Agent as Partner: Enterprise-led Institutional Change in a Chinese Prefecture

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[Abstract]

Existing accounts of state enterprises' responses to China's recent marketisation focus on the continuation of a slack strategy that perpetuates soft financial discipline. We offer a case study of an alternative strategy aimed at market opportunities and growth. This course of action entails efforts to influence the behavior of the officials interacting with the enterprise concerned. Fostering economic and political dependency is key to advancing such efforts, which may bring about important economic institutional changes. The success of the market strategy hinges on an interplay between path-dependent choice structures of pertinent officials and entrepreneurship of the enterprise leader.
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Introduction

A common finding in studies of contemporary western economies is that large business organisations exert significant influence on defining the rules of the economic game [e.g., Lindblom, 1977; Lazonick, 1991; Perrow, 1991]. A contrasting and equally familiar fact is that enterprises in former Soviet-type economies functioned like extensions of the state bureaucracy and enterprise leaders played a minimal role in shaping the way economic activities were organised. The post-communist era, however, has seen a plethora of changes. A major development in the past decade is that, through revolution or evolution, economic organisations in most former Soviet-type economies have rid themselves of the shadow of central planning and become a major engine of both economic growth and institutional change [World Bank, 1996].

In this paper we explore the growing role of powerful enterprises in shaping the course of economic institutional change in post-Mao China. Instead of looking at the rapidly growing non-state sector that has been extensively
examined in the literature, we focus on the state sector, which is commonly portrayed as a domain of tight state control and a passive force in economic change. We identify two responses of state enterprise leaders to the recent marketisation of the economy: a strategy aimed at maneuvering for organisational slack, and a strategy designed to explore and capture market opportunities. The slack strategy is widely seen as predominant and, according to a prevailing principal-agent perspective, rooted in the governance structure of state enterprises. The market strategy has until recently received little attention. A major reason for this, however, is not that enterprises have rarely pursued or attempted it, but that successful efforts are either little known in detail or simply ignored. This omission glosses over important changes in the behavior and environment of state enterprises. The purpose of this paper is to narrow such a gap in the study of China's economic transformation.

We argue that marketisation since the late 1970s has both generated strong competitive pressures and posed growing economic opportunities to state enterprises. Capturing the gains from such opportunities entails efforts to overcome existing bureaucratic constraints embedded in the organisational and institutional settings of state enterprises. The avenue for advancing such efforts has been broadened by the decentralisation of government decision-making.
power to lower jurisdiction levels in the reform. Yet the incentives and abilities
to embark on this course of action vary among enterprises in the state sector,
which is not a monolithic entity. State enterprises differ in resource endowment,
in the opportunities and constraints in their changing regulatory and market
environments, and in the entrepreneurship of their leaders. Such variations have
a direct bearing on the selection and outcome of organisational strategies.

We emphasise the diversity of organisational responses to marketisation
and illustrate this with a case study of the pursuit of the market strategy. The
case in point is Yuxi Cigarette Factory (Yuxi Cigarette hereafter) in the
southwestern province of Yunnan." A state enterprise, it has grown from an
average-sized plant with lackluster performance to one of China's largest and
most profitable enterprises within less than two decades. Its rise from obscurity
to national prominence is in large part the result of its leader's active efforts to
influence the decisions and actions of various levels of government that the
enterprise interacts with. In the course of maneuvering for resources and ad hoc
regulatory flexibility in the political process, it has also brought about important
changes in the rules governing the local economic space.

The experience of Yuxi Cigarette is illustrative of some important aspects
of recent economic change in China. It shows that under certain conditions
leaders of state enterprises may gain and exert significant influence over the political process and use such influence to capture market opportunities, thereby playing an active part in redefining the rules of the new economic game. The incentives for this course of action come from marketisation and from the potential gains to institutional unevenness among competing enterprises. It may take the same form of behavior--i.e., bargaining with officials--as the slack strategy, but such behavior serves a different purpose--i.e., promoting growth rather than finessing for slack. The success of this strategy hinges greatly on the ability of the leader of an enterprise to foster economic and political dependence of pertinent state authorities on its performance and competitiveness. Such ability is conditioned by the path-dependent constraints in the enterprise's regulatory environment and directly related to the political entrepreneurship of the enterprise leader.

We do not claim that what happens at Yuxi Cigarette represents what happens in the state sector at large. Indeed, given the enormous variations within the state sector, it is highly problematic to draw any sweeping generalisations on the basis of one case study. We see our findings as pointing to a source of institutional change neglected by the prevailing image of the state sector economy, and as a bench-mark against which more revealing questions may be
reformulated in future research. By investigating the driving forces of the strategy pursued by the factory and the factors contributing to its success, we also hope to identify some clues to understanding the plight of state enterprises that do not pursue this strategy or fail to deploy it effectively.

I. Reform and change in Chinese state industry

Economic reform in China’s industrial sector started in the late 1970s when pilot programs were introduced to delegate decision-making authority from government supervising agencies to selected state enterprises [Naughton, 1995a]. Throughout the 1980s and into the 1990s, that undertaking continued and expanded to increasing numbers of enterprises. Gradually, direct government control over input supply, production, pricing, and sales has been relaxed or reduced. Profit-making has replaced fulfilment of government plan as the main concern of state enterprises, which have gained growing autonomy in the use of their profits but face an increasingly competitive and uncertain economic environment [Ibid.].

