developed and outgrew the planned economy, this gave the households better opportunities for obtaining input and selling output individually. The major shift from contracting output to the household to contracting everything to the household occurred after the price reforms had reduced the cost of contracting greatly for the individual farmer.

To whom did the household sell their output? Hansmann (2000: 120-123) notices that farmer owned marketing cooperatives are widespread in the United States. The reason being an attempt to reduce the costs relating to the great market power the processing industry often has over the individual farmer. The market power exists since the number of the farmers is so great and they tend to produce very homogeneous products while the processing industry is highly concentrated. The SOEs initially controlled the agro-processing industry in China but as we will see the TVEs soon took over. Farmer owned cooperatives on the other hand do not play a dominating role in China like they do in the United States. The reason for this could be that there are high costs associated with collective ownership, as we will see in chapter 3.3. Furthermore, actual cooperatives also face their own special costs due to their legal status; this will be discussed in chapter 4.3.1. Finally, and maybe the most important reason, is the fact that many TVEs within the processing industry actually work as de facto cooperatives, this issue will be discussed more in chapter 4.2.3. Some actual agricultural cooperatives were also set up to supply farmers with input and process the produce as well as help with information and technology, these cooperatives had limited success (Kojima 1993: 109-110).

So-called economic unions were also set up. By 1985 3.2% of rural household had joined an economic union, most often these were unions between relatives and friends. This might also relate to the costs of ownership and how the close relationship among the owners reduced the risk of opportunistic behaviour. The economic unions were organised after the concepts of shareholder enterprises and most were engaged in the agricultural processing industry or within transportation (Chen et al. 1991: 195-196).
The development of markets has also influenced the farmers’ self-sufficiency. It had always been a key goal of the communist party to make China self-sufficient. At the national level as well as within each level of the society and right down to the individual production team. As the reform started in 1978 trade in above quota grain production became allowed. This speeded up the move away from local self-sufficiency towards an increased use of cash crops (Charter et al. 1996: 41-42). This implied an increased use of the market.

Starting with the harvest of 1979, the government raised the premium on above quota sales with 50% thereby increasing the incentives to maximize the output and made it attractive to sell to the state (Kojima 1993: 98; Guo 1992: 24). With the price reform of 1984-1985, the government changed its purchasing policy away from guaranteed prices. This in turn increased the farmers’ risk related to using the market and meant a step away from the commercialisation of agriculture (Putterman 1993: 42-43). The increased risk related to using the market was a cost that made it more attractive to be more self-sufficient. This trend only lasted a short while and cannot change the overall picture of the household becoming less self-sufficient in the reform era.

Farmers went from spending 40% of their living expenditures on “market” purchases in 1978 to 65% a decade later (Chen et al. 1991: 184, 230). This is a clear step away from being self-sufficient towards the use of the market. This could be due to decreased cost of contracting. Two other factors are likely to have influenced this development. One is the decreased size of the hierarchy. It is unclear how Chen et al. define market purchases in pre-reform China. It is likely that products produced by the production team and consumed by one of the households have not been considered as being purchased on the market as it was produced within the hierarchy. As the size of the hierarchy decreased, so it only consisted of the individual household, it became difficult to produce all the products in each household that previous were produced by the production team, thereby increasing the use of the market. The second factor that is likely to have influenced the use of the market is the increased standard of living among farmers, which had increased the demand for products, such as radios and
watches, which cannot realistically be produced within a hierarchy only consisting of one household or even by a production team.

3.2.3 New Technologies

The HRS tended to slow down the introduction of new technologies and seeds (Puttermann 1993: 20). There are several possible reasons for this. One reason could be asymmetric information regarding the quality of new seeds introduced. The shift to new technologies often also involves a risk and the households did not have the same abilities to bear risks as the villages. Technologies such as machine ploughing are also likely to be more expensive in a household system. The individual plots sometimes became so small, that they could not justify the use of machine ploughing. However a group of farmers could still have gone together to get their land jointly ploughed. This would require contractual relationship between the farmers as well as a contractual relationship with the owner of the plough.

Another reason for the reduced mechanization of agriculture could be that the high degree of mechanization was not optimal. Much of China’s rural areas had surplus labour that could not leave their home region due to the registration system in force.\(^{11}\) In the years prior to 1978 a modernization programme had started in China, which included a mechanization of the agriculture. This was done without making any feasibility studies of the investments made. So the agriculture might have been over-mechanized by the beginning of the reform (Naughton 1995: 67-70).

The reduced use of new technologies might also relate to the fact that the HRS failed to attract much investment into agriculture. Instead, the increased household and collective savings generally ended up in industrial investments via the rural credit cooperatives. Most households were not able to obtain capital via the capital markets such as the Agricultural Bank or the rural credit cooperatives (Charter et al. 1996: 47; Selden and Lu 1993: 204).

\(^{11}\) China’s civil registration system, known as hukou (户口), prevents people from migrating freely within China.
3.3 Cost of Ownership

This part of the analysis focuses on some of the problems related to the collective system. In this way it shows how the HRS has helped limiting many of these problems. The HRS is based on the household and the cost of ownership is therefore likely to be minimal in aspects such as collective decision-making and monitoring costs.

The whole household is active at the same farm and the family has often invested the majority of its savings in the farm. This results in the family bearing a high risk as its entire income and savings will be lost if the farming is unsuccessful. The collective benefited from being able to share the risk among more farms and between agriculture and other activities within the collective.

3.3.1 Agency Costs

The collective system suffered from low work effort among the farmers due to lack of motivation. A key reason was that there was little, if any, relation between the effort put into the work and the benefit received in the form of work points (Gao 1996: 59).

The lack of incentives has two main origins. Firstly the work points were given out very evenly, with little possibility of penalising farmers who did a bad job or rewarding farmers who did a good job. Secondly it was difficulty to monitor the actual quality and value of the individual tasks done during the year (Huang 1998: 42; Putterman 1993: 229). The last of these two aspects might be the most difficult to deal with. This is indicated by the fact that collective teams in general always tend to suffer from free-rider problems and these tend to be especially high in agriculture (Putterman 1993: 228).

The early responsibility system of contracting output to the household only gave the freedom to organize the labour. Not until later, during the system of contracting everything to the household in the mid 1980s did the household get actual control over the land (Unger 2002: 100). Even under the early responsibility system a new way of
allocating work points was introduced so that the number of work points received was linked to the amount of grain handed over to the team. This was a measurement that was easy to monitor (Gao 1996: 60; Ash 1993: 18). In this way it reduced the monitoring costs even if it could be argued that the new system was not always fair, for example due to differences in soil quality. Nevertheless as each household could see a clear link between the work efforts put into the cultivation of the land and the return to the family, the household farming greatly increased labour efficiency (Unger 2002: 112).

Incentives do not have to be materialistic. In China under Mao Zedong it was assumed that team members would have a desire to create a new society, and that this desire would be sufficient motivation to work hard (Shen 1990: n. pg.). These non-materialistic incentives in general had limited long term effects in China, while they at times did succeed in short-term mass-mobilisation (Puttermann 1993: 23-25). Ideological incentives did thereby not play any major role in reducing the monitoring cost significantly prior to the reforms, and after the reforms there have been little attempt to introduce ideological incentives.

3.3.2 Collective Decision Making and Political Interference

The decision making process in the pre-reform collectives was to some degree collective, but there was also great political influence from higher-ranking authorities. The work points were often given out evenly, this could have both political reasons as well as it reduced the cost of collective decision making regarding allocation of work points. When work points were attempted allocated according to work effort this often led to exhausting self and mutual evaluation meetings (Puttermann 1993: 23). This resulted in significant costs of collective decision-making. Furthermore, it is likely that there would also be costs during the year, as people wanted to make sure that their work effort was being noticed.

It was a political goal to be self-sufficient prior to the reforms. The agriculture thereby took part in the production of political goods. In case these goods were not optimal for the de jure owners (the citizens), this production of political goods can be seen as an
agency cost. It is arguable whether the goal of self-sufficiency in fact was in the interest of the local citizens. There are some security reasons for self-sufficiency as well as some ideological reasons. The demand for self-sufficiency reduced the total agricultural output, as it did not allow villages to become specialised in crops that were ideal for the local soil condition. Naughton (1995: 141) lists the move away from local self-sufficiency along with the increased labour efficiency as key reasons for the increase in agricultural output.\(^\text{12}\)

What to plant and in general how to manage the farm was decided by the political leaders and economic planners at various levels of the bureaucracy, despite the fact that, the local farmers had a better knowledge of how to get the most out of the local soil (Chow 2002: 48). This illustrates that valuable information could not flow freely from the local farmers and upward in the system, resulting in plans being made without sufficient information.

### 3.3.3 Change of Ownership

To create an enterprise or to change the ownership in an existing enterprise involves costs. This implies that the costs of changing the ownership can not be greater than the benefits gained from the new ownership, otherwise the change is not optimal according to the transaction cost theory. To change the ownership in the whole of agriculture surely had some major costs, including having to divide the assets. There are some factors that have helped making the transition easier in China. Chinese farmers still had a memory of household farming, due to the relatively short duration of just over two decades of collectivisation. Furthermore, there had been widespread experiments of household farming in the early 1960s. Both factors helped making the transition to a household based system easier (Naughton 1995: 140).

Despite the fact that China’s agriculture had experienced a mechanization in the years before the reforms, China’s agriculture still had a low degree of mechanization by international comparison. This might have helped reducing the cost of changing

\(^{12}\) The first years of the reforms also benefited from favourable weather condition, this in itself helped increase the output (Selden and Lu 1993: 202).
ownership. Lin (1988: 212) showed that there is a link between how long it took to change to the HRS and the developmental level of the team. It is much easier to divide land and simple tools than to divide big pieces of machinery. Poor areas might also have been more desperate for changing the situation they were in.

3.4 Case Study in a Cantonese Village

Much of the literature on the HRS is from the 1980s and early 1990s. This case study will illustrate the situation in Chao Sheng Cun in 2004. It is important to notice that this is only a case study of one village and it is uncertain to which extent the findings are similar to what could have been found in other villages. Nevertheless, it is believed that the case study will be helpful to illustrate how the situation is in a Chinese village today.

The case study was carried out during the spring of 2004. Chao Shen Cun in Guangdong province was mainly selected due to practical circumstances. I visited several other villages both in Guangdong and in other provinces. Due to the assistance I got from Ms. Kim Huang, an engineer and interpreter at Guangdong Ericsson Technology Limited, I had the chance to get a deeper knowledge of the situation in Chao Sheng than in other villages.

Ms. Huang was born in the village and still has relatives that live in the village and in other nearby villages, and she is still a well-known face to most of the local residents. I believe her connection to the village helped me greatly in carrying out the study as she introduced me to many of the residents and they felt safe to talk with me via Ms. Kim Huang.

Despite the fact that Ms. Huang introduced me to all the people I spoke with and did the interpretation the citizens, including her relatives, were not willing to take part in more formal interviews. Instead, they were happy to talk more informal with me about how things worked in the village. During these informal talks I was able to ask most

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13 “Cun” means village and indicate the administrative status of Chao Sheng.
14 Guangdong is the official pinyin spelling for the province also known as Canton.
of the questions I had. However, it happened a few times that the residents indirectly indicated that there were topics they did not wish to discuss, with replies like for example “I don’t know”. This normally happened to questions about their opinion. The most extensive answers were clearly given by Ms. Huang’s relatives, who showed me great trust, to the extent where I even was invited to sleep in their house. This invitation made this case study possible, instead of a one-day trip to Chao Sheng. I spent two extended weekends in the village getting to know the people living there and observing how their everyday life went on.

Using a local person as interpreter gave some advantages due to her network, knowledge of local customs and her abilities to communication in Taishanese. Taishanese is a dialect of the Cantonese language used in Chao Sheng and generally not understood by people speaking standard Cantonese.\textsuperscript{15} Naturally it also raises some concerns to use a local person who has a personal relationship with the people interviewed. First of all Ms. Huang to a large extent made the selection of whom to interview, these people were either relatives of her or good friends of her family.

Also the statements made by the residents are likely to have undergone a kind of double self-censorship. There are things people do not want to say to a local person with connection to the local community, due to the possible impact on their reputation. Just like there are things that they do not want to say to a complete stranger. Being a stranger with a local interpreter I am likely to have lost both kinds of information. If I had gone to the village with an interpreter with no connection to the village maybe I am likely to have got some of the first kind of information, if the people interviewed understood, and trusted, that the information given to me would not get back to the local community. But it would have been difficult and timely to gain the trust of the village with no one to introduce me.

