

# The Formation of New Economic Institutions in China

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YE Gang

### I. Introduction

It is difficult to overstate the enormity of the collapse at the end of the last century of the “socialist system” as a world system. Nevertheless, the actual way in which the systematic change has occurred in the various countries that had formerly labeled themselves as “socialist” has depended on the historical conditions and the degree of modernization in each.<sup>1</sup> In the case of China, like other countries, the reform of the economic system has required the transformation of an economic system from that of a “planned economy” to that of a “market economy.” However, while the economic reform of the Soviet Union and various other Eastern European countries has taken the form of “instant” economic liberalization, it is said that “gradual progress reform” is peculiar to China.

As for this Chinese type of gradual restructuring, the reform of the state-controlled price system has formed the main pillar,<sup>2</sup> and the reduction of state-controlled production and distribution has formed a secondary pillar.<sup>3</sup> It has been pointed out that, after a period during which the market was opened up, such a process seems to gradually produce a national economy that moved in parts towards the widespread introduction of the market mechanism. Furthermore, in this gradual progression of the transition process, along with the removal of “planned prices,” there can be seen the emergence of freely moving prices and products, and eventually a trend toward commodity economics. In short, economic development reaches a point where the macroeconomic environment allows entrance into the market by all different kinds of enterprises, and in such a way that these enterprises themselves are not only able to adapt to market changes, but also even to participate in and shape changes, too.

In other words, in the transition from a “planned economy” to a “market economy,” the introduction of market principles not only affects simply the conversion of the state function, but also a change in the economics of the various national productive activities of a country. Moreover, this transition can be seen as an unprecedented historical process whereby various national institutions and the management practices that make up economic activities are subjected to violent change in ways that had not been previously anticipated. This research recognizes the transformation of the various national institutions and management practices as being the essence of a transitional economy such as that which can be found in China. Thus, a

nation's various institutions and economic practices cannot be thought of as unrelated and independent from the productive activities of the national economy. As has been written elsewhere, institutions "are the underlying determinant of the long-run performance of economies."<sup>4</sup> It is because institutions and practices deal with the actual workings of an economy that they can adjust and cope with changes in it.

Based on the above setting of the problem, the present paper examines the Chinese-style transitional economic process. Close attention is paid to the transformation of the transaction practices of management, since it is the management of enterprises that must cope with any changes in national price institutions, in this case, towards the freeing of prices. Questions to be addressed are how, why, and at what timing are state systems and management practices changing. In an attempt to demonstrate clearly and empirically the nature of Chinese-style transitional economics, analysis is done on the formation of institutions and practices, the relationships between institutions and practices, and the relationships between institutions. The gradual transitional economics of China is made clear due to the approach like a institutional analysis.

## II. The transformation of formal institutions

### 1. The role of administrative regulations

Generally speaking, institutions can roughly be divided into those that are formal and those that are informal.<sup>5</sup> The former are the various institutions that have been established formally on paper by a national government. The latter can be described as the various practices of business organizations that are followed in conducting economic activity. Section II of the present paper is concerned primarily with formal institutions; Section III will deal with informal institutions. There are two broad categories of formal institutions. The first category contains the rules and regulations that have been enacted by a nation's various administrative bodies. The second category is made up of the laws that have been passed by the national government. In order to make clear the role played by each, in its analysis, this paper makes the necessary distinctions between regulations and laws.

As is commonly known, the government first promulgated price regulations beginning in 1978 with the "Price Control Temporal Regulations" (July, 1982). However, this document simply stated the national principles regarding prices, the punishments for violations of various price regulations, and made clear the function of the government concerning prices. While in accordance with the law, it did not lay out specific rules and regulations for the prices of various producer goods. As described earlier, Chinese economic reform began by the government granting state-owned enterprises independent decision-making authority for production and sales and allowing non-state-owned enterprises the freedom to enter markets. Subsequently, there was an expansion of sales of products across enterprises and regions that had been neither produced nor

distributed through state planning. Gradually, independent selling prices began to take shape. For example, from 1978 to 1981, while the state planned price for steel did not change, the independent selling price diverged from this amount and moved upwards. The government was unable to ignore the formation of this independent selling price for this producer good. The planned price for steel was raised by a small increment showing the state's acceptance of the temporary local price, and in this way the state was forced to make an adjustment in the controlled price to eliminate the differential.<sup>6</sup> Clearly because "there are complementarities between institutions, so an institution's inertia continues to have an effect,"<sup>7</sup> prices also had to be liberalized as production and distribution were liberalized.