Two concurrent developments have accompanied the marketisation of the state sector. One is the rapid expansion of market-oriented non-state enterprises—urban and rural collectives, private enterprises, and foreign capital enterprises.
From 1978 to 1995, for example, the share of the state sector in gross industrial output declined from 78% to 34% [Guojia Tongji Ju, 1996:401-403]. Another development is the deterioration of the financial performance of many state enterprises. From 1978 to 1995, the percentage of state enterprises running a loss increased from 19.3% [Fang Weizhong and Wu Jiajun, 1989:378] to 33.8% [Pucha Bangong Shi, 1997:16]. A widely cited official estimate further categorises another 33% of state enterprises as incurring 'implicit losses' [Lin, 1995].

Competition from the expanding non-state sector is identified as a major contributing factor for the declining performance of the state sector [Naughton, 1995a]. Such performance has also been seen as being related to the ad hoc, on-again, off-again process of enterprise reform driven by the complex bargaining and shifting balances of power between different interest groups in the political process [Shirk, 1993]. But the main cause has been traced, within a framework of principal-agent analysis informed by theories developed from past studies (e.g. Janos Kornai’s works) on the state socialist economy, to the governance structure of state enterprises. Such structure is claimed to have driven enterprise leaders to rely on slack-oriented bargaining strategies despite the introduction of market-
oriented reforms (such as emphasising profit over state plan). This is due to two major factors.

Supervising authorities (the principal) depend on state enterprises (the agent) for non-financial functions (such as provision of employment) [Walder, 1995] and parochial financial gains (such as locally disposed fees in lieu of taxes) [Huang, 1991]. Such dependence makes it possible for state enterprises to bargain for soft financial discipline, protection, and subsidies—all symptoms of organizational slack. On the other hand, ambiguity and instability in the boundaries between different loci of state authority and between supervising agencies and state enterprises make it difficult to ascertain and individualise responsibility [Lee, 1991; Naughton, 1992]. Also, supervising agencies suffer from information deficiency due to large numbers of state enterprises placed under their regulation [Walder, 1995]. These conditions weaken officials' incentive and capacity to monitor state enterprises closely, adding further room for the latter to maneuver for slack and resulting in the perverse outcome of deteriorating performance.

Recent research findings begin to raise questions about this predominant view, especially its claim about the insensitivity of state enterprises to changes in their regulatory and market environments. Weakening financial capacity of the
state\textsuperscript{2} and increasing economic uncertainties faced by state enterprises are found to have led to a gradual hardening of financial disciplines by supervising authorities and even by enterprises themselves (Jefferson and Rawski, 1994; Rawski, 1994, 1995). Pointing to the same trend, Guthrie [1997] further shows with survey data that under pressure many state enterprises adopted a strategy of diversification in their struggle for survival. On what scale these responses have occurred and to what extent they are successful have yet to be ascertained more precisely. But the fact that they take place without major changes in the basic organisational characteristics of state enterprises suggests that governance structure per se is not a reliable indication of the strategy pursued by an enterprise. And, as Guthrie [1997] points out, poor outcome resulting from using an alternative strategy is no indication of the lack of effort to pursue it.

In the analysis below, we further show that even bargaining with supervising authorities--the focal behavior examined by the principal-agent view--may not be equated to a slack strategy. Bargaining is a tool that can serve different purposes. Instead of finessing for slack, leaders of state enterprises may use bargaining to overcome bureaucratic constraints on their efforts to explore and capture market opportunities. Whether they pursue this course of action hinges greatly upon their comparative cost-benefit calculation, which is an issue
under-explored by the principal-agent approach. To see this linkage clearly, one needs to broaden the view from the mounting pressures faced by state enterprises in their environments to the inducement engendered by economic change. A major outcome of the marketisation process initiated by non-state enterprises is that it both creates a new and growing domain of economic opportunities and provides a clear frame of reference within which to assess the opportunity costs of state enterprises' existing strategies. When the gains from organisational slack diminish relative to those from market opportunities, the leadership of a state enterprise may be inclined to change course.

Since state enterprises operate in a pre-existing regulatory framework of central planning, pursuing the market strategy involves not only economic and technological innovation but institutional change. This inevitably entails extensive efforts to influence the decisions and actions of the rule-makers and gate-keepers--officials at various loci of the state authority pertinent to the state enterprise concerned. Thus the success of the market strategy requires both economic and political entrepreneurship, a quality that is not evenly available among state enterprise leaders. The core element in the political aspect of this strategy is the same as that in the slack strategy: dependency. The more an enterprise can make its success in the market (instead of its organisational slack)
an indispensable asset for the officials concerned, the stronger its ability to influence the decisions and actions of the latter toward helping this course of action. Growing common interests of the officials and the enterprise leader in the enterprise's successful pursuit of market opportunities may make the principal-agent relationship between them look more like a partnership in which the role and initiatives of the latter are greatly enhanced.

Forging such a tie, however, is no easy task. It depends both on shrewd calculations and skills of the enterprise leader, and on the formidability of the regulatory constraints embedded in the path-dependent economic conditions faced by the enterprise. The feasibility of overcoming them with the help of pertinent officials has increased as a result of decentralisation since the early 1980s. This development has increased the discretionary power of local officials in the regulation of economic activities, and tied their interests closely to the revenue from such activities [Oi, 1992]. But whether they are willing to bend the rules to open ways for a particular enterprise's attempt to pursue market-oriented growth depends greatly on the range of their alternative choices for increasing revenue. The higher the opportunity cost for helping an enterprise, the weaker the incentives for the officials to act, and vice versa.
In short, recent changes in state enterprises' regulatory and market conditions make the market strategy a pursuable alternative to the slack strategy under the governance structure carried over from the pre-reform era. State enterprises are not a homogeneous group. Their organisational responses to marketisation vary because of variations in the competitive pressures and the inducement of opportunities faced by enterprises situated in different market niches, in the entrepreneurship of their leaders, and in the constraints that they have to tackle in their regulatory environments. Investigating how the effects of these factors on the selection and outcome of strategies among state enterprises are played out may reveal useful clues to understanding the driving forces of China's recent economic change.