\textsuperscript{15} While the written Chinese is standardised in the entire mainland, the spoken Chinese varies greatly among regions. In China as a whole Mandarin (Putonghua) is used as the lingua franca, while in Guangdong province Cantonese (Guangdong yueyu) is the standard language. Cantonese is in the West considered to be a language in its own right instead of merely a dialect of Mandarin; however even within Guangdong there are many local dialects, some not understood by people only knowing standard Cantonese.
When I first started to visit villages in China, I had two objectives; firstly to see how the living conditions are in rural China and secondly to hear the local residents’ opinion on the recent changes. The first objective proved easy as long as I had a guide/interpreter with me.

The second objective, to hear the locals’ opinion on the changes since the economic reforms started, proved much more difficult. One obvious reason is that the topic is more sensitive. While especially young people in the big eastern cities often are happy to discuss politics, the situation changes as soon as you move away from the coastal urban areas. In villages I visited without any personal connections, this was clearly not a topic for discussion. Even in Chao Sheng the willingness to discuss the topic was very limited. My impression is that this was partly due to a tradition in China not to discuss political issues in the public, and people might still be afraid of discussing politics. But I got the impression that it was just as much due to a genuine lack of interest. The residents took any changes in rules and policies as something external given, and did not see much point in trying to find out if the changes were positive or negative.

During my interviews I was able to get much information about how life in Chao Sheng goes on and how the land is cultivated. From this information it is possible to comment on some of the transaction costs issues raised previously in the chapter. The information I analyse is the information of a more objective nature, such as the ownership of various facilities. The interviewees were happy to share this kind of more objective information with me.

It is the aim to give a broad analysis of how transactions are made in the village, this includes transactions not directly related to agricultural production. The reason to give this broad analysis is that the hierarchies in form of households that interact in business also are social units that together make up the social network in the village. It is therefore difficult to separate business transactions from private transactions.
3.4.1 The Village

Chao Sheng has, like the rest of China, adopted the system of contracted everything to the household. The official number of residents is around 280. This includes a large number of people who now "temporary" reside in other places such as the nearby city of Taishan or the provincial capital of Guangzhou. While these people still are registered as permanent residents in Chao Sheng and only have temporary rights to stay in the city they presently live in, many have not lived in the village for years and only return once or twice annually to take part in important holidays, such as the Spring Festival or Tomb Sweeping Day.

Some 200 people still call Chao Sheng for their home but many of these are also away from the village most of the time. This is the case for children who during the week live at nearby schools and the many men who in periods work in the nearby town of Bai Sha. These jobs are seasonal jobs in TVEs. As the majority of the residents who find jobs outside the village are men, this has led the women to take over much of the everyday work on the land. This is very similar to what Unger (2002) finds in his study of agriculture in China. Unger furthermore reports that it is common that the women have completely taken over the agriculture while their husbands work far away, sometimes even abroad to earn money to the family. There are no such cases in Chao Sheng.

Taishan has a long tradition of emigration and migration is still common among the residents in the area. Taishan is known as being the home region for a very large share of the Chinese emigrants to America prior to World War II. Today there is still a steady migration from Taishan to mainly the United States and Canada. This tradition of emigration has some impact on the daily life. Most families have relatives abroad, even many of them have not been to China for many years they are a source of income for the village. In this way the villages in the Taishan region differs from much of the rest of China.

The relatives living abroad do not normally give a fix monthly support to the village or to their relatives. Instead they often help out when it is time for major investments.
Overseas Chinese are often the main contributors when it is time for major collective investments in the village, just as they helped their own relatives with investments in machinery, medical care and improvement of their housing. Finally, since most people in the village have relatives abroad, many of the village’s residents have dreams of emigrating themselves, and a few even have specific plans on how to emigrate.

There are two other villages placed so close to Chao Sheng that the three villages to the outsider look like one village. Tian Xin is of same size as Chao Sheng. There is only a 10 meters distance from the last building in Tian Xin to the first buildings in Chao Sheng. Chang Long is a smaller village with 32 people around 50 meters away from Chao Sheng. Each village works as an independent administrative unit, but the villages are closely related via everyday cooperation and inter-village marriages.

3.4.2 Land

The land is divided among the individual household just like what is seen in the rest of China. The land was redistributed in 1985 for 15 years and redistributed again in 2000 for a period of 10 years. This shortening of the period is opposite what was seen in chapter 3.2.1. The shortening of the contract was not something that had been decided in the village itself. The shortening increases the risk of short-termism. There are also benefits in reducing the length, especially in villages like Chao Sheng with rapid changes in the household sizes due to migration or other factors.

Each household pays an annual rent measured in rice for the right to cultivate the allocated land plots. This amount of rice does not depend on how much rice or other crops that are in fact harvested in the particular year. This kind of flat rate rent is naturally much easier, and thereby cheaper, to administrate than a traditional tax system. It also maximizes the initiatives to increase the yield of the land. The amount is fixed according to the number of people that has been allocated land, regardless of the quality of the land allocated, this has made it more important to make sure everyone gets some good and some bad land, therefore the land plots are likely to be smaller than otherwise optimal.
The households that have migrated to other parts of China but still have their official registration (hukou) in Chao Sheng, still hold land rights. These cannot be given up until the next redistribution, and even as the land is redistributed they still have the right to get land allocated if they wish. Migrants who still have relatives in the village normally let their relatives cultivate their land, and in this way support the relatives left behind. It is normal that the emigrants do not require any rent in return, just as the migrants most often pay the rent to the local government.

The emigrants who do not have any relatives left in the village, sometimes rent out the land while others leave the land uncultivated. But as long as they are still registered in the village they still have to pay rent for the land, it is not possible simply to quit the contract before the next redistribution. The land that is left uncultivated is used for feeding the other residents’ cattle and chickens. This leads to non-optimal use of the land, as the most of the land in the village is considered to give the highest yield when used for cultivating rice. Only the emigrants have the right to use the land but since it often is not used for several years, the other residents considered it to be a good place to find food for their cattle and chickens. It would be even better to cultivate rice, but no one wants to cultivate rice and risk having to give it all up because the emigrant returns. It is much easier to move out the cows and chickens in case the emigrant returns one day. Another reason could be that by opening up the land to the animals of the village it is easy to share the benefits of the land among many households, while if it is used for cultivating rice only one household could benefit from each plot of land.

Selden and Lu (1993: 194) report that it is possible to receive compensation for investments made in the land if moving away and giving up the rights for future land allocations in the village. Chow (2002: 48) reports, that land has become transferable and the difference between renting the land and traditional ownership therefore is limited. None of this seems to apply in Chao Sheng. I talked to one family that was in the process of completing the formalities for immigrating to America, they could tell me that they would not receive any kind of compensation when moving away from the village and would lose their land rights, as they would leave China. Their land would be redistributed among the families that have members with no land rights, this could
be children born since last time land had been redistributed or women born in other villages that have now moved to the village following a marriage with a local man. The lack of compensation reduces the incentives to make improvements to the land.

3.4.3 Agricultural Production

The agricultural production happens at the household level so that each household has its own plot of land, which it cultivates. Occasionally relatives from different household merge their individually land plots into larger units as these are easier to cultivate. There are no cases of households not related by blood merging their plots, just as households have not swapped land plots so that instead of several small plots they could get one big plot.

The typical household in the village grows rice, various vegetables, peanuts, beans and corn. Only the rice is sold, the rest is solely for domestic consumption within the household, as the yield of these products is lower than for rice. When it comes to animals, each family has chickens, that are used for cooking and only occasional sold at the marked in Bai Shan. The one family with pigs, either slaughter one pig at a time and sell it to the other residents in the village and to residents of the other two villages nearby, or if it is time to sell more than one pig, they are sold in Bai Shan. The cattle are used for working in the fields and later sold in Bai Shan.

The troubles of going to Bai Shan for shopping is likely to be the main reasons for the households to be self-sufficient within vegetables, peanuts, beans and corn even these give a lower yield than if the land have been used for cultivating rice. Another reason is likely to be that by being self-sufficient within as many products as possible reduces their dependency on the market and the yield of rice in a particular year. It is only 20 years since the area was hit by famine and this is likely to encourage the residents to be self-sufficient.

The TVE that used to buy up agricultural products in Bai Shan has been taken over by a private businessman. Cattle and rice from the village are now always sold to this businessman. This businessman has something close to a monopsony on agricultural
products in Bai Shan, however there are some people buying up smaller amount of agricultural products in the town, just as there are several other towns slightly further away with other possible buyers. This reduces the amount of monopsony power the private businessman can exercise. While it is possible, it is both difficult and costly, for the individual farmer to control all the prices in different towns, as the prices are not fixed but negotiable, depending on the quality. The village benefits by being covered by both the landline phone system as well as by the mobile phone network, this makes it possible to call around and hear about the price level before going to town. Nevertheless no residents reported doing so normally. The private businessman in Bai Shan therefore relies on his reputation for giving a fair price.

### 3.4.4 Investments

This will cover a wide range of the investments made in the city and how they are made. There are three mini-tractors in the village and these together with a couple of pumps represent the majority of what can be termed agricultural machinery in the village. The ownership of the different types of machinery is not the same. Individual households own the three tractors, while the village owns the pumps. The ownership of a car and the two wells in the village will also be analysed, the financing of a concrete road will also be covered.

#### 3.4.4.1 Pumps and Irrigation System

The irrigation system is collectively maintained and the pumps are also under collective ownership. This seems reasonable, following the discussing in chapter 3.2.2 regarding the problems for any individual contractor of the irrigation system to prevent free rider problems. The pumps are mainly being used to help run the irrigation system between the rice fields, thereby supplying a public good to all the farmers. To prevent free-rider problems a private owner of pumps would have to invest in digging new canals only leading to his fields, this would imply large costs, not only for digging the canals but also as they would take up a part of the land otherwise used for growing rice in.
Alternatively he would have to make contract with the other residents benefiting from the improved water supply. With the issues discussed in chapter 3.2.2 neither seems very optimal. As all residents grow rice and therefore to some extent benefit from having an irrigation system that has a steady supply of water thanks to the pumps it seems reasonable that the village is responsible for the pumps. This is not to say that the system is “fair”, in the current situation all residents pay to the pumps with no adjustments made with regard to whom benefit the most. It is likely that the cost of information searching and negotiations over who benefit how much would simply be too great for this kind of adjustments.

3.4.4.2 Tractors

Three individual households own the mini-tractors in the village. The reasons for the tractors being individually owned instead of by a group of households or the village are less obvious than the public ownership of the pumps. One reason could be that ownership divided between households result in worse treatment of the machinery, as the degree of responsibility decreases as the number of co-owners increases, as discussed in chapter 3.2.2. Another reason could be that collective ownership would result in conflict over the control of the machinery, as all the owners are likely to need the tractor at nearly the same time. On the other hand no household in the village had so much land that the full capacity of the tractors was used. So when the three households are finished using their tractors for a particular task, the other households are often still working in the fields using draught animals.

While the tractors easily could cultivate an area larger than what the individual household’s own, they are not used outside the household. As tractors are considered to be much more efficient in cultivating the land than cattle used as draught animals, it should be expected that the tractors would be rented out to other households if the benefits of using mini-tractors over draught animals were greater than the costs of contracting.

One reason could be that the benefits of tractor ploughing partly consist in a reduction of the labour power needed, and some households still have significant surplus of
labour. However, Cha Sheng has much less surplus labour than many other villages in China due to emigration. According to the residents mini-tractors are not just more efficient but also do a better job than the draught animals in cultivating the land. This has led to some households to hiring a tractor station to come and plough their land with the use of mini-tractors. But it is always people from outside the village that are hired to come and help, not one of the three households in the village that own a tractor. The households who hire a tractor station do not just rent a tractor. Instead the tractor station is hired to cultivate the land, meaning that they supply both the mini-tractor and a person to operate the tractor.

That the tractors are not being rented separately can relate to the costs of monitoring that the tractors are brought back in the same condition as they were rented out, relating to the previous discussing of the feeling responsibility of the machinery decreases as the share of ownership decreases, also relates to rented equipment. The cost of monitoring can be high since increased wear due to improper use can be almost impossible to detect. And the labour costs are relatively small compared to the price of the machinery, this can help justify why machinery is not rented out separately.

