

Central Intelligence Agency



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DIRECTORATE OF INTELLIGENCE

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**China's Contract Management Responsibility Systems:
Touchstone for Economic Reform in 1988?** [redacted]

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Summary

Chinese reformers are touting contracts that spell out performance targets for large state-owned enterprises as the prescription for China's sagging industrial sector. We believe the contracts will reduce unwarranted enterprise spending by increasing Beijing's ability to supervise bonuses and construction outlays. But we also believe that irrational prices, controlled markets, and bloated work forces will limit gains in enterprise efficiency and competitiveness. Resistance from workers, managers, and local authorities may also dilute the effectiveness of the system. In any case, orthodox leaders will probably use whatever short-term improvements in enterprise performance that do occur under the contracts to argue that more far reaching market-oriented reforms are unnecessary. [redacted]

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This memorandum was prepared by [redacted] Office of East Asian Analysis. Information available as of 14 December 1987 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Economic Assessments Branch, China Division, OEA [redacted]

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The Contract System: A Prescription for Ailing State Industries

Early this year, Chinese leaders began pushing contracts between the government and large- and medium-size state enterprises as the new centerpiece for industrial reform through at least 1988. Although they account for less than 2 percent of all Chinese enterprises, the 9,000 large- and medium-sized enterprises:

- Produce 46 percent of China's industrial output.
- Dominate the heavy industry, energy, and transportation sectors.
- Produce 60 percent of the profits and taxes earned by China's industrial enterprises.
- Provide 60 percent of central government revenue

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These firms are scoring impressive production gains, but they are making little progress in improving efficiency or raising quality, while rising costs and expenditures are contributing to stagnating profits. According to Chinese statistics, although the output of all state enterprises increased over 11 percent in the first five months of 1987, profit increased by less than 1 percent, and nearly one-fourth of state enterprises are now running in the red.

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Beijing hopes the contract system will reverse this sagging performance. In limited use since the early 1980s, the "contract management responsibility system" had been adopted by only one-third of China's large- and medium-size state enterprises by June, but the portion jumped to three-quarters by late October. And party chief Zhao Ziyang told last month's party Congress that, in the future, all enterprises must use contracts.

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Under the system, the enterprise manager and the supervisory government department sign an agreement that commits the enterprise to specified performance targets.¹ In some cases, party leaders and worker representatives also sign the contract, according to US Embassy reporting. The system provides factory managers with

¹ Because the targets are negotiated individually between the enterprise and the supervisory department, features of the contracts vary. They usually have three- to five-year terms, and can list up to eight targets, including profits, taxes, wage bills, technical upgrading, and quality standards. Some use a base year--usually 1986--and specify annual increases in profits and taxes the enterprise is to achieve through the contract period. Most contracts also build in incentives; for example, one formula taxes profits equal to those in the base year at 55 percent and additional profits at only 30 percent. Contracts with selected key industries--such as steel, petroleum, and the railroads--emphasize input and output targets similar to past planning criteria, probably to reduce the risk of disruptions from more substantial innovations.

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operating discretion but affirms state ownership and retains sufficient government control to assure output of key goods and to safeguard the labor force. If the enterprise fails to meet the contract obligations, the factory director may lose his job and worker bonuses may be cut. [redacted]

Enterprise Management Reforms

The contract management responsibility system is one of several management tools Beijing has introduced to spur economic growth. Each of these targets an aspect of industry or economic management:

- Since the early 1980s, reform leaders have advocated the factory director responsibility system--a management reform that increases the authority of factory managers to make business decisions free from the meddling of enterprise party officials and government bureaucrats. For example, the manager can independently appoint deputy directors and other management personnel under this system. The factory director responsibility system is often used in conjunction with the contract management responsibility system in larger state enterprises.
- Beijing has endorsed leasing systems as the key to management reforms in smaller state and collective enterprises. Under this reform, also referred to as the contracted management responsibility system, an enterprise manager is selected through competitive bidding, and then signs a contract stipulating the taxes he will remit during the lease period. Unlike the contract system in larger state enterprises, leasing arrangements make the manager the virtual temporary 'owner' of the enterprise, allowing the manager to retain aftertax profits, and often requiring the manager to put up collateral to cover potential losses.

Potential Benefits


One reason to believe the contract system will produce results over the next year is that it is receiving considerable attention and assistance. Indeed, Chinese officials are already pointing to improved efficiency, quality, and profits at several large enterprises. [redacted]

Further improvements can be expected for several reasons. For one, the contracts should boost the accountability of the enterprise manager. In the past, managers have not been directly responsible for meeting both output and fiscal targets.





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Contracts in the Chinese Context

"Contract" is the latest buzzword in Chinese reform, but Chinese contracts differ substantially from the Western concept. In China, parties tend to view contracts as memorandums of understanding rather than binding agreements. For example, the head of the State Economic Commission recently remarked that, once enterprises signed contracts with supervisory bureaus, if they found that the terms were too harsh or if the enterprise benefited "excessively," the contracts should be "readjusted." 

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China's approach to contracts in part reflects the decades of Maoist rule when Beijing subordinated legal procedure to government fiat. In addition, key elements of Western legality do not exist in China's legal system; for example, there are strict limits on holding private property--land and capital goods in particular are "publicly owned," although they may be leased for fixed terms. 