Our case study contributes to this investigation with concrete findings on the process in which the enterprise under study has responded to marketisation by adopting the market strategy and used the strategy effectively to promote its growth. Our selection of the case is based primarily on its illustrative value for discerning the mechanisms at work in this type of organisational response. Our analysis is made possible by the availability of large amounts of published information (in Chinese) about the recent history of the enterprise. They include four book-length case studies on its growth path from the mid 1950s to the early
1990s [i.e., Wang Yizhi, 1992; Chu Shijian and Huang Qiuyan, 1992; Wen Ningjun, 1994; Chu Shijian, 1995], and descriptions and discussions about the enterprises in other books, reports, and local gazetteers. We draw primarily on the factual accounts from various sources (which are cross-checked for consistency), rather than their interpretations (which may be affected by the authors' own preferences and perspectives).

II. Yuxi Cigarette's rise to national prominence: a brief account

Tobacco is the largest source (11%) of government revenue in China [FBIS, May 24, 1995; Huus, 1996], and Yuxi Cigarette is China's and Asia's largest cigarette manufacturer. In 1995 manufacturers of tobacco products made up 1.6% of the total assets in the industrial sector, but they generated 12% of the total profits and taxes [Pucha Bangong Shi, 1997:195]. One quarter (3% of the total) of this contribution came from Yuxi Cigarette [Yunnan Sheng Tongji Ju, 1996:411].

Located in Yuxi prefecture of the southwestern province of Yunnan, Yuxi Cigarette was established in 1956 as a state enterprise to process tobacco leaves for cigarette plants. It started to produce cigarettes in 1958. During the ensuing two decades, the production and distribution of its products were fully guided by
the central plan. When economic reform was started in 1978, the factory was little known in the nation and earned a meager profit (1.03% of sales) [Wen Ningjun, 1994:354]. Technologically, it was far behind major cigarette manufacturers in Shanghai, Henan, and Shandong. It used semi-mechanised equipment to produce low-grade products, 80% of which were sold within the province [Zhang Youlin, 1991:2-6].

That lackluster situation began to change after the appointment of a new director, Chu Shijian, to the enterprise in 1979. Chu was a personnel officer in the prefectural government in the mid 1950s. In 1958, he was purged for opposing the leading political line of the communist party and sent to the countryside to do farm work. He was rectified in 1961, and re-assigned to work as the director of a sugar mill in the prefecture until his appointment to Yuxi Cigarette as its director. After arriving at the factory, Chu adopted several measures that greatly improved productivity, product quality, and competitiveness.

In 1981 when the overwhelming majority of state enterprises still used a time wage system that did not have a clear link between effort and performance, Chu introduced a piece rate system that tied workers' wages to their workshops' output. It provided a strong incentive for workers to enhance their work efforts,
resulting in a significant increase of output. That measure was expanded in 1985 to tie the total wage bill of the enterprise to its total output so that the enterprise was directly subject to the penalties and rewards associated with its performance in the market. In 1989, the link was modified to make the enterprise's total wage bill proportional to the total amount of profits and taxes generated.

In 1983, taking advantage of a stipulation that state enterprises could use their pre-tax earnings to pay back bank loans, Chu made a bold move to borrow US$ 24 million from state banks for the importation of advanced western facilities to upgrade Yuxi Cigarette's technology. That gave a great boost to the enterprise's effort to narrow its technological gap with leading domestic cigarette manufacturers. In the following decades, two more rounds of massive technological upgrading through importing state-of-the-art facilities were arranged in 1988 and 1992, making Yuxi Cigarette the technologically most advanced cigarette manufacturer in China.

While making efforts to increase work incentive and upgrade technology, Chu reached out to forge close ties between the activities of the major suppliers and the factory's production. Through a contractual arrangement to be detailed below, Yuxi Cigarette started in 1985 to provide financial and technical support for local tobacco leaf farmers. In return, the farmers were bound to a
commitment to selling their improved output to the enterprise. This arrangement fostered relational stability between leave suppliers and the enterprise, and reduced uncertainty in the increasingly competitive and volatile tobacco leave market. Similar collaborative arrangements were also made between the factory and the suppliers of its intermediate inputs and services (paper, printing, glue, cartons, plastics, chemicals, etc.). The result was a significant improvement in the quality of the cigarettes produced by Yuxi Cigarette, which were greatly dependent on the quality of inputs (especially tobacco leaves).

