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Preface to the paperback edition

The publication of this paperback edition of *Management in China During the Age of Reform* affords an opportunity to update the reader on relevant developments since the book first appeared in 1994. This preface begins by recording salient economic developments in China which have taken place since then. It notes key events in the state-owned sector of industry on which much of the book concentrates, and concludes with a synopsis of developments in the foreign-funded sector. Although new events follow one another rapidly in China, the underlying economic and political structures and systems which mark out the country's unique character as an environment for management have not changed dramatically. I therefore believe that the analysis offered in the following chapters remains valid and useful.

China's economy has continued to develop rapidly during the 1990s, in terms of its growth, participation in world trade and investment in resources. It is now, without question, one of the world's major economic powers with a GDP which by 1995 ranked third behind those of the USA and Japan. It is estimated that, with a continuation of present trends, China will have become the world's largest economy by the year 2005.

In the first half of the 1990s, China attained a rate of economic growth that averaged 10.1 per cent despite a slow-down during 1990 and 1991. This level of economic growth has surpassed that of any other significant economy in the world. By 1994, China ranked first in the physical scale of production of many raw materials such as coal, cement, cotton and cereals, though its per capita output of agricultural and industrial goods was generally still far below that of the norm for developed countries. The structure of Chinese industry remains heavily weighted towards primary and secondary industry, with an as yet underdeveloped tertiary sector. Some 60 per cent of the country's total labour force is engaged in agriculture, while the large secondary sector accounting for almost half of the country's output value is still relatively inefficient.

A number of manufacturing industries have, nevertheless, become internationally competitive. This is especially true for industries, such as electrical products, which have attracted considerable foreign investment, and the newer technologies and methods of management which accompany it. These areas of

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production have also benefited from a rapidly expanding domestic market. China is, for instance, anticipated to become the world's largest market for personal computers by 1998.

The so-called 'Open Door Policy' has been reflected in a rapid growth of China's international trade. This increased annually by 19.7 per cent from 1991 to 1994, greatly exceeding the world average growth rate of 4.5 per cent in the same period. China ranked 11th among the world's trading nations in 1995. With the exception of 1993, it has run a positive overseas trade balance during the 1990s to date, and had built up its foreign reserves to $US 75.4 billion by the end of 1995. This positive balance is, however, threatened by a high rate of inflation and double-digit growth. Enterprises with foreign investment are playing a major role in the increase of foreign trade. Such enterprises in 1995 accounted for 39.1 per cent of the national combined total of imports and exports. Although these foreign-funded firms have until now recorded a higher value of imports than exports, the gap is rapidly closing. During 1995, for instance, the value of their exports grew by 35 per cent, while the value of imports they accounted for rose by only 19 per cent.

Through considerable investment during the 1990s, China has endeavoured to sustain high growth and an improvement in socio-economic quality. In 1994, the proportion of GDP going to investment was 36 per cent, which is approaching twice the figure for many developed countries. About 10 per cent of this investment was supplied by foreign companies, including those owned by Overseas Chinese. Foreign capital-funding has been the most rapidly growing component of investment in China. It is easily the largest recipient of foreign direct investment among developing countries, and in 1995 stood second only to the USA as a global destination for FDI. Other indicators of improving socio-economic conditions include a rising literacy rate for adults, which at 73 per cent in 1992 was above the world median, a large and growing body of trained scientists and technologists, and an average life expectancy which at 69 years comes close to that of developed countries. Despite these improvements, however, China still lags behind developed countries in certain key respects such as the quality of its infrastructure and the share of its GDP going into research and development. The reform of its state-owned industries remains a particularly urgent need, requiring injections both of capital and of superior management.

As indicated above, foreign-funded firms are making a significant contribution to China's development. By the end of 1995, 259,379 projects involving negotiated funds of $US 395 billion had been approved, with some $US 135 billion actually being deployed. The 120,000 foreign-funded enterprises in operation by the end of 1995 employed 16 million people and accounted for over 13 per cent of China's national output value. Many of them are important sources of technology transfer and new management expertise.