The question still remains, why assistance is hired from outside the village and not from within. Stanifird and Marshall (2000), as presented in chapter 2.2, argue that, the tight social network in the village would help lower the transaction costs and reduce opportunistic behaviour. According to this it would be cheaper to rent assistance within the village. I had the chance to ask one of the owners of a tractor why he did not rent out his assistance to the other farms, he explained that he was “too busy”. This seems like a fair answer but as he also had a son who assisted on the farm and who was looking for a part-time job in the town of Bai Shan. I asked if not his son could offer the other residents to tractor-plough their land. To this the dad replied that he would not like his son to work for another farmer.

I did not have the chance to ask the other two households that own a tractor about their willingness to work on other farms. But the reply of the father indicates that the
reason of renting assistance from outside might not be one of economic reasons but instead due to a resistance against working on other households’ plots. This might be rooted in the traditional Chinese way of thinking that working on another man’s land is closely associated with exploitation. This might especially be a problem as the tractors are owned by the wealthiest families in the village, and if they worked on other farms this could change the internal social status in the village.

3.4.4.3 Cars
There is one car in the village. It is a small pick-up truck owned by an individual household, but unlike the situation with the mini-tractors this car is working as a taxi service for the residents in Chao Sheng and neighbouring villages. The car is rented out with a driver as no other people in the village have a driver license, and even if they had, we would face the same issues as with the tractors with high monitoring costs. While there is a taboo about working on another man’s land, the same seems not to be the case for working as a taxi driver, maybe as being taxi driver naturally does not have the same historic symbolic meaning for the Chinese as it has to work on another man’s land. Individual households also own bicycles, it is common to borrow bicycles from other households at no charge.

3.4.4.4 Road
The village built concrete road connecting the village with the public paved road around 200-300 meters away two years ago. The construction was solely funded via voluntary donations from the residents of the village and their relatives. Donations were made from both the residents who in fact still lived in the village, and their relatives abroad as well as the many residents who now live permanently in other parts of China. All who contributed to the construction got their name on a plaque listing the amount donated.

The residents in the village are clearly proud of their concrete road. Ms. Huang told me that having a concrete road was normally seen as a clear symbol of being a modern village. Travelling around Taishan County I saw that most villages of a certain size
now have a concrete road, while very few have modernised their irrigation systems by moving away from the traditional canals dug out and built irrigation systems out of concrete. This is somewhat surprising as an irrigation system made out of concrete reduces the work effort needed significantly compared to the traditional systems. In other parts of southern China I often did saw a development opposite to the one in Chao Sheng. So that they first built concrete irrigation systems then later concrete roads. This route of development was especially often observed when visiting villages in Guangxi province.

The construction of the concrete road seems to have little practical value. It went on the same route as an old dirt road via the village of Tian Xin. This detour meant that few people used the road when walking to the public road instead they walked via an unpaved pathway between the rice fields, so the road was hardly ever used expect by an occasional bicycle and once in a while when the one car in the village used it, and it seems this traffic in most weather condition might as well have used an old dirt road. I feel that instead maybe the investment was a question of face. With the construction of the concrete road the villages of Chao Sheng and Tian Xin had become modern villages.

People who do not live in the village anymore were behind most of the donations. By making these donations they gained face in the village, as well as gave face to their relatives left in the village, not only because their now live in a village with a concrete road but also because they are related to the people who paid for it. At the same time as the people making the donations are happy to know that they are now from a modern village. That most of the donations came from people that does not live in the village and therefore do not work in the fields, might have influenced the kind of investment made. These emigrants might be more interested in the prestige than in the practical value of the project.

There is more prestige in giving money to a prestige project like building a road than in giving money to something of practical use, such as improved irrigation systems. In Guangxi there is not the same tradition for emigration as in Taishan so a larger share
of the funding is likely to come from people who directly benefit from practical investments like improved irrigation system.\textsuperscript{16}

\subsection*{3.4.4.5 Wells}

There are two wells in the village: one is public while the other is private. The public well is located centrally in the village in the middle of the concrete road that connects the village with the nearby public paved road leading to Bai Shan town. The construction and maintenance of the well is taken care of by the village. The benefits associated with public ownership are the same as discussed with the pumps and irrigation systems, since everyone in the village needs access to water. The private well was built by a family who lives relatively far away from the public well and therefore got tired of carrying water home. One individual household has paid all the costs associated with establishing the well, but the household has invited their neighbours to use the well too, free of charge.

\subsection*{3.4.4.6 Compensation}

Just as with the land there is no compensation when moving away from the village for one's share in the public goods. If many households intend to move away this can reduce the incentive in investing in public goods for the village in the form of roads, wells, pumps, irrigation systems, etc.

It is difficult to determine if the lack of compensation in fact has led to reduced investments in the village. As discussed in chapter 3.4.4.4 it might have changed the kind of investment made, from more practical investments that reduce the labour requirement, to more prestige-oriented projects.

\textsuperscript{16} It should be emphasized that I am not aware of how the projects in Guangxi actually have been funded. It could have been by donations like in Taishan, but it could also have been via local governments. Local governments are likely to focus more on investments that increases the rice production.
3.5 Conclusion

Farming in China has during the reform era gone from collective farming to private farming. The development has happened in two steps. The first step consisted of each household being allowed to organise the everyday work on the land while the collective decided what to grow and supplied the input and sold the output. The collective also carried the risk. Each household was rewarded according to how much grain they handed over to the collective. This was an easy way to monitor the households and created strong incentives to work hard. Monitoring the individual members of the production team had previous been a major problem of the collective farming.

It is arguable that the system of contracting output to the household did not actually change the scope of the hierarchy or the ownership in the agriculture. Contracting output to the household did not involve a full change of ownership, this made it less costly to implement. However, it did involved cost to create and enforce the land contracts, and created problems of short-termism. In trying to create a fair system each household got many small plots, this meant loss of land to boundaries, and meant that many plots become too small to use large machinery to cultivate them. Contracting output to the household did not reduce problems associated with shared ownerships of tools or machinery, as these remained collectively owned.

The second step towards household farming, contracting everything to the household, meant that the individual households became responsible for buying the needed input and selling their output. This second step was taken after the price reform of 1984-1985 had liberated the markets and thereby making it possible for the households to rely on the markets, previously this was not possible as most of the needed input were only available via government allocations.

With the new system the household was no longer a part of the collective hierarchy, instead each individual household represented an independent hierarchy. This created costs related to administrating the nexus of contracts each household had to have when acting in the market. Contracting output to the household had been introduced
easily with a minimum of costs, but the new system meant that land and tools had to be divided, this process was associated with costs. Contracting everything to the household improved the contracts associated with renting land from the village to reduce the costs of short-termism.

The system of contracting output to the household seems easily justifiable from a transaction cost perspective as it had some large reductions in costs. Only few areas experienced increased costs, the cost of the change itself was also low. This is likely also to explain why the change happened so fast. The situation is more complex when it comes to the change to contracting everything to the household. It is difficult to determine if the change resulted in a net reduction of the cost. However, that the system had its breakthrough following the price reform seems naturally. The price reform meant it became easier to use free markets for transactions and thereby significantly decreased of cost of contracting for independent households.

The case study illustrates how the system of contracting everything can work in a village in 2004. Most of the findings were in harmony with the literature. The study however made clear that when analysing the costs of ownership and contracting in a small, tightly knit, society it is important not only to include the economical costs but also the social costs, as well as the concepts of face and honour. This helps explain the limited transactions internal in the village, and also why some investments can be financed via voluntary donations. The actions are not just business based, but also based on friendship and help among neighbours, such as borrowing another household’s bicycle or use their well.

The compensation system for improvement of the land that should have been introduced nationwide seems not to have been implemented in the village. Taking into consideration the tradition of migration in the village the lack of compensation system might increase short-termism. This also illustrates how it is difficult for the national government to secure that policies are implemented nationwide. Few local residents have any knowledge of the law and therefore rely on the local officials to secure their rights.
4 Township and Village Enterprises

TVEs are often considered one of the most successful aspects of China’s economic reforms. Nevertheless there is no general agreement on a definition of what a TVE is. The TVEs initially grew out of what were known as commune and brigade enterprises. The change of name was a result of abolishing the communal system. The TVEs are also characterised by being far less restricted than the former commune and brigade enterprises (Carter et al. 1996: 69; Naughton 1995: 148). This thesis deals broadly with the changes in the de facto ownership of the TVEs.

There are several factors that make TVEs worth studying. The TVEs today make up a significant part of China’s economy and have dominated the rural industrialisation. According to Perotti et al. (1999: 158) no other countries have seen the same scale of successful rural enterprises and entrepreneurship. 133 million people are now employed in TVEs in comparison to just 28 million in 1978 (National Bureau of Statistics of China 2003: 127).

TVEs in their initial form were essentially mini state enterprises. The “state” to which they belonged was the local governments (Byrd and Zhu 1990: 89). The TVEs had access to less sophisticated equipment, technology, capital and skilled labour than the state sector. Nevertheless the TVEs seemed more successful than the SOEs from early in the reforms (Li and Karakowsky 2001: 340).

Many of the TVEs became de facto private operations in the late 1980s and during the 1990s. Pei (1998: 89) argues that traditional property right theory would predict these TVEs to perform badly due to the unclear ownership forms, but this has not the case. The change in de facto ownership leads Chen et al. (1991: 201) to define TVEs as “all rural enterprises with the exceptions of SOEs and farms run under the HRS”. The National Bureau of Statistics of China (2000) subdivides the rural enterprises into four categories: TVEs, private, self-employed and other types of enterprises. The problems defining the TVEs are described by Sun (2000: 57):
“Township and village enterprise” (TVE) is a Chinese specific term to identify those firms that are initially collectively owned by rural community such as a township or village…. This term has increasingly become an administrative and historical icon rather than an economic one.

Despite that Sun argues that the term TVE is more a historical and administrative icon than an economic one, the TVEs are still interesting to analyse; which factors were behind their success and why have the TVEs changed during the reforms.

Some sources report that TVEs have faced problems in the 1990s while others reports that the TVEs have continued to grow rapidly, e.g. Li et al. (2000: 265) and Sun (2000: 52). The differences are likely to arise from different definitions of what a TVE is. The traditional TVEs closely linked with the local government have lost much of their importance since the early 1990s. The de jure TVEs that work as de facto private ownership on the other hand have continued to experience strong growth (Chen 2000: 2, 8).

### 4.1 Responsibility Systems

Unlike the situation with both the HRS and SOEs there have been no nationwide responsibility systems for the TVEs. Instead there have been launched many different systems across time and location. The general movement have been towards more autonomy from the local authorities.

The central government encouraged new management forms for TVEs in the 1990s, some closely approximating private ownership (Oi 1999:81). One system is leasing the TVEs to private management. Another way is shareholding, where the TVE keeps hiding under the collective umbrella while the shareholder system opens up a new way of raising capital. Hiding under the collective umbrella is a way for de facto private enterprises to get political acceptance (Oi 1999: 84). The number of TVEs fully owned by local governments decreased rapidly in the 1990s, while especially ownership by management became popularly (Li et al. 2000: 268). It should be emphasized that the TVEs also have seen increasing competition from de jure private enterprises (Unger 2002: 131).
4.2 Cost of Contracting

There are two types of cost of contracting that seem practically relevant to analyse in relation to TVEs. Firstly the access to the markets for input and output is relevant due to the limited development of markets in China. Secondly the costs associated with enforcing contracts and managing contractual relationships. Lack of an effective legal system made it costly to enforce contracts. Thus it was difficult to penalise opportunistic behaviour via the legal system. Both factors were mainly true in the beginning of the reforms. These costs of contracting have dominated the situation in China and will therefore get special attention in this chapter. In chapter 4.2.3 special attention will be given to the TVEs engaged in the agricultural processing industry.

4.2.1 Market Access

Under Mao Zedong the TVEs had only been responsible for producing a few products for use in the agriculture. The situation started to change in 1979 as a new policy was adopted stating: “Whenever it is economically rational for agricultural products to be processed in the rural areas, rural enterprises should gradually take over the processing work.” This was the first step toward expanding the number of products produced rurally as agricultural output previously had been processed by urban SOEs (Naughton 1995: 147). Later the TVEs also became very active in the manufacturing industry.

Except for a few markets for certain agricultural products all markets were closed under the planned economy. According to White (1993) there existed a well-developed black economy, and this played a key role in keeping the economy working despite the collapse of the planned economy. The black economy continued to exist after the initial reforms, Guo (1992: 113, 117) estimates that the black market made up 10-15% of all producer goods in the 1979-1983 period, this share is likely to have been reduced as the markets developed following the price reform of 1984-1985.