These efforts paid off well. Because of the drastic improvement in the quality and market reputation of Yuxi Cigarette's products, four of its major brands (i.e., Hongtashan, Ashima, Yuxi, and Gonghexinxi) were among the first thirteen premium brands freed by the government from price control in 1988. The wide gap (a difference of 1-3 times) between market and government prices brought huge profits to the factory [Gao Hang, 1990:165]. In the late 1970s, 80% of its output was sold within Yunnan province; by the late 1980s, 75% was sold outside the province, 10% exported, and only 15% sold locally [Wen Ningjun, 1994:210-211]. Hongtashan (meaning Red Pagoda Mountain), its leading brand, has become the best selling cigarette product in China, fetching higher retail prices than such leading import brands as Marlboro and 555 [Wen
Ningjun, 1994:220]. The popularity of Yuxi Cigarette's products is such that bogus products bearing its brands have been widely manufactured [FBIS, March 23, 1995]. From 1980 to 1995 its total asset increased from 19.3 million yuan to 15.8 billion yuan [Wen Ningjun, 1994:303; Yunnan Sheng Tongji Ju, 1996:411]. The enterprise became China's largest cigarette manufacturer in 1990 and has since maintained that position. According to the latest enterprise ranking compiled by the Asiaweek magazine [4 June 1997], it is China's eighth largest state enterprise in terms of sales revenue. In 1995, it started a fourth round of technological upgrading and expansion. According to one report [Huus, 1996], when the project is completed in late 1997, Yuxi Cigarette will become the world's largest cigarette manufacturer in terms of production capacity, and one of the most advanced in terms of technology.

III. Bending the rules

None of the above measures taken by the enterprise leader to promote Yuxi Cigarette's growth would appear extraordinary in a market economy. But in post-Mao China where the economy was beginning to grow out of the shadow of central planning, it took more than economic entrepreneurship to carry them
through. At every step of the way towards its success, the enterprise encountered
pre-existing bureaucratic constraints but managed to overcome them effectively.

The production and distribution of tobacco products in China has been a
government monopoly--only enterprises licensed by the state tobacco authority
are allowed to produce cigarettes and other tobacco products. In 1995, there
were 432 tobacco product producers, 302 of them were in the state sector and
accounted for 97% of the sales [Guojia Tongji Ju, 1996:414-418]. Contrary to
some existing accounts [e.g., Naughton, 1995b], the lack of massive entry by
non-state enterprises has not prevented competitive market forces from
developing within this sector. Despite a slow start, enterprises in the tobacco
sector have gained, at varying paces, increasing autonomy in decision-making,
and based their decisions on market demand and supply since the mid 1980s
[Editorial Committee, 1994]. There are, however, two peculiar features in this
economic sector. One is a large tax component in the price of cigarettes; the
other is an output quota system that applies to all tobacco product
manufacturers.\(^3\) While the taxes have been imposed rather uniformly, the quota
system has not been evenly enforced among enterprises under different
government jurisdictions [Editorial Committee, 1994:505-593]. Because of the
variations in the pace of gaining autonomy in decision-making and in the
constraints posed by the quota system, enterprises that can break away from the old mode of regulation and obtain flexible regulatory treatment in the enforcement of the quota system tend to have a competitive advantage over those that cannot.

Administratively, Yuxi Cigarette has been under the joint supervision of the provincial and central tobacco authorities, where the provincial authority has played a more significant role. What is meant by supervision in this context is that the enterprise is subject to the regulation by its supervising authority in decisions on planning, supply, production, sales, and finance. Its top leaders are appointed by the supervising authorities, to which flow the taxes on its products and (before the mid 1980s) part of its profit. But the enterprise has also had close interaction with the government of the prefecture where it is located. The communist party cell in the enterprise, which exerts significant influence on internal personnel decisions and labor-related issues, has been controlled by the prefectural government. Also, the prefectural government regulates the activities of the local transaction and interaction partners of the enterprise, such as input and utility suppliers, social service providers, and government service providers at the prefectural and lower (county and township) administrative levels.
Ad hoc relaxation of existing regulations by these various levels of government jurisdiction as well as their backing and help have been critical to Yuxi Cigarette's building up its competitiveness in the market. The key to its effectiveness in enlisting such support lies in fostering economic and political dependence of government authorities on the market-oriented economic success of the enterprise. What has made this possible is a combination of the initial conditions of the local economy and the enterprise leader's shrewd efforts to take advantage of such conditions to open ways for the growth of the enterprise.

Economic dependence

Yunnan has been one of China's poorest and least industrialised provinces. Under the pre-reform central planning system, the province was given low priority in resource allocation. As a result, the development of its infrastructural and industrial facilities lagged behind that of most other provinces. When economic reform was started in 1978, Yunnan's per capita income ranked 25th among 29 provinces and central municipalities in the nation [Yunnan Sheng Tongji Ju, 1996:18]. Its gross industrial output only accounted for 1.3 percent of the national total, giving it a 24th ranking in the country [Gongjiao Tongji Si, 1987:145].
Like many other provinces in the nation [Oi, 1992], Yunnan entered a fiscal contract with the central government in 1980 [Gao Zhiguо, 1991:707-709]. Under the contract, the provincial government was required to generate a certain amount of annual revenue for the central treasury, which would in turn determine, allocate and closely monitor the regular budgetary fund for the provincial government's expenditure. Any surplus revenue above the contract target would be shared by the central and the provincial authorities, and the provincial government was granted greater latitude in the use of the above-target revenue. The purpose of the arrangement was to provide an incentive for the provincial authority to increase its effort to expand revenue base. To make that happen, however, the provincial authority needed to provide incentives to lower level governments as well, for they oversaw the main revenue bases in the province. As a result, the arrangement between the provincial and the central government was duplicated between sub-provincial levels of government (prefecture, county, and township).