Finally, we believe China's fledgling legal system reinforces the nonbinding, informal nature of Chinese "contracts." The number of contracts is increasing exponentially: millions of new state workers and a growing number of government bureaucrats and factory managers are signing fixed-term contracts for their jobs; entrepreneurs are leasing smaller state and collective enterprises by contracts; and enterprises themselves are entering into contract agreements with government departments and other enterprises. At the same time, the number of lawyers and courts to help advise on contracts and to handle disputes is severely limited. Shanghai, for example, with the nation's highest ratio of lawyers to population, has only 400 full-time and 1,100 part-time lawyers to serve over 11 million people, and they must handle both criminal and civil cases. Although cases involving contract disputes in Shanghai mushroomed 76 percent in 1986, we believe many more disputes were handled outside of the legal system because of the lack of lawyers and jammed court dockets. 

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Once the manager signs the contract, however, he is likely to feel more committed to his enterprise's success. [Redacted]

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Workers and party members may also believe the contracts increase their accountability, particularly if they must sign them. In such cases, bickering between managers and party and worker representatives may wane. And, even if all parties do not sign, terms that directly link bonuses to enterprise performance should relieve pressure on managers to issue blanket bonuses. This will help control the drain on enterprise funds from bonuses, which jumped 45 percent in the first half of 1987. [Redacted]

Regarding other dividends, we believe this system will help Beijing regain some control over other unwarranted enterprise spending. Identification of fiscal goals, in conjunction with other reforms, including the establishment of the Ministry of Supervision and more stringent banking controls, should help reduce unauthorized investment and other expenditures that have contributed to enterprise deficits. [Redacted]

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We also believe the contract system will help identify good managers. Managers who meet or exceed contract terms should stand out under the system, and managers who fail can be moved to other jobs. In addition, the contracts may help some managers gain more independence from supervisory bureaus. Managers will be able to argue that if they fulfill the targets, they should be free to make decisions without administrative interference. [Redacted]

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What the Contract System Cannot Do

On the down side, we believe the contract system will encounter many of the problems associated with the Stalinist-style command planning system, under which enterprises are handed specific targets and given incentives for overquota production. For one, contracts will not make good managers out of bad ones. A senior Chinese management researcher pointed out to US officials recently that weak management is one of the major problems of China's larger enterprises, noting that managers frequently are drawn from the ranks of engineers and have a "narrow vision" of business management techniques. The system in larger enterprises will probably reinforce this deficiency by focusing management attention on narrow financial objectives. [Redacted]

In addition, the system will reward managers for bargaining for and achieving targets, rather than simply encouraging managers to make sound, innovative business decisions on the basis of market signals. Indeed, because Beijing forces larger state enterprises to employ surplus workers, to produce goods according to plan rather than market needs, and to absorb rising input costs while holding the line on prices, managers have only limited areas where they can improve performance. At the same time, although contracts may increase their accountability, managers know that because Beijing cannot tolerate bankruptcy or widespread layoffs, the government must underwrite enterprise deficits. Thus, managers may continue to look for loopholes in Beijing's supervision to spend indiscriminately, without significantly improving competitiveness or efficiency. [Redacted]

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We also doubt that contracts will eliminate bureaucratic interference. Contracts do not alter most of the factors that bind administrative departments and enterprises, such as access to materials, funds, and marketing channels.

because the contracts are negotiated individually, they tie the enterprise and the supervisory bureaus together. Participants at a recent World Bank symposium in Beijing reportedly raised the same point, suggesting that the systems could encourage "sweetheart" contracts between the enterprises and the bureaus.

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We also believe that many workers, enterprise managers, and local officials may resist the contract system. Because many managers have been granting blanket bonuses to maintain shop floor harmony, contracts that link worker bonuses to performance could stimulate discord among workers. Hong Kong press reports have already referred to growing worker dissatisfaction with the system. Managers, too, are reportedly reluctant to sign contracts unless they are certain the targets are achievable. For their part, local officials may fear that contracts will restrict their power to tax profits, and thus may reduce revenues. Such concerns may lead managers and local officials to take a cautious approach, perhaps signing bare-bones contracts to claim they are implementing reform, without making any substantial changes. Indeed, the stunning growth in the use of contracts this year suggests they may be negotiating quick but empty deals.

Interim Measure or Step Back for Reform?

We believe the duration of the contract system to a large degree will presage the future of Beijing's broader economic reform program. Orthodox leaders are championing an enduring contract system because it fits well with state planning and reinforces the role of the bureaucracy in enterprise management. Reform leaders and economists support the system to maintain the appearance of reform momentum, but are concerned that it is a step back from market-oriented reforms. For example, a Chinese official told US diplomats that the contract system sidetracks the introduction of uniform tax rates, which market reformers advocate. The official confided that he hopes the contract system will be in effect for only one or two years. Another reform economist pointed out to US officials that, if they become widespread, the contracts could stall further reforms by binding enterprises and bureaus to set prices and tax rates. These statements reflect fears of many reform advocates that the system may develop from a "pause" into an effective retreat from broader economic reform.

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Orthodox leaders will probably cite any improvements in enterprise performance to argue that the contract system and other such reforms that tinker with the bureaucracy--rather than tackle tough problems such as irrational prices and bloated work forces--are the best solution for China's economic problems. If this occurs, the short-term success of the contract system may make it harder for reform proponents to achieve more fundamental changes in China's price, ownership, and financial systems. Thus, the success registered by the contract system may prove a mixed blessing.



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