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17 The TVEs were known as commune and brigade enterprises at the time.
Both the TVEs and private enterprises benefited from the price reform and grew rapidly in the following years (Byrd and Zhu 1990: 85; Chen 2000: 170). The price reforms made it more attractive for TVEs to become de facto private enterprises as the improved markets reduced the value of close links to the local government. The TVEs have mainly had success in regions that could be classified as suburban, especially near urban areas with high economic growth (Naughton 1995: 154). This indicates the importance of a location near the urban markets. However, this does not in itself justify the special ownership structure of TVEs and why the TVEs could be so successful and compete with the urban SOEs.

Under the collective system commune and brigade enterprises had been part of a hierarchical system that supplied land, capital, labour and other input. While the TVEs had to rely on markets to obtain some of the input, they could still get help from the local government for inputs where the markets were not yet fully developed. It was also easier for the TVEs to obtain the needed permits from the local government than it was for de jure private enterprises.

The majority of free markets were closed down in 1957 and remained closed until the beginning of the reforms when the number of markets and market transactions increased rapidly (Oi 1999: 7; Zweig 1997: 153). During the first years, the markets were generally insufficiently developed to allow enterprises to depend solely on market transactions. Even private enterprises did regularly get a share of the needed input allocated. The problems were general inefficiencies and a lack of products available at the market. Following the price reform the markets developed rapidly and by 1985 more than half of the TVEs did not get any of their input allocated. By the early 1990s most commodity markets were free (Chen 2000: 143-145).
The TVEs often benefited from links to the local government to get access to land and capital, as these were especially difficult to access via the market. The local governments did not offer the same kind of assistance to private enterprises. Furthermore the local government often helped supply the labour needed in the TVEs. Despite the fact that there existed surplus labour in most parts of the country, private enterprises often found it difficult to get access to the needed labour (Byrd and Zhu 1990: 87). There are likely to be two reasons for this. One is that the majority of “rural” industrialisation in fact happened in suburban areas near the coast where the number of surplus labour was not as great as in other part of the country. But maybe more importantly was the lack of an effective labour market that could connect the surplus labour with the enterprises. While the TVEs had natural links to the local government to secure permits and inputs, private enterprises had to use corruption (Byrd 1990: 216, 296).

TVEs had some access to cheap loans through the state banks, if not to the same extent as the SOEs (Carter et al. 1996: 14). Banks gradually gained more independence during the 1980s and according to Byrd (1990: 207) the TVEs’ advantages over private enterprises were reduced in this aspect. As we will see in chapter 5.2.1 it is questionable to what extent the behaviour of the state banks in fact has changed. The TVEs also had access to capital from other sources than from the state banks. The reforms resulted in increasing household savings, which the TVEs gained access to via the rural credit cooperatives. The importance of the rural credit cooperatives peaked in 1986 when they supplied 27% of the TVEs’ capital (Naughton 1995: 153).
The local governments also helped TVEs gaining access to capital by working as guarantors and thus spreading the risks (Naughton 1995: 153). This model was used to attract more individual households’ savings into the TVEs (Byrd 1990: 205). The issue regarding the cost of risk bearing will be dealt with in more details in chapter 4.3.5.

The TVEs also benefited from having leaders with good connections in general. One indication of how important it was to have the right connection in gaining access to needed input, is that many of the private entrepreneurs who started up private businesses also were former cadres (Chen et al. 1991: 143). They benefited not only from having a relatively good training, but also from having created a good network due to their former positions.

4.2.2 Enforcing Contracts

The cost of managing the contractual relationships includes cost of negotiation and creation of contracts as well as the cost of solving conflicts. The People’s Republic of China has used contracts to control economic exchanges since the early 1950s. But the state’s interests always had precedence over any contractual agreement (Zweig 1997: 154). Due to the lack of private enterprises under Mao Zedong there were no laws covering private enterprises (Shen 2000: 22). Especially in the beginning of the reforms, it is likely to have given the TVEs a degree of security being under the wings of the local government, compared to being a fully private enterprise in a society without an effective legal system.

In the beginning of the reforms when the lack of an efficient legal system was greatest the TVEs benefited from the closer ties within the rural areas that meant a reduction in the transaction costs. The reason for the reduced costs closely relates to the discussion regarding guanxi-based businesses in chapter 2. The close ties in the rural societies created a high degree of information exchange regarding previous behaviour of the other party in a transaction, this can prevent opportunistic behaviour (Pei 1998: 90). As discussed in chapter 2.2 the potential costs of conduction opportunistic behaviour is high not only in economic terms but also in social terms as you live in the
community. The lower transaction costs in the rural areas are linked to the location and not the TVE ownership form. Nevertheless, TVEs are still likely to have a special beneficial position as the local governments often have mediated and resolved disputes over transactions (Sun 2000: 57).

The informal rules helped the reforms succeed in the rural areas without having all the institutions in place. Legislated norms generally replaced customary rules during the 1980s, there remain great regional differences in the use of legalised contracts versus norms (Pei 1998: 92; Zweig 1997: 153, 177). Zweig (1997: 157) found that in Shanghai contracts for vegetable often fixed the price for future deliveries without consideration for variety or quality to be supplied. The TVEs might benefit in a situation like this, as they are likely to be seen as a more trustworthy transaction partner than an unknown private businessman, thereby reducing the cost of contracting.

Transactions are increasingly based on free market terms and the legal system has improved significantly, making it cheaper to act in the market. And the local government play a more passive role today (Sato 2003: 78). This reduces the need for government links, and thereby the benefits by being a TVE. To further decrease the cost of contracting, especially for small individual business, many contracts are standardised. This is done to make them easy to deal with and to reduce the costs of creating contracts and dealing with badly created contracts (Zweig 1997: 156-157). Of course, standardised contracts themselves bring some costs such as the lack of possibility of taking special issues into consideration.

4.2.3 The Agro-processing Industry

There are 206,000 TVEs engaged in China’s agro-processing industry (Jiang 2000: 259). Hansmann (2000: 120-124) notices how farmer-owned cooperatives play an important role in market and processing agricultural products in the United States. Hansmann finds this justifiable since agricultural products are very homogeneous commodities with a very large number of producers while the middlemen and the processing industry often are highly concentrated thereby creating market power.
At a nationwide scale the middlemen and processors seem to have less monopsonistic power in China than in the US since the number of middlemen and processors is much larger in China. This does not necessarily imply that a processor cannot have substantial market power in his specific area. The possibility for this is increased by China’s lack of an effective infrastructure. This implies that it would be difficult for the individual farmer to sell it outside the local area as well as to obtain prices for the markets in the other nearby townships. This is likely to have been a much greater problem 25 years ago than it is today.

There are basically three possible relations between the farmer and the processing sector: a purely buyer-seller relationship; sign formal contracts for future sales, or to establish some form of cooperative thereby making the farmer part owner (Han 2000: 221). According to Han, the situation in the reform era has generally moved from the pure buyer-seller relationship, between the TVE and the household, over contracts towards a cooperative mode in the form of farmer controlled TVEs. In the 1980s there were attempts to create farmer cooperatives these were generally unsuccessful. One reason seems to be the cost of ownership of the time that will be discussed later in chapter 4.3.

It is questionable if the relationship between the individual household and a TVE controlled by the local government in fact can be seen as a pure buyer-seller relationship as Han does. The TVE ownership is likely to have resulted in some of the same reductions of transaction costs as a cooperative ownership could have done. TVEs were in the beginning of the reforms normally both de facto and de jure owned by the local government. It must be assumed that the local government at least to some extent represented the interest of the local residents who in many places mainly consisted of farmers. The TVEs would therefore be less likely to exploit the farmers, via the use of their market power, than is a private company or indeed an urban SOE.

Today many of the TVEs that are engaged in the agricultural processing industry or act as supplier to the agriculture have adopted some aspects of cooperative ownership.
However, there are only few de jure cooperatives in rural China while cooperatives play an important role in many other countries. The idea of rural cooperatives is not unknown in China, and some were introduced in the 1950s. The farmers later lost control over them to the government. Han (2000: 224) claims that one of the main problems today is an almost total lack of legal protection of cooperatives together with a general lack of legal regulation of cooperatives, and this is the reason why the processing industry remains dominated by TVEs, that have adopted some aspects of cooperative ownership.

4.3 Cost of Ownership

Studies covering cost of ownership normally focus on the cost of monitoring and agency cost in general. This section will begin with an introduction to the costs that are politically determined due to regulations and discriminative treatment. Oi (1999: 60) points out that politics in China have had a major influence on the choice of the ownership form of rural enterprises. While politics might have a greater influence in China than in most industrialised countries, this does not mean that politics does not have a significant influence in the West. As Hansmann (2000) shows, taxation policy tends to have great influence on the choice of ownership type. The chapter also analyses the costs of political interference and production of political goods.

4.3.1 Legal Background

What is termed legal background here, is a general term for the environment the governments at different levels create for enterprises to operate in. This does not only include actual laws but also discriminative treatment in general. It does not cover direct political interference in the management of the enterprise as this is covered in chapter 4.3.2. This chapter especially focuses on the taxation policy due to its influence in the success of TVEs.

If an ownership structure is not legal, it will result in very high transaction cost under the assumption of effective control and punishment. The same is true in the case of an ownership structure that is legal but relies on illegal transactions, such as the use of a
black market due to the lack of a free market. The first case would be a cost of ownership while the second would result in increased cost of contracting. The TVEs benefited from their political connections to obtain goods as discussed previously, just as the TVE form of ownership was recognised by the government from the beginning of the reforms, unlike private ownership.

TVEs have in general had an advantage over private enterprises and SOEs due to tax exemptions and reductions (Charter et al. 1996: 14; Li and Karakowsky 2001: 346). Naughton (1995: 151-152) can report how the TVEs in average paid 8% in tax in 1978, this increased to around 20% in the 1980s, much lower than the tax rates of SOEs and private enterprises.

One reason for this preferential treatment of TVEs over private enterprises was that TVEs were a way of preventing redistributing the original assets that would happen if private enterprises took over. Thus TVEs were politically more acceptable as no one seemed to gain at the expense of others. (Pei 1998: 93-94). The party congress in September 1997 declared, “China is a ‘mixed’ economy in which a variety of ownership forms, including private ownership, co-exist” (OECD 2000: 51). This is indication of how the resistance against de jure private enterprises is reducing. The TVEs also often benefited from the local governments "bet on the strong" bias. This meant a support for enterprises that already had shown success. Some TVEs benefited from this as they were already established while private enterprises were just about to set up.

While the official tax rate was low the TVEs suffered from having other political imposed costs. Especially in the beginning of the reforms, TVEs often had to hand over money to the local agriculture or to support the start-up of new TVEs (Byrd and Zhu 1990: 89; Song and He 1990: 351). Naughton (1995: 152) estimates that TVEs paid as much as 30-40% of their profit in support of agriculture, leaving just under half to be reinvested in the enterprise. Private enterprises, and the few cooperatives that did exist, did not have to pay a share of the profit in support of the agriculture (Naughton 1995: 152).
National regulations have allowed TVEs to get favourable tax treatment at the same

time as local governments often have been generous in estimating the profit of the

TVEs and collecting the taxes (Oi 1999: 35). Sato (2003: 57) reports that
discriminative treatment against enterprises due to the ownership structure generally
has faded away both in the form of legal status and taxation policy. It is unclear if this
only relates to official policy or also to reality.

As indicated it might have some advantages to be a de jure collective owned
enterprise. This has naturally helped the TVEs to have success. However, the most
successful TVEs have, in the last decade, been the TVEs that are de facto private
enterprises. This is partly due to the fact that it is fairly easy to register a de facto
private enterprise as a TVE and get access to some of the preferential treatment (Li

One problem related to the classic TVE ownership is that you lose your ownership if
you move away from the village or township (Carter et al. 1996: 24). This might result
in costs related to reduced mobility as well as short-termism, like what we have seen
in agriculture. As long as the local government remain in partly control of the TVE, they might be able to prevent some of the short-termism.