Under the reformed fiscal structure, the career advancement and financial reward (especially bonus) of local government officials depended greatly on the revenue, especially above-target revenue, generated from the economic activities under their purview [Oi, 1992]. Thus local authorities were eager to identify and
support sectors and enterprises where the growth potential was high. In Yunnan, tobacco stood out as an apparent choice because of the lack of better alternatives [Wan Longshan, 1993:220]. Unlike those in the then leading centers of tobacco production (e.g., Shanghai, Henan, and Shandong) where the significance of tobacco in their local economies was overshadowed by the greater magnitude of other industrial sectors, Yunnan's tobacco sector occupied a prominent place in the underdeveloped local economy. By the late 1970s, the province had established 5 cigarette factories, though the technological level was low. Tobacco earnings (mainly from taxes on leave production) made up about one fourth of the province's government revenue [Wan Longshan, 1993:296]. The opportunity cost of supporting other sectors appeared to be higher than that of concentrating on tobacco [Ibid]. In 1982, such comparative advantage calculations led to a decision by the provincial authority to promote tobacco as the 'spearhead sector' in the province. Because of this emphasis on the tobacco sector, throughout the 1980s the centrally imposed cigarette quotas were loosely enforced by the various levels of government in Yunnan. This created an opportunity for enterprises in the tobacco sector to grow.

It was in concurrence with this development that Yuxi Cigarette grew and maneuvered its way from an average local player to the national leader in the
industry. In 1980 it was among the first group of state enterprises in the province to be chosen for experimenting limited reforms. Director Chu seized upon that opportunity to restructure the factory's wage system and turn it into a center of incentives for improving productivity. In 1983, when a newly introduced tax reform opened up the possibility for state enterprises to use their pre-tax profit to pay back bank loans, Chu quickly responded by borrowing a massive amount of fund to upgrade and expand Yuxi Cigarette's facilities. In both cases, the responses of the enterprise far exceeded the scope originally intended by the government and thus were at first rejected. But Chu was persistent and made vigorous efforts to lobby the prefectural and provincial officials in charge. He brought up extensive evidence (including that from unauthorised use of the new wage system in one of the factory's workshops) to illustrate that significantly improved economic results could be achieved with the new measures. This made the proposition too attractive for the officials to resist, leading to a change in their initial positions.

But Chu did not simply capture and extend the opportunities opened up in the political process, he also created new opportunities. In 1986, he succeeded in making the prefectural government to appoint him as the head of the prefectural office of the national tobacco authority in addition to his position as the director
of Yuxi Cigarette. Under the new arrangement, the staff of the local tobacco authority were put on the pay-roll of Yuxi Cigarette. Acting both as the chief regulator of local tobacco production and distribution and as the head of the main local manufacturer, Chu effectively reduced the regulatory constraints faced by the enterprise. That measure was claimed to aim at improving administrative efficiency of the local tobacco authority by reducing the intermediary roles played by the authority between the enterprise and local tobacco leave production. Yet an obvious outcome of its adoption was the weakening of the influence of the national tobacco authority in the local economic space.

Chu had already proposed that measure as early as in 1983. But the proposal was turned down by higher level authorities. Instead of giving up the idea, he repaved the way for reviving it. In 1985, Yuxi Cigarette undertook an initiative to provide financial support for improving local tobacco farming in return for a commitment from local farmers to selling their improved products to the factory. It produced remarkable results. Farmers under the contract gained more income from selling improved tobacco leaves; local government revenue from taxes on tobacco leaves increased; and the enterprise secured more high quality input. But the experiment also exposed problems in the tobacco regulations of that time. Farmers were required to produce according to state
quotas and sell their products to the local tobacco authority at state-set prices (which were lower than market prices). The local tobacco authority in turn distributed the tobacco leaves to manufacturers designated by the national tobacco authority, many of which were located outside of the prefecture and even the province. That system of central planning provided little incentive, and limited the means, for farmers to improve product quality, whereas cigarette manufacturers faced difficulty in obtaining locally available, high quality tobacco leaves.

The initial success of the experiment by Yuxi convinced the prefectural leaders that a major change in the regulatory structure was worth making. Armed with the evidence on such success, Chu turned to the provincial and central authorities for a reconsideration of his original proposal. Again, his main bargaining chip was a promise of significant improvement in enterprise (and hence government) revenue through improvement in product quality and competitiveness, which was particularly appealing to the provincial authority. With strong support from the prefectural and provincial authority, Chu's proposal was accepted.

Under the new arrangement, Yuxi Cigarette entered a joint effort with the prefectural government to expand the farm assistance program. From 1986 to
1991, a total of 610 million yuan—of which 56% came from matching funds of the local government [Wen Ningjun, 1994: 49]—was spent for the development and supply of high-yield seeds, price subsidies for imported fertilisers, cultivation of 'demonstration fields', provision of technical training and consultation, construction and improvement of roads, subsidies for transport and coal, and use of bonus prices for high quality leaves [Wan Longshan, 1993:14-69; Xu, 1993:7-13]. These measures not only enhanced the incentive for farmers to improve the quality of their leaves, but also provided the means for them to do so.

More importantly, with regulatory power in hand, Chu worked closely with lower level government jurisdictions to form a mutually beneficial partnership. Since 1979, farm land in China has been divided into small pieces and contracted to individual households which, after fulfilling government quota for grain production, are free to make their cropping decisions and sell their output on the market. Yuxi is a densely populated prefecture where the land-population ratio has been the lowest in the province. With the approval of the local tobacco authority (in the hands of Chu), the quotas on tobacco leaf production could be relaxed. But growing tobacco leaves directly competed with
the growth of grain for arable land and other resources, to which the central authority required local governments to attach utmost importance.