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Foreign-funded firms also contributed 10 per cent of China's total tax revenue in 1995, a rise of 60 per cent over the previous year. By end-1994, the largest sources of foreign investment in China in order of magnitude, following Hong Kong and Macau (through which much re-investment is channeled back into China), were Taiwan, the USA, Japan, Singapore and the UK.

Since 1992, there has been a steady increase in the number of transnational corporations investing in China, coming mainly from the 'Triad' of the USA, Japan and the European Union. Most of the projects funded by transnationals are relatively large scale and capital intensive. They bring advanced technology, high-level management expertise and a long-term strategic orientation. This category of foreign direct investment has primarily fed the development of the electronics and machinery sectors, and infrastructural projects. The Chinese partners are in the main state-owned enterprises, the revitalization of which has been a major objective of the Chinese economic reform, as this book describes in some detail.

State-owned enterprises in 1994 contributed approximately 34 per cent of China's gross industrial output by value, but were by that time accounting for under 7 per cent of the country's industrial growth and hence were playing only a minor role in driving China's economic development. It is, however, not easy to obtain either a comprehensive or a balanced view of the condition of state-owned enterprises. This is partly because there are quite wide variations in their economic health and vitality, and partly because their inefficiencies and losses have often been exaggerated by factors such as the communal burden they are expected to carry and misleading accounting systems which result in the understatement of book profits.

While some state-owned enterprises had improved their position, through rationalization, mergers and the exploitation of export opportunities, the majority were still in trouble. Their low efficiency was reflected in falling profits, rising losses, increasing indebtedness and a shortage of funds. Many of them face increasing competition from joint ventures with foreign companies and wholly-owned foreign subsidiaries. The inability of state enterprises to pay each other for goods and services continued to increase during 1995, according to a survey of some 300,000 businesses across China (Walker 1996a). This so-called 'triangular debt' also draws the banks into making unproductive loans and distorts the whole financial system.

During 1994 a series of new reforms was promulgated for the banking, taxation, foreign trade, enterprise and social security systems. These measures were to a large extent intended to reduce the financial burdens on state enterprises and improve their competitiveness. They heralded a unified tax system for domestic enterprises designed to ease the incidence of tax falling on state enterprises, a progressive separation of welfare and other non-productive activities from enterprises, and an increased application of the 1986 bankruptcy

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law. According to the State Tax Administration, the overall tax burden on companies did in fact fall by about 20 per cent in 1995.

Additional capital has been raised by some prominent state-owned enterprises through the issue of shares on the Shanghai, Shenzhen and Hong Kong stock markets. The performance of these shares has, however, been lukewarm at best. Problems of disclosure and indifferent management continue to present risks for portfolio investors. There has been discussion of experimenting with wholesale privatization, though the official watchword has continued to be that China will remain a socialist market economy.

A development of the social security system was also envisaged in order to provide a safety net for employees who would be displaced by downsizing and rationalization among state enterprises. Its introduction has, in practice, been very slow and this has contributed greatly to the delay in the implementation of further enterprise reform, particularly in view of the authorities' marked desire not to provoke social unrest. As it is, China already admits to an unemployment level of 3 per cent, and the true figure is probably closer to 10 per cent.

By the second half of 1995, it had become apparent that enterprise reform was proceeding only slowly. The implementation of bankruptcies among state-owned enterprises, originally scheduled to begin in that year, was postponed to await the establishment of appropriate social security arrangements to provide for displaced employees. Radical solutions such as privatization were no longer being seriously considered, although the conversion of state enterprises into joint stock companies through the formation of joint ventures with foreign-investing partners continued to be encouraged. Improvements are now expected to come from within the system in its largely existing form, and this places the onus on achieving better enterprise management. As an article in the official *People's Daily*, 26 October 1995, put it, 'it is the management system that is not in keeping with the market economy'. To emphasize this view, the *People's Daily* of 11 December 1995 took the unusual step of announcing that seven heads of state-owned enterprises in the north-eastern industrial city of Shenyang had been dismissed for bad management. As Chapter 9 describes, the central government has several times used Shenyang as a standard-bearer in its drive towards further economic reform. It was, for example, in 1986 the first city to permit the bankruptcy of a state-owned enterprise.