However, by allowing independent production and sales, the control of actual market prices simply by adjusting the controlled price quickly reached its limit. As a result, real policies for urban economic reforms had to be worked out. Quickly numerous industrial goods were being sold at independent prices which were allowed to fluctuate within 20% of the "state-planned price."<sup>8</sup> During this period the contents of the "Price Control Temporal Regulations" of 1982 were significantly reworked and promulgated as the "Chinese Price Control Regulations" (September, 1987). At the same time that these regulations strengthened the system of "state-planned prices" for the distribution of industrial goods, they also established the coexistence of a double-price system that included the system of independent selling prices. This double-price system stands out remarkably as a characteristic of the gradual progression of the transition economy in China.

The double-price system was essentially brought to a close with promulgation of the "Central Government Price Table" on July 11, 2001.<sup>9</sup> In this Table, there remained only thirteen kinds of product prices and service fees for which the government decreed prices.<sup>10</sup> This result has become possible due to the smooth functioning of market mechanism that has been seen in the reindustrialization of the national economy. The move towards the complete termination of "state-planned prices" for steel, which began from the latter half of 1992, is also an example of this fact.<sup>11</sup> In other words, it was accepted that nearly all product prices (for steel and steel products) would be determined by the transactions of enterprises in the market.<sup>12</sup> Moreover, since the transaction prices for these steel goods had become effectively market-based, when the government introduced "state-guided prices" for ten different types of steel three different times from 1994 to 1996, in no instance did these prices become the standards for the actual market transaction prices.<sup>13</sup>

On the other hand, as state control of prices was relaxed and the entire national economy became increasingly market-driven, market prices began to fluctuate widely and the price behavior of business organizations became more varied.<sup>14</sup> However, the government did not overlook the low-price competition that had appeared in the steel and home appliance industries.<sup>15</sup> The State Council issued a number of notices prohibiting low-price competition. Moreover, the State Administration of Metallurgy Industry and the State Economic & Trade Commission developed a policy in January 1999 limiting steel enterprises to a total steel

production of 10% less than the total for 1998. The reduction was divided among enterprises with annual production of 50 thousand ton. In other words, the government regulated the reduction of operations for steel enterprises. Enterprises that did not reduce their production were subject to adverse conditions, such as having their borrowings for variable capital cut by their banks.<sup>16</sup>

At the same time, in a further effort to promote stability in the industry, the State Administration of Metallurgy Industry made a sweeping appeal to abolish the 20 million ton annual capacity of miniature blast furnaces of under 50m<sup>3</sup>, the 7.2 million ton annual capacity of miniature converters of under 10 ton/one change, and the 4 million ton annual capacity of miniature arc furnaces of under 5 ton/one change, and began to probe the closing of small and superannuating equipment operations.<sup>17</sup>

Production structure adjustment done in this way under state leadership corrected the distortion in the accumulated structure of the steel industry, and as such it cannot be denied that this shows that the state was indeed fulfilling its intervention function as a stockholder that seeks to promote the further upgrading of the structure of the industry.<sup>18</sup> Alternately, in acting as it did, it must not be overlooked that the state, through its national bodies, also performed its administrative function to stabilize the business cycle by its imposition of limits on production volumes of steel and other goods. Price destruction (i.e., the sudden fall of prices) is inevitable as long as overall supply exceeds demand. Under price liberalization, the violent competition among enterprises in pursuit of market share had seen the expansion of production volume used as the chief tool to achieve this aim. In short, while at the same time national administrative bodies exited price setting, they strove to promote stability in the national economy and society, all within the context of the Chinese-style gradual progression of economic transition. Of course, the all of the price institutions, and so on were not renewed during the period. But the various institutions were induced naturally with committing the complement function.<sup>19</sup> Therefore, it is said the transition economics of China were the gradual transfiguration process of the institutions.