To reduce the transaction cost of dealing with large numbers of tobacco farmers on an individual basis and to provide an incentive for grassroots governments to evade the 'grain first' policy in support of the development of a local base of high quality tobacco leaf production, Chu as head of the local tobacco authority commissioned them to help formulate, administer, and enforce Yuxi Cigarette's contracts with tobacco farmers. The fees paid to the various county and township governments depended on the amount and quality of the tobacco leaves supplied by the farmers under their jurisdiction. In Tonghai county where about 50% of the local government revenue came from tobacco-related activities, the total revenue from such bonus in 1990 reached 3.5 million yuan [Chu Shijian and Huang Qiuyan, 1992:35]. On the other hand, after it had accumulated sufficient financial strength in the mid 1980s, Yuxi Cigarette started to offer help to alleviate the pressure of the 'grain first' policy on the grassroots governments that had bent the rules to allow an expansion of tobacco growth to meet the enterprise's demand. It made huge investment, which totalled 14 million yuan during 1987-1989 [Gao Hang, 1990:24], in the development of
irrigation facilities in mountainous areas so that part of the tobacco leave production could be moved out of the grain-growing plains.

**Political dependence**

As a result of the above efforts to explore growth opportunities and overcome pre-existing bureaucratic constraints ahead of other cigarette manufacturers, Yuxi Cigarette was able to derive a competitive edge from institutional unevenness across different economic spaces. As a result, its importance in the local economy increased sharply. In the late 1970s, it barely contributed any significant amount of financial resources to the local governments. In 1991, tobacco-related activities centered around Yuxi Cigarette contributed 76.3% of the government revenue in the prefecture [Wen Ningjun, 1994:194-195]. 70% of the tobacco farmers in Yuxi were engaged in tobacco leave production. Largely because of tobacco, Yuxi has had the second highest per capita income in the province after Kunming (the provincial capital). It also contributed 50% of the province’s cigarette profits and taxes.

The increasing economic importance of the enterprise made it a star enterprise in the province and the nation. It was rated by the central government as a 'tier-two' enterprise (enterprise with very good performance and
management) in 1988 and a 'tier-one' enterprise (enterprise with superior performance and management) in 1991. Starting from the mid 1980s, Chu was awarded medals by different levels of government each and every year and became one of the most reported entrepreneurs in local and national media. The publicity that Yuxi Cigarette has received is in part the result of Chu's deliberate efforts to enhance the profile of the enterprise and make such a profile an indispensable political capital for local leaders. Those officials need concrete evidence (especially evidence from successful reforms in the troubled state sector) to showcase their performance to their superiors so as to secure and advance their positions. The political dependence of the local leaders on the enterprise could in turn help secure, perpetuate, and further advance the changes that the enterprise has brought about.

In 1988 Yuxi Cigarette set up a public relations office to raise its profile in the media. It started to publish its own newspaper (Yuxi Tobacco News) and run a local TV station. With its growing financial power, the enterprise has made huge donations to various 'good causes' at the local and the national level. It has made contributions, for example, to widely broadcast provincial and national TV programs, national events (e.g., the 1990 Asia Game), and local educational institutions, among others [Gao Hang, 1990:171; Wen Ningjun, 1994:496,497].
Although the changes initiated at Yuxi Cigarette took place in an ad hoc fashion, Chu has made active efforts to publicise, at government meetings and through the media, its experience in changing the rules of the game. That has resulted in a spread of the institutional changes that he initiated to other major tobacco manufacturers and tobacco producing regions in the province. By the mid 1990s, for example, all the 7 major tobacco-producing prefectures in the province had adopted the Yuxi model of combining local tobacco authority with the main local cigarette manufacturer. The wage system introduced in the 1980s has also been duplicated by other cigarette manufacturers. This not only helps perpetuate the changes that Yuxi Cigarette initiated, but raises Yuxi Cigarette's importance in provincial leader's political calculations, which in turn strengthens its bargaining power. The enterprise has become a regular site for visits by central government leaders during their work inspection tours in the province. Such visits were all arranged and accompanied by top provincial leaders. Given the growing economic and political importance of the enterprise to local leaders, it is not surprising that, after a serious tightening of cigarette quota allocation and enforcement after the enactment of the Tobacco Monopoly Law in 1992, Yuxi Cigarette was able to continue to further expand its production capacity.
IV. Managerial incentive and monitoring

There is no question that the strategy of Yuxi Cigarette in the reform era has been oriented toward exploring and expanding market opportunities rather than maneuvering for organisational slack. It is through extensive efforts to influence the decisions and actions of the officials in interaction with the enterprise that such opportunities have been secured and advanced. In fact Director Chu has acted more like a partner than an agent of the various levels of government authority. In the course of his pursuit of economic opportunities through the political process, he has brought down many traditional barriers to economic freedom and brought about important changes in the rules governing the local economic space.

But a puzzle remains. As the director and (subsequently) the head of the local tobacco authority, Chu has been a government employee drawing the salary of a middle-ranking official. Although large sums of ad hoc bonuses have been given to him from time time (especially in the 1990s) as an incentive to keep him doing his job well, the formal financial and career rewards that he has received appear not to be in proportion to the success that he has led the enterprise to achieve. What, then, motivates him to make the extraordinary efforts in pursuing the market strategy?
In the reform era, Chu faced two possible career choices: to stay in the state sector or to become a private entrepreneur. At the outset, the latter choice was neither a feasible nor attractive course of action for Chu. Like other state enterprise leaders, Chu faced bureaucratic restrictions on exit from his state-assigned job. The non-state sector (especially private economic activities) was underdeveloped in Yunnan. That raised the opportunity cost and risk, and thus added to the difficulty of his leaving the state sector. On the other hand, there were opportunities in the state sector, especially in the emergent national tobacco market of 300 million smokers and in the economic environment of Yunnan at that time when the local governments were willing to promote the growth of tobacco enterprises. A change in Yuxi Cigarette's competitive disadvantage would earn Chu credit in the evaluation by its supervising authorities. Such credit not only helped secure his position, but could and did translate into financial rewards. Limited as they were at that time, such rewards represented an improvement in his income.