Employment and human resource management is one area of enterprise reform in which experimentation has continued. The so-called 'Three Systems Reforms' (*san gaige*) have concerned employment contracts, payment systems and social insurance. The introduction of contracts for employees was an important feature of the labour market reforms introduced in the second half of the 1980s. It signalled that lifetime employment could no longer be taken for granted and introduced limited-period contracts for newly recruited workers. By 1994, 26 per cent of staff and workers in state-owned enterprises were

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employed as contract workers (*hetong gong*), a proportion that had risen steadily over the previous ten years. The percentage of contract workers in collective enterprises was somewhat less at 20 per cent, while the figure for other firms (including foreign-funded ones) stood at almost 46 per cent (State Statistical Bureau 1995: Table 4-11). The contract system offered enterprises a growing opportunity to plan employment and secure additional flexibility in employment policy, as well as exerting some pressure for employees to perform adequately.

Reformed reward systems now stress material benefits. A 'post-plus-skills' formula was introduced by the government in 1992, whereby the basic salary is supposed to be determined by the responsibility of the post, plus technical skills acquired, with a bonus added for achievement of performance targets. The social insurance reform is intended to compensate for the progressive loss of the 'cradle-to-grave' protection which Chinese workers had enjoyed since the 1950s, and which has become a serious burden for state enterprises in particular. With the 1994 Labour Law, implemented in early 1995, fully legitimizing redundancies for the first time, unemployment insurance now assumes a critical role in covering a percentage of former earnings plus welfare benefits and pensions.

As with all the new laws and regulations under China's economic reform programme, it has taken time for new provisions to be implemented. In addition, they are typically subject to a large measure of local re-interpretation. Warner (1996) investigated the specific implementation of the employment reforms in ten enterprises located in Beijing and China's North-East during 1993. He found considerable variation in the extent to which the new provisions had been implemented, with the proportion of workers on contracts ranging between 10 and 100 per cent, and with the post-plus-skills payment system operating in only six of the enterprises. As already noted, it is also taking longer than anticipated to implement the new social security arrangements.

The management policies being encouraged in the present phase of enterprise reform are illustrated by state enterprises that have been officially selected as models worthy of emulation. One such is the Handan Iron and Steel Works, located some 300 km south of Beijing (Walker 1996b). Before 1990 when it began to introduce reforms, Handan was a loss-making enterprise. In that year, net profit was 1 million Yuan and net assets 580 million Yuan. By 1995, profits had climbed to 709 million Yuan and net assets stood at 4.6 billion Yuan. One of the first changes was to introduce accounting standards which valued the real cost of producing a ton of steel and set production targets based on market prices. The workers' bonus system was revised so that, instead of being paid extra whatever their contribution, workers are rewarded according to how well they achieve targets and contain costs. A strong market

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orientation has been injected into the firm, together with a determination not to incur the bad debts which were a concomitant of the regime of transacting on the basis of traditional ties and old relationships. Handan's policy is now not to ship any product until a contract is signed or payment received.

China's recent economic performance has been remarkably successful and, despite interludes due to inexperience in macro-economic regulation and political upheaval, the country's programme of economic reform has moved forward at a reasonably steady pace. This is not to say that there are no substantial problems remaining. As well as the inherited problem of the state enterprises, others are the concomitant of economic development itself. Any visitor to China in recent years cannot but be aware that a major environmental problem has emerged, and that corruption and lawlessness have become almost endemic in certain parts of the country. While the infrastructure has improved enormously during the past ten years, especially in telecommunications and internal air travel, power supplies and provision for the internal transportation of goods still trail the growth in demand for such services.

These problems are clearly pressing, but there is one issue which threatens to divide the country itself. It stems from the fact that the market forces given increasing rein under the economic reform have, since the mid-1980s, increased inequalities both between regions and between urban and rural areas. Given the natural economic advantages of the coastal provinces, which have attracted the lion's share of foreign investment, the gap in per capita income between them and the inland regions is likely to grow. Government policy-makers are acutely aware of these and other problems, which have been exacerbated by a combination of rapid growth and the progressive liberalization of market forces.