4.3.2 Political Interference

This chapter focuses on the political interference by township and village
governments. Political interference has naturally been greatest for the TVEs that were
directly controlled by the local government. While the government have less
opportunity to interfere with TVEs, that are de facto private enterprises (Naughton
1995: 146)

The TVEs are technically collectively owned by the local citizens (Luo 1990: 166;
Chen 2000: 23). Therefore the relationship between citizens and the local government
is not unlike the principal-agent relationship seen between shareholders and the board
of directors. The most important difference seems to be that the citizens due to a lack
of elections have no direct way of punishing the local politicians (the agents), if the citizens are unhappy with their performance. Chen (2000: 53) can report that local leaders nevertheless do care about their reputation, and that this helps limiting the degree of opportunistic behaviour among the political leaders.

TVEs are used by the local governments to produce political goods such as reduction of unemployment and rural-urban migration via over-employment. Local residents are regularly given preference when new people are hired at TVEs (Sun 2000: 58; Byrd and Zhu 1990: 166; Luo 1990: 168; Pei 1998: 71). Production of political goods does not have to result in agency costs as long the production is in the interest of the owners, which are the citizens of the local community. Naturally this is not always the case. There have been increasing problems with corruption among local government officials as well as TVE managers (Sun 2000: 58). The political interference in the TVEs also results in short-termism according to Pei (1998: 76).

While it theoretically should not necessarily be a problem, that the TVEs are being used to produce political goods, it seems to be so in reality. According to Perotti et al. (1999: 167) some of the problems include difficulties in setting up clear objectives, as these become a combination of economic and political targets that often are conflicting.

Perotti et al. (1999: 152) also points out that core TVEs typically still are owned by the citizens of the local community, thus, have not been privatised. One reason for this might be that, the behaviour of these core TVEs is central to the well being of the community. And that it is optimal to keep it under the control of the local government instead of privatising them and relying on contracts to control their corporate behaviour.

There is a great number of different ways to organise the ownership and control of the TVEs. Each region tends to have developed their special ways. TVEs that are still de facto owned by the local government in most places, suffer from no clear separation between public and corporate finances. This situation is much the same as is seen with
SOEs and carry the risks of either soft budget constraints where losses have no consequences for the TVE or alternatively that the enterprise is being exploited by the local government. To prevent the exploration there have been some attempts from the national government to control the behaviour of the local governments in this aspect (Sato 2003: 56; Sun 2000: 58).

Despite the fact that the TVEs often have been the target of political interference by the local governments, they still have much more freedom than the SOEs, this has led some urban SOEs to establish close links to TVEs as they could avoid some of the close control from the central government in that way (Naughton 1995: 155-156).

4.3.3 Agency Costs

This chapter focuses on agency costs in a more traditional sense. A key element in reducing agency costs is to be able to both monitor and discipline managers and workers. As we have seen in chapter 3.3.1, monitoring was a key problem with the collective farming in China during the Mao era. This was not only the case within farming; lack of encouragement and punishment was a problem in the society as a whole.

Early in the reform the TVEs gained more opportunities to discipline their workers. Some TVEs have also introduced mutual monitoring teams at the horizontal level. Managers in TVEs have no guaranteed lifetime employment and their terms are often up for renegotiation (Perotti et al. 1999: 172-173). Salaries in the TVEs nevertheless remain much more equal than in the private sector (Gelb 1990: 291). These tendencies towards higher equality/security in the TVEs might be due to political reasons as they can help secure political stability. The larger degree of equality can however make it difficult to attract the best managers.

The relative small size of TVEs might help reducing monitoring costs. The investors in the TVEs, which are the local governments or others, show much greater interest in monitoring the TVEs than the state does with the SOEs. (Perotti et al. 1999: 163). One reason for this might be that it is simply easier to monitor a few and often smaller
enterprises in the same geographical location than the big SOEs located around the country. The investors also depend more on the individual enterprise and therefore have an incentive to monitor. This includes the local residents who have an interest in keeping an eye out for unacceptable behaviour (Pei 1998: 90).

As the de facto ownership of the TVEs started to change, the first step was often a contract between management and the local government. The management had to hand over a fixed rent and could keep the remaining profit. Later floating rent systems were adopted (Oi 1999: 26). Oi does not come with any suggestion for this change. Monitoring costs might play a role. By handing over a fixed rent, the local government have no problems with monitoring the actual profit of the enterprise. Monitoring could have been very costly due to inefficient accounting and auditing standards. As the accounting and auditing systems are developed, it might become more attractive to introduced floating rent system. By handing over the de facto ownership of the enterprise to the management the agency costs between the local governments and the management will be eliminated, as the owners and managers become the same group of persons. There might still be problems with agency costs within the group of managers/owners, and between the owners and other employees, but the managers as owners are likely to be good monitors.

4.3.4 Entrepreneurship

As discussed in chapter 4.3.1 the TVEs were allowed to keep some of the profit within the enterprise, from early in the reform, this resulted in an incentive for each enterprise to pursuit profitable business opportunities. Then the TVEs later were contracted out to the management, this gave the managers strong personal incentive to pursuit profitable entrepreneurial activity.

The success of the TVEs, as well as the private enterprises, is closely related to their entrepreneurial activities (Byrd 1990: 189). During the first years of the reforms many TVEs achieved very high profits from finding niche markets with a latent demand or entered markets with high prices set by the government. A third market type the TVEs
often entered was the fast growing market for building materials (Naughton 1995: 151; Chen et al. 1991: 133; Unger 2002: 133).

### 4.3.5 Risk Bearing

Ownership also includes risk bearing. Not all patrons have the same costs of bearing the risk, and risk bearing is therefore also a part of deciding the optimal ownership. As we have seen in chapter 4.2.1, the TVEs often operated with the financial support from the local government or the local government act as guarantor for loans given to the TVEs or even as guarantor for invested capital in the form of household savings.

Both local and central government must be assumed to be in a better position of absorbing risks than the individual investor as they have the benefit of being able to share the risks and losses over a larger group of enterprises (Byrd 1990: 189-190). Furthermore, due to TVEs political status, state banks were more willing to absorb the risk of TVEs than the risk of private enterprises (Byrd 1990: 205)

After the 1989-1990 crisis in China, the TVEs sought alternative ways of financing, from either private investors or from employees. Sometimes employees’ shares work as "buying a job" (Sun 2000: 65; Pei 1998: 71, 74). As discussed in 4.2.3, ownership by managers or employees might reduce monitoring costs. Seen from a risk bearing point of view it is unlikely to be optimal, as the employees often are not well fitted to bear the risk and have no chance of spreading the risk over several enterprises. Instead, they face the risk of losing both their job and savings, if the one enterprise they work for go bankrupt. This became increasing true as the local governments’ safety net under the TVEs was being reduced.

### 4.3.6 Collective Decision Making

Shared ownership results in collective decision-making. The local government might have reduced the cost of collective decision-making by holding de facto ownership of the TVEs in the first years. Instead of letting the citizens choose their own managers for each enterprise, this was done by the local government, thereby reducing the
number of people who had to be involved in the process. However, the result of the process might not have been in the best interest of the citizens and this way also results in decision-making costs inside the local government over how to control the enterprise.

There is also collective decision making within the enterprise itself. The small size of TVEs gives them great flexibility compared with the state owned sector and TVE can make decisions faster than the SOEs (Perotti et al. 1999: 162). Decision making in TVEs also benefits from the lower degree of political interference compared with SOEs. However, the political interference is still likely to make the process longer than for the same size private enterprise. The TVEs were often deliberately kept small and decisions to create a new TVE were often merely an administrative confirmation of successful development of new products by an existing enterprise (Byrd 1990: 197).

In the cases where the TVEs were changed into share based enterprises, the managers often managed to buy up a large part of the shares (Pei 1998: 77). This behaviour might be an attempt of reducing the circle of ownership and thereby reducing the problems with collective decision making. At the same time as managers often had the best information about the enterprise this can reduce problems with agency costs. Managers were often the principal contractors even the responsibility system officially included both managers and workers (Oi 1999: 26). This is also likely to have been due to a wish to reduce the number of persons actually responsible for the decision-making. Just as some of the people with the best chances of influencing the performance of the TVE also became responsible for the performance.

4.4 Conclusion

The TVEs were to begin with essential mini state enterprises belonging to the local governments. The TVEs have been very flexible in reducing their relations to the local governments step-by-step, as they no longer needed the support of the local governments as the institutions developed. Today the township and village enterprises are often de facto private enterprises that only remain under the collective umbrella to
have access to the few remaining benefits associated with being a de jure TVE. The increasing number of de jure private enterprises indicates that the benefits now in many cases are becoming smaller than the disadvantages.

The TVEs grew out of the commune and brigade enterprises. This meant that there was little cost associated with changing the ownership to begin with. This can only be used as an explanation for the TVEs that already existed as commune and brigade enterprise at the beginning of the reforms, but many new enterprises have since been established as TVEs. The TVEs have been an attractive alternative to both the SOEs and the de jure private enterprises, as the TVEs have been a third type of ownership in-between the other two. The TVEs have been suitable for the transition period between the planed economy and a market economy.

As the Chinese society developed, so did the TVEs. The flexibility of the TVE ownership form is a key factor in their success. The TVE ownership has changed to an extent where the ownership form is becoming almost unrecognisable. The TVEs have gone from being mini state enterprises to being de facto private enterprises. There are some indications that this development is justifiable. As the markets have developed and the formal institutions, including the legal system have been developed there is less need for close ties to the local government. Therefore it becomes more attractive to move away from the local governments, since the close links also impose some costs due to political interference in the management of the enterprise.

The TVEs’ move away from the local government often started with introducing a responsibility system, with bonuses paid out if certain financial targets were met. The contracts in these responsibility systems were between the local government and the managers, and possible the employees, of the enterprise. Later it often developed into de facto ownership by the management. China’s continuous lack of effective accounting and auditing systems increases the costs of monitoring the performance of the enterprise. The management might therefore be suitable owners as it helps reducing the agency costs.
Most of the TVEs engaged in the agro-processing industry are not de facto owned by management or by employees, instead they are mostly producer owned. That the agro-processing industry works as de facto cooperatives can be explained by the large possible market power, since the products are homogeneous, the producers many, and only relatively few buyers. The producer ownership might thereby reduce the cost of contracting enough to make up for the increased agency costs that are likely to occur when the enterprise is not owned by the management.

By being small units associated with the local governments, the TVEs have often been able to combine the best elements of two alternatives. The responsibility systems made it attractive for the management to pursue new sources of income and the small size of TVEs helped creating a flexible environment often with high entrepreneurial activity. The local government acted as a risk bearer, this could have made the managers taking too great chances due to the government safety net. This problem seems to have been smaller than the benefits from the many new projects established due to the authorities support. The risk of getting fired might have been one factor that prevented managers from taking too big risks.
5 State Owned Enterprises

The behaviour of state owned enterprises (SOEs) was under Mao Zedong determined by political and bureaucratic criteria. The SOEs acted more as administrative units than economic ones, and the enterprises normally only had so-called soft budget constraints (Jackson 1992: 61).

*Until the 1970s China had no companies as such. What are now SOEs were merely arms of government bureaucracies* (The Economist 2000: 71)

The SOE reforms started in Sichuan province in October 1978 and quickly spread to the rest of the country (Jackson 1992: 64). Under Mao Zedong products had been produced according to plans issued by the central authorities, this often resulted in the production of products for which there were no demand. The situation has changed during the reforms so that production increasingly happens due to a demand from the market. (Chow 2002: 255).

The SOEs totally dominated China’s industrial production under Mao. In the reform era their importance has been steadily decreasing, nevertheless they still play an important role. Profits of state-owned industrial enterprises are an important source of income for the government, but SOEs’ profit fell from 7% of GDP in 1987, to 2% in 1994 (EIU 2004: 34).

Table 4: Industrial output

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>2002</th>
</tr>
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<tbody>
<tr>
<td>SOE output (billion RMB)</td>
<td>3,362</td>
<td>4,518</td>
</tr>
<tr>
<td>SOEs’ share of total output</td>
<td>50%</td>
<td>41%</td>
</tr>
</tbody>
</table>

Note: The output values are in current prices. Only output from enterprises with an annual turnover of over RMB5 million is included. Source: National Bureau of Statistics of China 2003: 461

The SOEs’ output listed in table 4 includes output from the 41,000 industrial enterprises official listed as SOEs. The EIU (2004: 33) doubts the accuracy of this statistic and believe it heavily underestimates the number of SOEs and their importance to the Chinese economy. According to the EIU many companies that are SOEs are categorised as “co-operatives” or “collectives” in the statistics. The EIU
estimates the total number of SOEs to be over 170,000, including non-industrial enterprises. Zhou and Wang (2000: 297) on the other hand estimate that the SOEs only represented 28% of China’s industrial output in 1996, down from 78% in 1978. A part of the difference might be that the official statistics only include output from enterprises with an annual turnover of over RMB5 millions. This excludes many small private and other non-state enterprises. The success of the TVEs is sometimes suggested as a role model for the SOEs, this will mean more private control. Some SOEs have already been sold off others have been partly privatised (The Economist 2000: 73).