As the enterprise became successful and grew larger, the exit option became less attractive to Chu. To do what he was doing well, he needed political clout, no matter whether he was in the state sector or the non-state sector. To him, staying in the state sector was a comparative advantage, because that was

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where he had accumulated personal contacts and, more importantly, dependency relationships that were specific to the enterprise that he led. Also, as success built up and the prospect looked brighter, it made little sense for him to pursue the slack strategy. But what about his career and financial rewards?

First of all, Chu does not need a high position in the government in order to mobilise political power to promote his goals. What really matters is the access to political power, which his current position and cumulative experience and connections can make available to him. In terms of financial reward, his formal pay or even bonus may matter less if he is able to direct the use of large sums of enterprise resources for self-defined purposes, including private ones. This ability, of course, depends very much on the internal and external monitoring that he faces in using such resources. With the extension of his tenure, he has also accumulated personal loyalty and consolidated his power base within the enterprise [Hui 1996]. Thus the internal constraints, posed by people (e.g., the financial and accounting managers) that are appointed by him, may be increasingly weakened over time. The external constraints may be deliberate relaxed by the supervising authorities, which depend very much on the success of the enterprise and have the incentive to give him a free hand in running it.

Moreover, Chu may use enterprise resources to bring private gains to officials in
higher offices in return for lax monitoring. According to a recent report [Huus, 1996], evidence of this seems to be surfacing. In 1996, Chu's wife and daughter were arrested on corruption charges, and his daughter committed suicide in prison. Although Chu's position has not been affected by that incident, his ability to stay on may simply be due to his political clout rather than a clean record.

This brings up the issue of managerial incentives and monitoring in state enterprises. What the above discussion suggests is that some leaders of state enterprises may be able to find ways to reduce the constraints on their discretionary decisions in the use of state-owned assets, though this scenario may take a long time and extraordinary political entrepreneurship to materialise. Instead of discouraging the enterprise leaders concerned from actively taking part in market activities, this possibility represents a source of private incentive and thus may strengthen their tendency to do so. But it does involve a cooptation of pertinent officials by fostering economic and political dependency. Whether or to what extent Chu has used illicit means to influence the decisions of pertinent local officials cannot be ascertained at this time. But the growing latitude that he has had in decision-making indicates an important and increasingly likely factor that has sustained his entrepreneurial drive.
V. Discussion

The agency problem—i.e., the owner's need to delegate authority and find ways to motivate and monitor the agent—is a perennial issue in organisation and management [Arrow, 1974; Williamson, 1985]. A peculiar institutional feature of the public sector economy is the lack of concrete owners of public assets. The principal (government officials) of state enterprises has only fiduciary authorities and limited responsibilities for the resources used by the agent (state enterprise leaders). While the structural design of the economic system may contain incentives for the fictitious principal to act like a real owner of state enterprise, they do not change the fact that the principal in such a capacity is not the owner. This leaves open room for collusion between officials and enterprise leaders. The conventional view of enterprise behavior in reforming state socialist economies emphasises the slack-orientation of such collusion. Our account above shows another possible direction of interaction: formation of a de facto partnership between a state enterprise leader and officials at various pertinent loci of state authority for an enterprise-based, market-oriented joint-venture that promotes their mutual interests. Three aspects of this possibility are worth noting.
First, the driving forces of this course of action in post-Mao China come from two major sources: marketisation and decentralisation. Marketisation initiated by non-state enterprises generates competitive pressures, increases fiscal constraints, and signals new economic opportunities to enterprises. Decentralisation increases the discretionary power of lower-level loci of state authority and ties the interests of local officials to the growth of economic activities under their purview. These developments provide the impetus and increase the regulatory means for promoting market-oriented growth of state enterprises.

Second, for enterprises in the state sector, pursuing the market strategy necessarily involves efforts to enlist the help of pertinent officials to bend existing rules in an ad hoc fashion so that the enterprise concerned may increase the freedom to explore market opportunities and capitalise on the institutional unevenness with its competitors. Such efforts may be greatly advanced by fostering dependence of pertinent officials on the success of market-oriented activities of the enterprise. In this context of interaction, bargaining may be turned from a tool for organisational slack within the existing institutional confines to a lever to facilitate the expansion of growth opportunities.
Third, the outcome of the market strategy is closely related to the path-dependent choice structures of the authorities under which a state enterprise operates, and to the entrepreneurship of its leaders. Where fiscal pressure is strong and when the pertinent officials have few alternative choices for increasing revenue, there is significant probability for local enterprise(s) with growth potential to have the existing rules bent for building a competitive advantage in the market. But it takes shrewd political skills and business acumen of the enterprise leader to make this materialise.

The experience of Yuxi Cigarette illustrates these mechanisms at work. It contrasts sharply with the image of passive organisational response of state enterprises to marketisation. Our analysis indicates a hitherto neglected source (i.e., influence on the state exerted by powerful enterprises, including those in the state sector) of institutional change. It also indicates a need to qualify the sweeping generalisations drawn from the conventional view, which does not provide an adequate examination of how, within the existing governance structure, the behavior of state enterprises may be affected by the important changes in their environments (i.e., marketisation and decentralisation). To be sure, the rather extraordinary experience of the enterprise under study by no means suggests a uniform pattern of such effects. There are enormous variations
both in the form, scope, and timing of the changes in state enterprises' environments and in the selection and outcomes of their responses. Our findings do not settle the empirical question of whether the overall poor performance in the state sector is largely due to the lack of such a shift or unsuccessful efforts to pursue the market strategy. But they clearly indicate that this question merits serious attention in future research. Moreover, they provide some clues to understanding the latter possibility if it is empirically proven to be a growingly important cause.