The Chinese authorities are keen for investment by foreign companies to play a role in resolving some of these difficulties. With this in mind, they have now more clearly distinguished between those industries, commercial activities and regions in which foreign investment is to be encouraged, or at least permitted, and those in which it is to be restricted or banned altogether. They continue to welcome inward foreign direct investment, but are determined to steer it towards priority sectors and the disadvantaged inland regions.

In June 1995, the central government published its *Interim Provisions on Guidance for Foreign Investment and the Industrial Catalog Guiding Foreign Investment*. The Interim Provisions apply to projects involving Sino–foreign joint ventures, co-operative ventures, and wholly-foreign-owned projects, together with all other types of project involving foreign funding. These projects are divided into four categories, in which foreign investment will be, respectively, encouraged, permitted, restricted or prohibited.

Projects in which foreign investment is encouraged are those contributing to

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agricultural development; those providing new and advanced technology, or assisting the conservation of energy and raw materials, or the production of scarce equipment and materials; projects which contribute to exports; projects which assist environmental policies on renewable resources and pollution; and projects which direct investment to the inland central and western regions. The *Industrial Catalog* lists in detail the industries in which foreign investment is encouraged, under the following broad categories: agriculture and related industries, advanced products in textiles and other light industries, transportation, post and telecommunications, coal, power generation, certain ferrous and nonferrous metals products, selected petroleum, petrochemical, chemical and mechanical engineering ('machine building') products, advanced electronics products, certain sophisticated building materials, most pharmaceutical products, space and aviation products, special-purpose shipbuilding, new technology industries and certain high-technology services. While foreign investment in transportation, postal and telecommunications products and technologies is encouraged, investment in the operation of facilities in those areas is prohibited. Foreign investment is to be restricted in industries which are already satisfying domestic demand, are subject to overall State planning, involve the exploitation of rare mineral resources, or are monopolistic in nature.

Excise duty and tax adjustments have led to some concern among foreign investors. The Chinese authorities decided late in 1995 to abolish tax exemptions on the import of machinery and equipment by foreign-funded enterprises, as from 1 April 1996. This removed an advantage that foreign-funded firms had enjoyed over domestic enterprises, and meant that foreign ventures requiring sophisticated imported plant and equipment would have to pay a 40 per cent duty plus 17 per cent VAT on them. Although the removal of the exemption is being phased over two years for larger projects with a total investment of $30 million or more, foreign companies complained widely that this was a further illustration of the Chinese government's tendency to change the rules of the game unpredictably. For example, the chief representative in Beijing of the semi-official Japan External Trade Organization (JETRO) was reported as saying that sudden changes in the law and a lack of transparency in their application are major worries for Japanese companies: 'Almost every day they announce new laws . . . but very often we have trouble interpreting them' (Walker and Ridding 1996). Previously, in late 1993, China's State Council published new tax regulations which included the standardization of taxation policies governing domestically and foreign-funded enterprises. Two years later, this provision had still not been implemented, though an official intention to do so 'gradually' continued to be expressed (*Beijing Review*, 18 March 1996: 4).

This general tightening of policies toward foreign-funded firms raises the

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question of whether the time is approaching when China will no longer rely so much on foreign investment. The long-term aim appears to be one of establishing internationally competitive indigenous industries under Chinese control. This can be seen, for example, in the Automotive Industrial Policy formulated in 1994 and expressed in the *2010 Long-Term Target for National Economic and Social Development* published in March 1996. The policy envisages continued support from foreign investment in the medium term, in order to build up a modern production capacity and basic R&D capabilities by the year 2000, but then a move towards a self-supporting and internationally competitive automotive industry by the year 2010.

The authorities have made it quite clear that they only intend to offer preferential treatment to foreign investors who suit its industrial policies and can contribute to its development needs. There also has to be uncertainty in the long run as to the degree of managerial control which China will permit foreign parent companies and other investors to exercise over their subsidiaries and joint ventures. This could frustrate the preference of foreign investors, particularly multinational corporations, to increase their equity share and degree of active management control over joint ventures with Chinese partners. The intention is partly to compensate for the limitations of Chinese management and partly to integrate such ventures more closely both with their other China operations and with their international organizations (Meier et al. 1995).