Almost half of the profits of the entire state sector in 2000 were generated by just a handful of SOEs in the oil and gas sector (EIU 2004: 35). These are considered too strategically important by the government to privatise, it is simply considered too risky (expensive) to have agents acting on the government’s behalf. Agency costs play an important role when analysing China’s SOEs and many responsibility system have been initiated, these will be introduced in chapter 5.1. It is also important to take into account the SOEs’ broad social contributions, and not only their financial results (Perotti et al. 1999: 151). Chapter 5.2.2 will focus SOEs production of political goods as well as political interference in general.

5.1 Responsibility Systems

The reforms of the SOEs have been more controlled and planned than the reforms of agriculture and the TVEs. There have been a number of responsibility systems in the reform era. These have often been focused on reducing the agency costs by increasing the incentives of the management to maximize profit.

The first step of the SOE reform is normally considered taken in Sichuan in 1978 as 100 enterprises introduced a profit sharing system. By 1979 the participating companies were allowed to keep 10-30% of the profit from selling above quota production on the market (Jackson 1992: 67, 90; Byrd 1991: 11). The system had become widespread across the country by 1980 and resulted in 17% of consumer goods being sold outside the state agencies (Jackson 1992: 71, 93). It should be
emphasized that the profit sharing system introduced in 1978 was not the first attempt to reform the SOEs, under Mao Zedong there had been several initiatives. The profit sharing system of 1978 was new in the way that it introduced the use of markets for a part of the production.

The first profit sharing system an experimental and was soon replaced by the Contract Management Responsibility System (CMRS). The CRMS was officially introduced in 1980 with the sixth Five-Year Plan (Hassard et al. 1999: 56). The CMRS consisted of a contract between the enterprise and the state. The duration of the contract could be up to 14 years, with the most common duration being three years. During the contract period the enterprise had to pay a flat tax (rent) according to the profit in 1978, this was relatively easy to administrate (Hassard et al. 1999: 58).

Some sources indicate that the CMRS had a rough start and did not become widely implemented until the mid 1980s when 90% of the SOEs were including in the system. (Jackson 1992: 108). The CMRS did not only include a flat tax but also gave the SOEs more freedom in their decision-making. (Choe and Yin 2000: 98-104). In this way the CMRS not only tried to give the incentives to maximize profit but also gave the management the power to influence the financial result of their enterprise. The profit belonged to the enterprise not to the management. However, it still helped creating incentives for both the management and the workers, as the profit was used for benefits such as improved housing, medical care etc.

The CMRS has been phased out since 1993 and replaced by two new initiatives. Modern Enterprise System (MES) and Group Company System (GCS). The two systems are interlinked. They meant introduction of shareholders, a board of directors, reduced government interference and in general made SOEs less reliant on the state (Forrester and Porter 1999: 61-65; Hassard et al. 1999: 57, 68). These systems were more advanced than the earlier systems and had a focus on corporate governance and transparency.
The GCS consisted of a parent company and a large group of subsidiaries that were supposed to have a high degree of managerial autonomy from the parent; this was not always the case in reality (Hassard et al. 1999: 70). Often the system has been used to merge SOEs together under the stronger management (The Economist 2000: 73). The GCS still exist now and are often called Enterprise Groups. These are often conglomerates and their economic performances are mixed. Subsidiaries in Enterprise Groups feel a pressure to hire redundant workers from other parts of the group (Hassard et al. 1999: 74).

The MES were introduced under the motto: *reform, reconstruction and restructuring.*\(^{18}\) The MES focus on the clarification of property rights and distinguishing between government and management functions (Hassard et al. 1999: 70). The MES never had much success and was abandoned in the late 1990s, instead the latest policy were introduced known as *grasping the large, letting the small go*\(^{19}\) the aim of the policy is to keep 500-1000 of the largest and strategically most important SOEs under state ownership while the rest should be privatised, merged or allowed to go bankrupt (Liao 1997: 4; EIU 2004: 34, 36). OECD (2000: 58-60) reports that the performance of the divested SOEs has been mixed and many of them are unlikely to survive.

### 5.2 Cost of contracting

Like in chapter 4.2, the focus of this chapter will be on the access to the markets and enforcing contracts. The SOEs’ central position in the planned economy gave them good access to the needed input in the beginning of the reform. The SOEs’ relations to the state still mean that they often act in a combination of the market and government hierarchy. This influences both their market access and the way they enforce contacts.

#### 5.2.1 Market Access

The SOEs were in the centre of the planned economy, and had the best access to the needed input. Since China’s planned economy never was in balance, this did not

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\(^{18}\) In Chinese: gaige, gaizu, gaizao (改革, 改组, 改造).

\(^{19}\) In Chinese: zhua da fang xiao (抓大放小).
imply that SOEs got all the needed input, only that they got more than the commune and brigade enterprises at a lower administrative level. The unsteady nature of the supplies resulted in many SOEs making orders larger than they needed in an attempt to secure as many supplies as possible, the enterprises also attempted to create large inventories as a buffer. Both factors resulted in large costs in the planned economy and made it even more unbalanced.

Vertical integration was common in many of China’s SOEs and remains common in the reform era. It is often argued that this expansion happened not for economic reasons but carried out by the enterprise management mainly to gain as much power as possible. However, there might also some economic arguments for this situation since there were no markets and the national planned economy worked so badly. In many cases the SOEs became small independent societies that could supply everything needed both in the production and in the lives of the employees. Dixon and Newman (1998: 54) give an example of one such “society”. Wuhan Iron and Steel Corporation have more than 200,000 employees but only 40% are involved in the steel production. The rest are employed within other activities such as a housing programme for its employees, a TV station, a hotel and a complete educational system including everything from primary schools to a university. This is an extreme example of integration. It is difficult to determine when the activities are a part of vertical integration when they simply are the activities of a conglomerate.

As the dual pricing system was introduced with the price reforms in 1984-1985 the SOEs started to rely partly on the market for both input and output (Jefferson and Rawshi 1994: 51, 62). As the market started to take over from the planned economy the SOEs’ advantages were reduced. The price reforms led to increased competition, this might be one of the reasons why most studies show that the SOEs’ financial performance have worsened in the reform era despite the fact that some of the same studies indicate that SOEs relative productivity performance has improved (Huang and Kalirajan 1998: 585; Jefferson and Rawshi 1994: 56).
Today the planned economy is close to non-existent. However some SOEs are still allocated cheap energy, and the banking sector remain influenced by the traditions. The SOEs’ advantageous access to the capital markets will be analysed in the following. China’s banking system is dominated by four big state owned banks. The first major reforms of China’s banking system that opened it up to other players came in 1995 (Wei and Wang 1997: n. pg). Foreign banks are now also allowed to operate in China, within certain limits. In March 2003 The State Banking Regulatory Commission was created, its purpose is to supervise the banking sector and to help speed up the banking reforms (EIU 2004: 36).

The SOEs remain important within China’s heavy industrial production as well as the oil and gas industry. One reason could be that these sectors have been considered to be of the highest importance to the well being of China. This will be discussed further in chapter 5.3.2 covering the production of political goods. Another reason could be that these industries are capital intensive, and few other domestic players can access the needed capital. 43% of the total investments in fixed assets in China’s enterprises are in the SOEs (National Bureau of Statistics of China 2003: 188).

As China’s money markets continue not to work well, it can be hard for private businesses to enter capital-intensive industries. The SOEs have a better access to the money markets due to their connections with the state owned banks and the government. Besides, the state banks, government ministries and other SOEs also often provide loans to SOEs in need, this often creates a complex web of triangular debt between different SOEs (Hassard et al. 1999: 74).

Most published articles on China’s state owned banks argue that state owned banks favoured the SOEs in the 1980s and early 1990s (e.g. Jefferson and Rawshi 1994: 63; Wei and Wang 1997: n. pg). And according to The Economist (2004: 17) the situation has not changed significantly despite many attempts of reforming the banking sector. The EIU (2004: 34) states that the “overwhelming majority of bank funds continue to be lent to state-linked firms” and the SOEs are responsible for many of the non-performing loans.
One of the latest initiatives from the China Banking Regulatory Commission is urging the banks to sue customers with bad loans in order to enhance the credit-culture in China. China has major problems with its legal system, and it might be difficult to enforce the initiative in the courts (BBC 2004: n.pg.). It should, furthermore, be noticed that the initiative is not directly aimed at the SOEs.

If the whole state sector was seen as one hierarchy the state banks can have good reasons to lend more funds to the SOEs than to other enterprises types. It might be easier to enforce their rights within the hierarchy than in the market where the relations are controlled by the inefficient legal system. In reality the relations between the SOEs and the state banks are a mixture of the hierarchy and the market. Officially the market should control these relations but political interference often means that relations between SOEs and the state banks, as well as between different SOEs, are not solely based on the market.

An alternative way to access capital is via the stock exchanges. There are currently two on the Mainland, one in Shanghai and one in Shenzhen. The stock exchanges have so far mainly been used to raise capital for the SOEs and not for private enterprises (Economist 2004: 18). In general the stock exchanges have their own problems that make them an expensive way to access capital. Some of the problems are continuous price manipulations and poor corporate disclosure (Gelb 2001: 35). Especially problems with corporate disclosure are widely discussed in the literature, the main problem in centred around lack of a well-working accounting and auditing system. This leads to asymmetric information and increases the costs associated with attracting investments into the enterprise. The SOEs naturally also suffer from this effect but not as badly as other enterprise types. First of all the stock markets are only one way to access capital for the SOEs, secondly the state often remains a major shareholder after the SOE has been listed. The problems with the Mainland stock exchanges have led some of the major SOEs to become listed on the stock exchanges in either Hong Kong or New York. This requires the companies to fulfil certain
requirements, but if they do fulfil these requirements, there might be lower costs associated with obtaining capital via the international stock markets.

5.2.2 Enforcing Contracts

As indicated in chapter 4 the TVEs benefited from the demographic stability in rural China. The small number of people in the individual rural communities together with the demographic stability promotes “invisible institutions” that provide a moral framework despite the absence of well-specified private property rights. The SOEs operate mainly in urban areas with the same degree of invisible institutions. The number of people in the urban area is much larger which make it difficult to socially punish opportunistic behaviour in the same way as in the villages. All of the big cities have furthermore experienced a major immigration of rural people. This immigration makes it even more difficult to apply social punishment to opportunistic behaviour, as these people do not have much to lose as they come to a new city with no social network.

The SOEs often act in a mix between market and hierarchy when dealing with the authorities, other SOEs and TVEs. This gives the SOEs some benefits as they might not need to rely on the legal system to manage contractual relationships but can use administrative tools instead, if these are more effective. Another issue is that since the SOEs are a part of the same hierarchy as the legal system, one might wonder if this could give the SOEs some advantages compared with a private enterprise. To go to court is still a taboo in China as it includes losing face. And going to court against the government is almost unheard of, finally the SOE officials often benefit from having good connections, a factor that is still of importance in China’s legal system today (Hu 2000: 7, 37, 95, 107).

5.3 Cost of Ownership

Political interference is given special attention in this chapter, as it has major influence on the behaviour and performance of the SOEs. For the SOEs the legal background and the political interference is often closely interlinked, since the majority of both
laws and interference comes from the national government. Besides political interference the aspect of agency costs will also be covered. Unlike the situation with the HRS and TVEs there have so far not been any responsibility systems that has effectively reduced the agency costs in the SOEs

5.3.1 Legal Background

SOEs have been restricted by more regulations than most other ownership types in China. These are likely to have imposed increased costs. First of all, the reform of the SOEs has been more controlled than the reforms within agriculture and TVEs. This implies that the SOEs have had little chances to experiment at a local level since almost all initiatives have been taken by the national government. The few local initiatives that have existed have to be approved by the national government. The opportunity to experiment, to crossing the river by feeling for the stones, has been a key element in the success of the HRS and TVEs.

Despite the introduction of different responsibility contracting systems in the mid 1980s the SOEs did not gain full autonomy in their decision-making. There was room for both official and unofficial political interference leading to soft budget constraints and inefficiency (Huang and Kalirajan 1998: 586).