As indicated earlier, the fact that large numbers of state enterprises are unprofitable does not necessarily indicate that they stay with the slack strategy. Also, it is important to note that not all state enterprises have been in the red. Even if we take the earlier cited estimate that two thirds of state enterprises are unprofitable, at least one third of them still make a profit. Most of those in this group are in the category of 'large scale enterprise', which, according to the 1995 industrial census, was the only segment in the state sector where total profits exceeded total losses [Pucha Bangong Shi, 1997:22]. One possible reason for this pattern of performance variation is that large numbers of small state enterprises may have sought to change course but achieved little success with the market strategy. Consequently, they may revert back to the slack strategy. But if
the room for pursuing the slack strategy has been narrowing because of the evidently increasing fiscal constraints, they are caught in an impasse. A question here is what accounts for their failure in using the market strategy. The experience of Yuxi Cigarette suggests that two factors matter greatly in this regard: the path-dependent choice structure of pertinent local officials and the entrepreneurship of the enterprise leader.

As shown above, a major reason for Yuxi Cigarette's successful efforts to cultivate political clout for institutional change is the limited range of choices for local officials to increase revenue at the initial stage of marketisation. In locales where such choices were more abundant (e.g., because of a dynamic and rapidly expanding non-state sector), small state enterprises may have difficulty enlisting sufficiently strong political influence to facilitate their attempts to pursue market opportunities. Their ability to do so may also be affected by the poor quality of leadership. This problem is further compounded by the exodus of entrepreneurial talents to the non-state sector. Such brain drain is particularly likely to be serious for small enterprises not only because of the greater attraction of financial and non-financial rewards in the non-state sector but because of the weaker administrative restrictions on the mobility of small state enterprise leaders.
Large state enterprises, on the other hand, consist of two groups: those that have grown large in the reform and those that were traditionally large and have maintained their magnitude through further growth in the reform. Yuxi Cigarette's experience indicates a likely path of growth followed by the first group. Because of the pre-existing dependency relationship of their supervising authorities, the second group could draw on ad hoc favorable allocative and regulatory treatments in the early years of reform when marketisation was just started by the non-state sector. With the deepening of marketisation that increases competitive and fiscal pressures while signaling growing opportunities outside the plan, relying on traditional privileges and protection becomes increasingly difficult and unattractive. Many of these enterprises may have gradually re-adjusted the goal of their vertical bargaining from slack to market. Because of the stricter rules on the exit of top managers of large enterprises, their careers and rewards are more closely tied to the performance of their enterprises. This 'locked-in' position may become an important driving force to arouse their entrepreneurial spirit. To be sure, their efforts to change may fail, but the probability may be lower than that for small enterprises because of large state enterprises' more advantaged initial conditions and stronger institutional blockage to brain drain.
It is beyond the scope of this paper to fully ascertain these possible causal linkages and thoroughly map out the various patterns of state enterprises' responses to marketisation. But we hope that our analysis may stimulate and inform further efforts to do so in future research.
Notes

1. In 1994 the enterprise was reorganized and renamed as "Yuxi Hongta Tobacco (Group) Co., Ltd." Since Yuxi Cigarette Factory was its name during most of the period that we discuss, we use Yuxi Cigarette to refer to the enterprise in this paper.

2. During 1991-1995, for example, government subsidies to loss-making state enterprises declined by 12% (without taking into account the effect of inflation) over the period 1986-1990, despite the fact that the number of loss-making state enterprises had been on the increase [Guoji Tongji Ju, 1996:227].

3. It should be noted that the quota of an enterprise only places a limit on its total output (in terms of cases of cigarettes). It does not stipulate decisions on what to produce, how to produce, where to sell, and what prices to charge. What we mean by marketization in the tobacco sector is that all these decisions have been gradually guided by the enterprise's own reading of the information from the market rather than by government administrative commands, and that their financial gains have to be realized through sales of their products in the market.

4. It has been reported recently [Huus, 1996] that Chu was not on good terms with the new provincial governor appointed in 1996, who wanted to replace Chu
with his own appointee. It remains to be seen whether Chu could use his political skills effectively to turn the situation around.

5. The Chinese government uses a set of complex criteria, including production capacity, output and sales volume, number of employees, assets, etc., for the classification of enterprise scale [Guojia Tongji Ju, 1995:314]. The criteria were adjusted upward twice (in 1978 and 1992) in the reform era. Those classified as 'large scale enterprises' are the leading enterprises in different industrial sectors. There remain, however, inter-sectoral variations in the criteria used (e.g., the assets of a 'large scale' enterprise in the textiles sector may be less than those of a 'medium scale' enterprise in the petro-chemical sector).

6. According to a 1993 survey of 1,933 state enterprise leaders [CESS, 1993:17], 25.5% of the respondents indicated that given a choice they would like to become top manager of a private enterprise or joint venture, and additional 19.9% indicated that they would like to start their own private businesses. A 1992 survey of 1,440 private enterprise owners reveals that 36.4% of them left their jobs in units in the state sector to become private entrepreneurs [Zhang Xuwu et al., 1993:118].
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