Many of the multinational companies operating several joint ventures or subsidiaries have responded to the authorities' recent willingness to approve investment holding companies, when they can meet the minimum criteria of having at least $10 million in existing investment and a commitment to another $30 million. There are both financial and managerial benefits to establishing a holding company. On the financial side, it can act as a foreign currency swap centre for subsidiary companies; it has the potential to provide debt financing and to ensure a more efficient circulation of capital. On the managerial side, a holding company can act as an agent for the sales of its China subsidiaries and hence generate synergies in marketing and distribution. It may also help to promote some rationalization in procurement and production.

Generally speaking, the Chinese authorities regard foreign direct investment as playing a positive role through the provision of capital investment, as a vehicle for technology transfer, a contributor to management development and domestic market development, as a source of exports and import substitution, and in assisting state enterprises. On the other hand, they have been concerned about a number of negative features associated with foreign investment, such as the competitive effect of foreign brand names on local products, the greater interest that joint ventures are perceived to have in the domestic market than in exporting, the laying off of older Chinese employees when local enterprises

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form joint ventures with foreign partners, and smuggling and other illegal practices, especially in joint ventures with Overseas Chinese partners.

Surveys indicate that the majority of foreign investors find China a profitable investment environment, with good longer-term prospects. Nevertheless, many continue to face formidable difficulties in managing their ventures in China, according to investigations conducted by the author and his colleagues in recent years. The changes in government laws and regulations, plus the vagaries of their interpretation at the local level, are a major headache for most foreign managers in China. Logistical problems also continue, including poor infrastructure and services, low-quality suppliers and an insufficiency of market information. Bad debts and rising costs are other frequently mentioned concerns.

Companies in the consumer goods sector, marketing international brands, face the problem of counterfeiting and copyright piracy. While this has received most attention in connection with compact disks and computer software, the CEO of one large American soap and toiletries corporation told me recently that he considered it to be the most serious problem his company faces in China today. The authorities have taken some steps to reduce the problem – for example, it had registered some 460,000 trademarks by the end of 1994 – but enforcement at the local level continues to be variable.

Human resource issues also present a significant challenge. Problems of relationships between Chinese and foreign personnel are often mentioned. Indeed, the major frustration experienced by Chinese joint-venture managers concerns the behaviour of their foreign colleagues and how this can sour the relationship between them. For example, many expressed the view that foreign managers were arrogant and insensitive, and failed either to understand the Chinese environment or to consult them about this and other matters. Such problems can normally be overcome if efforts are made to create trust, improve inter-personal communication and encourage shared decision-making. A less tractable problem is the shortage of competent local managers available to the rapidly growing numbers of Sino–foreign joint ventures and foreign subsidiaries. This has brought to the fore issues of motivation and human resource development, against a backcloth of extreme labour mobility between companies which are bidding for good Chinese managers with high salaries and other benefits.

These issues point to the dynamic of the contact between traditional and foreign approaches to management which China's Open Door Policy and economic internationalization have brought about (Child and Lu 1996). This is particularly evident in joint ventures, where ways have to be found of reconciling the two. Although it reflects certain cultural influences, the traditional Chinese approach was largely shaped under the pre-reform centrally-planned economy. As following chapters describe in detail, most Chinese enterprises

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until the mid-1980s operated within a command system under which planning quotas for inputs and outputs were imposed on them. As a consequence, managers had to involve themselves closely with the higher governmental officials upon whom they were dependent, giving rise to a system of personal rather than formalized relations and roles. They were generally political appointees. Chinese managers had to meet physical performance targets and their decisions had to take account of multiple criteria which derived from social and political considerations as well as economic requirements. By contrast, the approach to management which has developed in the market economy emphasizes competence for the job, devolved strategy-formulation, formalized organizational procedures, and financial performance criteria. During the early period of internationalization, there were many accounts of conflict between these two approaches when most Chinese joint venture partners were still subject to strong direct governmental influence. Even today, it remain a major challenge to integrate the two traditions to the mutual benefit of both.

China, then, offers one of the most important contexts for business and management in the world today. Understanding it presents a daunting practical and intellectual challenge, but one that cannot be put aside. It is this book's aim to contribute to the task.

John Child
Cambridge, May 1996

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