One area where the SOEs have been restricted is within the appointment of managers. Government officials have been appointed to managerial positions in the SOEs without an open recruitment process. There have now been two so-called open recruitment rounds for managerial positions in SOEs. The open recruitment rounds are characterised by advertising the vacancies to the public, and the positions are open to all qualified Chinese applicants. In the second open round that took place in 2004, 23 senior management positions in 22 large SOEs were even open to foreign applicants (China Daily 2004: 9). That the application process is open to the public naturally does not guarantee that the final selection is done without political interference.
5.3.2 Political Interference

China’s SOEs often experience political interference and they produce political goods in the form of over-employment and social benefits to its employees. This is not a situation unique for China: “International experience suggests that state owned enterprises usually suffer from the imposition of non-commercial objectives by the state” (OECD 2000: 63).

In the planned economy under Mao Zedong each SOE were assigned a production target. Financial and cost objectives did not play any significant role. These soft budget constraints led to a lack of incentives to reduce costs and led to inefficient use of material and labour (Chow 2002: 257-259; Jackson 1992: 59).

As stated in chapter 4.3.2 the production of political goods is not necessarily something negative. The government, as the owner of the de facto SOEs, can for example put more value in the employment than in the profit the SOEs can create. It is not the aim to analyse whether the Chinese policies to prevent unemployment, and possible social unrest, are optimal or not. This thesis will only analyse how the production of political goods and political interference influence the transaction costs in the state owned sector.

5.3.2.1 Employment

In the reform era the SOEs have been responsible for keeping much of China’s urban population employed. If the SOEs suddenly had laid off all of the surplus labour this could have led to social unrest. In the beginning of the reform large labour costs were encouraged by the government since it indicated that the SOE helped solve the issue of unemployment and gave their employees a good salary (Jackson 1992: 86-87). The SOEs’ over-employment did not only exist in the beginning of the reform but continues to exist. The Economist (2000: 71) call the SOEs “heavily overstaffed” while up to one-third of the workers are redundant according to Liao (1997:4).
The number of loss-making SOEs grew fast in 1989 (Naughton 1995: 286). One reason could be that many SOEs, due to political demands, at that time were forced to hire people they did not need and produce products that were unprofitable, according to Naughton (1995: 284). This was a part of a general U-turn to secure China Communist Party influence and deal with the high inflation following the relaxation of price control in 1988, the closer control of SOEs was further increased after the Tiananmen Square incident in 1989 (Ji 1998: 53; Jackson 1992: 72-73). However, it is not possible to see any significant abnormal increase in employment from the official statistics reproduced in figure 1.

Efforts to transform large SOEs into corporate form started in the early 1990s (OECD 2000: 53). The reduction in the work force began in 1998 just as the government introduced the plans to privatise the majority of SOEs (EIU 2004: 34, 36). It is therefore difficult to determine if the reduced employment is a result of reduced labour force in the individual enterprises, or simply a result of some of the SOEs no longer is registered as state owned. According to the EIU (2004: 35) the SOEs have in fact laid off more than 26million workers between 1998 and the mid-2002. Maybe as a result of the Modern Enterprise System and the Group Company System, both introduced in the mid 1990s and both including initiatives to make the SOEs more competitive via reductions in the work force and in the social security burden.
5.3.2.2 Other Political Goods

Over-employment is just one political good. Others are how the social insurance system in China have been financed and provided at the enterprise level. The SOEs also provide political goods via the reliable of supply of strategic goods like energy. The introduction of the GCS and MES included initiatives to move the social security burden from the enterprise to the state and local governments, however there continue to be significant problems in financing the public social security system (Hassard et al. 1999: 70; Li 2000: n.pg.; EIU 2004: 34).

As mentioned in chapter 5.1 the state intents to maintain complete control over 500-1000 of the most important enterprises. This is likely also to be due to the political goods they produce, the production of political goods are difficult to control with contracts. The enterprises the state wants to remain in complete control over include enterprises in energy, raw materials and the defence industry. All of them are industries that by the government are deemed critical for the economic development and general well being of China (OECD 2000: 51; Xiaolin 1998: 92). Contracts are therefore difficult to create, as their financial results are not as important as being stable and reliable.

The state owned banks are also SOEs and the state owned banks’ preferential treatment to the state owned sector is also a political good, as the loans help keeping the SOEs and their many workplaces alive. Other SOEs can also be forced to supply loans to less successful SOEs or take over SOEs that would otherwise go bankrupt (Hassard et al. 1999: 74).

5.3.2.3 Initiatives to Reduce the Interference

So far the extent of political interference and production of political goods have been analysed. The aim here is to analyse the reasons for the production of political goods and what have been done to reduce the problem.
There is one clear reason why the enterprises produced political goods in the beginning of the reform, simply that the management had very little power. For example the management could not lay off redundant workers (Naughton 1995: 104). This started to change during the early- and mid-1980s, as managers were able to make more independent decisions on topics such as production plans, promotions, dismissals and sale. While the power of the government was declining the power of the re-established trade unions was growing and they often managed to block dismissals (Ji 1998: 48; Child 1994: 76-78).

Especially Deng Xiaoping’s tour around southern China in 1992 was at the time seen as a breaking point, the control of the SOEs was again relaxed and their autonomy was formalised with the 1992 regulation on “Transforming the management mechanisms of the state-owned industrial enterprises”. The SOEs got increased freedom, especially in regard to the labour force, and some redundant workers were laid-off (Ji 1998: 54; Naughton 1995: 294-295; Jefferson and Rawshi 1994: 62). A way of getting even more freedom was to change ownership, this did not have to be a move to complete private ownership, becoming a joint-ventures with at least 25% foreign capital meant a significant reduction in bureaucracy, as the government tried to attract foreign investors (Naughton 1995: 300). The MES further improved the contracts defining right and responsibilities between the state and the enterprise (Forrester and Porter 1999: 61-65).

Despite the initiatives, the separation of government and management functions is often more form than substance, and state agencies sometimes refuse to let the SOEs exercise their rights in areas such as employments, foreign trade and financial management (Jefferson and Rawshi 1994: 52; Hassard et al. 1999: 75; Forrester and Porter 1999: 61-65). The problems seem to be ongoing. The Economist (2000: 72) calls the managers’ lack of power and problems with political interference the SOEs’ biggest problem.

To separate state ownership from regulatory functions continues to be official policy. One of the latest initiatives is the creation of the State Asset Management Committees.
These committees will oversee the SOEs and the individual ministries will no longer be allowed to interfere in the managerial functions of the SOEs. The State Council will act as the ultimate owner of all SOEs on behalf of the Chinese people. (OECD 2000: 65). If successful this could be a way of reducing political interference. However, according to the OECD (2000: 70) so far there have been no major reductions in political influence on the SOEs. This might be due to the government’s fear of the possible social consequence, such as social unrest, if there no longer was a production of political goods in the form of over-employment and keeping unprofitable SOEs in business (Ma 1998: 379-381; Chow 2002: 264).

It is not enough that the SOEs have the right not to produce political goods, it is also necessary to change the way managers are appointed and rewarded. The state still manage to have major indirect influence on the behaviour of the enterprises through the way managers are mainly appointed among bureaucrats by a board of directors consisting of government and party officials (Chow 2002: 264-265). By 1998, 91% of SOE managers had been appointed by their superior government official (Zhou and Wang 2000: 288). This way of choosing mangers is likely to result in the production of political goods, for example in the form of over-employment instead of maximizing the profit.

It is also difficult to eliminate the production of political goods as long as the SOEs still need to have good connections in government since the markets still do not work perfectly. One example can be to be able to obtain political loans from the state banks. It is still beneficial for the SOEs to have good political connections as it opens up for preferential treatment (Hassard et al. 1999: 59; Sato 2003: 78; OECD 2000: 56). As long as SOEs need good connections they might be interested in producing political goods to stay good friends with the local or national officials. Despite the many initiatives the Economist (2004: 4) concludes: “State-owned enterprises are much more concerned to maintain patronage and employment than to generate profits…”
5.3.2.4 Increased Transaction Costs

There are several reasons why the political interference and production of political goods result in increased transaction costs. The political interference can often be in the personal interest of the local officials instead of the de jure owners in the form of the Chinese population. Problems like this are basically agency costs, discussed in chapter 5.3.3. The interference also often results in unclear contracts between the de facto owners, the government, and the enterprise management. The contracts in this way become unclear and incomplete, as the official contracts normally do not include the political good or the right to political interference.

As it is now the official policy to sell off the majority the SOEs, the costs of the political goods and interference seems even higher. The complexity of the SOEs’ position in the society makes it very expensive to change ownership form. If the government wants to make sure the enterprises continue to produce political goods in the form of over-employment and social benefits for the employees naturally this needs to be incorporated in a sales agreement. Such elements are difficult to incorporate into a contract and would increase the costs of creating the contract plus monitoring and enforcing the agreement. At present the SOEs can also, to a large degree, be used as political tools, this kind of political interference seems almost impossible to incorporate into a sales agreement, and the cost will be very high. The contracts would also be incomplete in many aspects, as it does not seem possible to predict what kind of political interference will be desirable by the government in the future.

5.3.3 Agency Costs

“China’s SOEs are in a deep crisis caused mainly by their agency costs” according to Zhou and Wang (2000: 316). To minimize agency costs, it is necessary to be able to monitor the behaviour of the agents, as well as punish unwanted behaviour and reward wanted behaviour. The high agency costs in the SOEs are a problem not only in China, but also internationally. The problem arises because there often are no clearly
accountable representatives of the state to monitor the performance of managers in state owned enterprises (OECD 2000: 64).

The SOEs are officially owned by *all the people*. This reduces the individual’s incentive to monitor the enterprises, as his or her share of the ownership is so small. Jefferson (1998: 431), Huang and Kalirajan (1998: 590) and Perotti et al. (1999: 165) all argue that SOEs’ more complicated management and ownership structure, compared to the TVEs, are partly responsible for the increased monitoring problems. The supervision of the SOEs has generally been moved from the central government to provincial and local governments (OECD 2000: 64). The local governments might have more incentives to monitor the behaviour of management of the individual SOE as the each local government relies on fewer SOEs than the national government. It can also be easier for the local government to control the behaviour of an SOE in its administrative area, than for national government in Beijing that perhaps lacks local knowledge.

All the SOEs are officially owned by the national government on behalf of the people. If the local government are responsible for the supervision, this also creates the risk of agency costs, as the local government will need to act on behalf of the national government. If a large share of the profit is taken out of the enterprises and transferred to the government in Beijing, the local authorities might be more interested in maximizing employment instead of the profit. This can result in a continuous production of political goods.

In the beginning of the reforms there were only minor financial incentives for managers achieve a good result (Chow 2002: 260; Forrester and Porter 1999: 59). Instead they could often earn much more by getting involved in corruption or plundering of enterprise assets. This behaviour was made possible by lack of a legal system plus the structure of ownership that meant that there were no clear identifiable principal. Nobody therefore had strong incentives to control the managers, resulting in high agency costs and collusion among the managers. Lack of effective accounting and auditing systems also made it difficult to control the managers’ behaviour.
To be able to monitor the performance of the SOEs it is necessary to have an effective accounting and auditing system. In January 2001 the Chinese Government's official auditor admitted that at least two out of three of China's SOEs cook their books. Among other problems this creates problems in price setting the enterprises on the stock market (The Economist 2001: 68). This in turn makes it difficult to find private investors to take over the SOEs and thereby makes it costly to change ownership.

Managers that manipulate the figures are widespread despite the fact that China early in the reform process introduced a new accounting system based on double-entry bookkeeping (The Economist 2000: 71). Besides cooking the books, it is also common for managers to defrauding the SOEs by selling dubious services from their privately owned enterprises to the SOE they work for (The Economist 2000: 73). This was especially a problem in the early reform period, the contracts “hindered long-term enterprise performance by creating conditions for moral hazard, where managers and workers could make small gains at a large cost to the firm or to the economy” (OECD 2000: 64). The responsibility systems did help improving efficiency in the SOEs by motivating managers and workers to make the SOEs profitable.

Short-termism was one of the major problems in the early reforms. The development is not unlike what was seen in the HRS. In the beginning there was often a focus on maximising the profit for the individual year, as the future was unknown. As the CMRS was introduced the situation started to improve as there contracts were fixed for up to 14 years, with 3 years being the most common duration (Hassard et al. 1999: 58). The lack of an effective accounting and monitoring system kept the monitoring costs high. Hassard et al. (1999: 60, 62) report that there often were problems in determining the profit, just as depreciation costs were not taken into account. Hassard does not report how investments then influenced the profit statement. There are basically two options. Firstly that the investment was considered as a cost in the year it was made, secondly that the cost of the investment was ignored.
If the investment was accounted as a cost in the year of investment this is likely to have resulted in heavily under-investment since the expense would have a negative influence on the bonuses to the management. The majority of the benefits from the investments were likely not to be achieved until after the contract had expired. SOEs suffer from a high turnover rate among its managers (Chow 2002: 3). This is likely to have increased the problems with short-termism. Alternatively if the costs of the investments simply were not taken into account, it was likely to result in over-investment. This is similar to the situation under the planned economy where depreciation costs and costs of capital were not taken into account (Chow 2002: 256). The Economist (2000:72) reports that some SOEs have state-of-the-art machinery as a result of investments since the late 1980s but that is often not maintained or used optimal. This could indicate that the investment in new assets might not be accounted as a cost while the ongoing maintenance is considered a cost.

As the Modern Enterprise system was introduced from 1993 it helped reducing the short-termism since the contracts became more detailed in defining rights and responsibilities between the enterprises and the state. The new contracts included the introduction of measurements to secure more long-term thinking by the management (Forrester 1999: 61-65).

China continues to suffer from an ineffective accounting and auditing system, making it difficult to monitor the actual results of the enterprises (Zhou and Wang 2000: 299-300). The SOEs also face problems with punishing unwanted behaviour and rewarding wanted behaviour. With the early profit sharing system the bonuses were given to the enterprise and not to the individual manager this implies that the individual’s incentive to work hard was limited, under the assumption that his work effort did not influence the other employees’ work effort.

The CMRS provided greater material incentives for both workers and managers than the profit sharing system (OECD 2000: 64). The system still suffered from the collective approach in rewards and punishment. In some cases there were set up specific contacts with the management, giving them a large personal awards if certain
targets were fulfilled, the ineffective accounting systems made this problematic. It was problematic that while the manager and enterprise could get significant gains by taking chances, their losses were limited. For managers the maximum penalty was often half a year’s salary, job security remained very high and managers were normally not fired, although they could be reassigned a lower lever position. The state was responsible for losses. The possible rewards for the enterprise and managers were unlimited with above target profit being shared between government and enterprise (Choe and Yin 2000: 98-104; Hassard et al. 1999: 62-64).

Despite the introduction of the MES there are still problems with rewarding good work efforts by managers and employees. The turnover rate among managers in SOEs is higher than in the non-state sector and there are problems with low motivation as successful managers in TVEs often earn more than managers of SOEs (Chow 2002: 3). It is also difficult to keep the most able managers in SOEs, as managers are mainly paid according to their political rank instead of their managerial abilities. The present bonus system is not enough to reward the individual’s effort and the key to promotion is often primarily your political performance (Zhou and Wang 2000: 299, 305). That the key to promotion is based on political performance might be able to help explain why it continues to be possible to have political interference in SOEs as seen in chapter 5.3.2.

5.3.4 Entrepreneurship

The SOEs had no tradition for entrepreneurship in pre-reform China. Prior to the reforms managers hardly had any autonomous authority and could therefore not make their enterprise unique in any way or adjust to demand (Naughton 1995: 107). Many SOEs still lack entrepreneurship. One reason is likely to be the way that employees are still not rewarded greatly for showing initiative, and rewards are normally collective while punishment are individual. As the job security has been reduced in the last years, employees and managers now risk losing their job if the initiatives are unsuccessful. The ongoing struggle of power between the official enterprise management and the government officials, leading to political interference, is also likely to reduce the possibilities of entrepreneurship. Finally, some parts of the attitude
from the traditional planned economy still exist, so that the SOEs are not focused on “linking the factory to the consumer” (The Economist 2000: 72).

When downsizing, the SOEs have often offered employees investment funds to set up their own small businesses (Hassard et al. 1999: 72). This gives the former employees a fair chance of maintaining an income as they leave the SOE and thereby also their social benefits. It is likely that the investment funds encourage the wrong people to leave, which are the people with an entrepreneurial spirit. Finally according to Hansmann (2000) entrepreneurial activities often decreases as the size of the hierarchy increases, the lack of entrepreneurial activities in the SOEs might therefore also partly be due to the size of the SOEs.

5.3.5 Risk Bearing

The state is in theory one of the best risk bearers. The state can spread risk and losses over the whole nation. The government has so far only allowed very few enterprises to go bankrupt. There are two types of limited liability company forms for SOEs, one for companies to be listed on the stock exchange with at least a part of the shares traded freely, and the other one for some of the enterprises that so far remain completely owned by the state (Hassard et al. 1999: 71). That some of the SOEs completely owned by the state are transformed in limited liability companies is interested since the other patrons, e.g. supplies, thereby takeover some of the risk from the state. The state will normally be better at absorbing the risk than the other patrons. The creation of limited liability companies might however be a step towards easing the process towards privatisation in the future.

The SOEs have one significant advantage over the TVEs in risk spreading, that they do not rely on employee ownership, as there have only been few experiments with this in the state owned sector. As we saw in chapter 4.3.5 employees are bad as owners, seen from their ability to bear the risk. The lack of employee/management co-ownership might however have other disadvantages, such as increased agency costs as analysed in chapter 5.3.4.
5.3.6 Collective Decision Making

There is very little material that focuses on the decision making process within the SOEs, but there are some indications that SOEs might suffer from high costs in this area. One is the mere size of the SOEs, the TVEs are deliberately kept small to make them suitable for fast decisions; this is not the case with the SOEs (Byrd 1990: 197).

The ongoing political interference also results in a cost decision making process, as there will develop conflicts between the enterprise management and the government officials who want to influence the decision-making. Also indirect political interference results in costs, as the management need to investigate if a possible action is acceptable to the political environment. Unacceptable actions can influence both the future career of the management and the enterprises’ political connections.

Like the situation in the TVEs, the population, as the de jure owners, do not decide how to control the SOEs and who should be appointed manager, the government does this. This saves some costs for shareholder’s meetings or other kinds of collective decision among a very large group of joint owners. But there are still costs associated with collective decision making inside the government and their decisions might not be in harmony with the wishes of the population; the de jure owners of the SOEs.

5.4 Conclusion

The ownership of the SOEs remains largely unchanged with the state acting as the owner on behalf of the population. In the first 20 years of the reform the focus was on improving the SOEs’ competitiveness and financial results via various responsibility systems. The official policy has now changed towards privatising the majority of the SOEs. The SOEs suffer from a number of factors, most importantly the production of political goods and the political interference together with the high agency costs.

At the beginning of the reform the SOEs did have some advantages. The SOEs belonged to the state. This gave the SOEs the best access to the needed input, and also
made sure the SOEs could sell their output. The price reform meant liberation of the markets and the SOEs’ advantages were greatly reduced.

In a time of great changes the SOEs have been used as political tools mainly to secure social stability through over-employment. This ongoing use of the SOEs as political tools has made it unclear what the SOEs’ are. Shall they focus on financial results, or on maximising employment? While the official goal has been financial based, the managers have mainly been judged and rewarded according to their production of political goods.

The incentives for the management are a key issue to understand not only the production of political goods, but also help to understand the great agency costs within the SOEs. The responsibility systems introduced different reward systems if certain targets were met while there was little possibility of punishment, this is likely to have led some managers to take too big risks, as they were not the risk carriers but did have the possibility of gaining, if things went well. Other factors also helped increase the agency costs. It was very difficult to monitor the managers’ performance due to the lack of effective accounting and auditing system, this is likely to have been an even bigger problem due to the size of the SOEs. The lack of accounting and auditing systems also made it possible for the managers to defraud the enterprises in many cases.

The lack of good monitoring system and the relative low possible rewards led to a high turnover rate in the state owned sector, with many of the most skilled managers leaving the SOEs for jobs in the TVEs or the private sector. The large size of the SOEs and their political management are also likely to have been disadvantages in the reform period. The SOEs have not been flexible enough, it has been difficult for them to adapt to changes, and there has been a lack of entrepreneurial spirit.

The characteristics of the SOEs are likely to make the current privatisation process very costly. The borderline between the state and enterprise is unclear, it seems impossible to sell of SOEs as long as the government continue to use them as political
tools. The SOEs also rely on the preferential treatment by the state to access capital and certain other inputs. This too makes it expensive to change ownership. At present there are few opportunities of raising the needed capital within China to takeover a large SOE without government support. If the initiatives to reduce the extent of political objectives like over-employment and social welfare succeed, this can reduce the cost of changing ownership. It is much easier to sell an enterprise with no such obligations. So far it has been difficult to finance the initiatives due to China ineffective tax system. A change of ownership is also made expensive by the unreliable annual statements, which make it difficult to valuate a SOE in a possible takeover situation.
6 Conclusion

The thesis has given a presentation of three ownership types and how their characteristics have changed over time. It has not been possible to cover all costs associated with the various ownership forms, but an analysis has been given to some of the most important costs associated with the three types of ownership. Some costs are more dominating in China, than in most Western countries. These include costs relate to the lack of effective markets and legal system, which increase the cost of contracting. China’s lack of effective accounting and auditing systems, on the other hand, results in increased monitoring costs. A lack of tradition for creating a relationship between work effort and pay, has also increased the agency costs. Attempts have been made to change this situation via different responsibility systems. Finally enterprises have suffered from political interference that has made the objectives unclear.

The HRS is the most simple ownership form analysed. In its early shape of contracting output to the household, it managed to minimize the agency cost, as it was easy to monitor the amount of grain handed over to the production team. The early system also meant a move away from equal pay regardless of work effort. The later system of contacting everything to the household meant that the individual household became an independent hierarchy. Contracting everything to the household minimized the cost of ownership. But it meant that the households had to rely on the markets for input and output. It is therefore natural that the move from the system of contracting output to household, to the contracting everything to the household came after the costs of operating in the market had be reduced following the price reform.

In the early reform period the TVEs were mainly engaged with supplying agriculture with input, soon the TVEs also got engaged in processing agricultural output. The TVE ownership form is likely to have had some of the same advantages as cooperatives forms have in the Western world. The TVEs were supposed to act in the
interest of the local residents, and the TVEs were therefore less likely to exploit the local household, via market power, than a private businessman would have been.

Later many TVEs got involved in manufacturing industries. The TVE form changed significantly over time, to the degree that many TVEs now are de facto private enterprises under the collective umbrella. The TVEs have two main advantages. Firstly they worked as a hybrid form between state ownership and private ownership. Secondly they have an ability to constantly change, according to the present situation in the society. In the early reform period the TVEs could benefit from their close links to the local government, this gave them access to the needed input and gave them some kind of protection in a society that lacked an effective legal system. The TVEs also benefited from lower tax rates than the SOEs. Later as the markets and other institutions developed, the TVEs could become de facto private enterprises, step-by-step, without great costs associated with changing the ownership.

The SOEs benefited from being under even more protection than the TVEs, and the SOEs generally had better access to the needed input early in the reforms. With the development of the markets, the value of these advantages decreased. The SOEs suffered from some major disadvantages. Unlike the TVEs, the SOEs did not have any favourable tax deals. The SOEs also suffered from heavy political interference, which resulted in production of political goods. The agency costs also remain high in SOEs, despite attempts with various incentive systems, problems include lack of effective monitoring tools, together with too small financial rewards to the managers. The lack of financial rewards also led many of the most skilled managers to leave the SOEs. The size of the SOEs together with the ongoing political interference and the lack of effective capital markets in China, make it difficult to change the ownership of the SOEs, despite the official policy now is to sell off the majority of the SOEs.

It is often argued that the TVEs benefit from the close social ties in the rural settings, while there are not the same ties, to reduce transaction costs, in the urban environments the SOEs operate in. However this argument relates more to the geographical location of the enterprise than to the ownership form.
One of the problems in applying the transaction cost theory on China, is that it is often difficult to determine the scope of the hierarchy, and thereby difficult to determine if the transaction is carried out in the market or within the hierarchy. But the theory has proven useful, as a tool to uncover and analyse a number of determinants that have influenced the optimal choice of ownership. The framework used in this thesis could be used for further studies concerning the ownership of enterprises in China, including creating a better understanding of the development of new enterprise forms in China, such as private and foreign enterprises, including various hybrid forms like Chinese-foreign joint-ventures.
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