## 2. The role of law

China's first price law, "Pricing law of the PRC," was adopted on December 29, 1997 at the 29th meeting of the Standing Committee of the 8th National People's Congress. The law elaborates the state's basic principles regarding prices, the price behavior of business organizations, the price behavior of national administrative bodies, the role of the state in ensuring price balance for all of society, supervision, and punishment for law violations. It is notable that the "Chinese Price Control Regulations," which had been modified repeatedly up until this time, was an important reference in the creation of this price law. As a national law, the price law was different from the price regulations that had been passed up to this point in that the law indicated the recognition of the national government that the price mechanism plays an important

role in the national economy. Because of its greater precision and universality, the price law has more long-term validity than that of the previous administrative price regulations.

The special characteristics of laws are, in fact, responsible for the long time it took to establish and adopt the law and its related paperwork, despite the presence of the many administrative regulations that served as reference materials. Also, an additional reason for the delay was that the law was being written for a subject that was moving from instability to stability and uncertainty to certainty. Obviously, a law not grounded in reality and created only for an imagined subject cannot be of much help in the real world.

Next, let us take a detailed look at the procedures that must be followed before the price law could be adopted in China. First, the adoption of any law must proceed according to the National People's Congress' legislative plan. The Standing Committee of the 7th National People's Representative Congress in 1991 made a plan for the enactment of legislation, and the price law described above was included in this plan. Subsequently, a five-year plan for the enactment of the legislation was made during the 8th National People's Representative Congress. In the passing of any law, after a number of National People's Representatives' make proposals concerning a piece of legislation, deliberation groups begin work investigating the specifics and actual conditions of the proposals. Careful discussion of this nature and consideration of the proposals by specialists in the related field is then repeated a number of times. Then, once a proposal is accepted, the Standing Committee of the National People's Congress initiates a special draft committee, specialists are invited to participate, and the draft is written. After the draft is made, specialists and concerned people are again asked to deliberate on the contents. The draft is then modified based on the opinions of the specialists. Of course, this process of writing and revising the draft is repeated a number of times. Finally, the document is delivered to the national assembly. The draft then follows the schedule set by the Chairman group of the National Congress' office for passage by the National People's Congress or Standing Committee.<sup>20</sup>

As can be seen from the above description, it takes a long time for legislation to be passed by the National People's Congress. In the case of the price law, it took about six years for the legislation to be adopted from the time the legislative plan was first introduced in 1991. Similarly, a proposal for anti-monopoly legislation was submitted in 1998, however, it didn't even make it as far as the draft writing stage in the 8th National People's Representative Congress. In the present 9th National People's Representative Congress the proposal has been submitted, but as before, it is still in deliberation.<sup>21</sup>

There is another special characteristic of economic-related legislation that should be mentioned here. Differing from constitutional issues, when a law is related to economics, it is enacted together with a number of related pieces of legislation. The reason for this difference is that when economic actors conduct their economic affairs they do so in response to a series of related phenomena, which occur together. A single piece of legislation is often unable to deal sufficiently with such cases. For example, prior to the passage of

the price law, other laws such as the “Law of the PRC on Product Quality” (enacted September 1993) and the “Law of the PRC on Anti-injustice Competition” (enacted December 1993, and revised by the 30<sup>th</sup> Meeting of the Standing Committee of the 9<sup>th</sup> National People’s Congress on July 8, 2000) were passed by the National People’s Congress. Both of these pieces of legislation are independent laws. The latter deals with the relationship between price and quality and is characterized by an emphasis on fairness in the price-setting decision. As a result, an economic actor must follow this law when setting prices under the price law. Whether or not a number of related laws are sufficiently prepared in coordination is one measure of how consistent (or mature) a nation’s institutions are.

### III. Enterprises and price behavior

#### 1. The price-decision mechanism and the sellers’ market

From 1978, when the state gradually exited from the reindustrialization activities of the national economy, enterprises gradually gained the right of citizenship and became the principal agents of economic activity. Naturally, together with the introduction of the market mechanism, this change in management was accompanied by a change in economic behavior and practices. This section of the paper examines the formation and transformation of the price behavior of business organizations using the steel industry as a case study.

The independent selling of steel materials was allowed at a relatively early stage. Beginning in 1979 under a contract system, steel and iron enterprises started to freely sell any surplus production over the required production volume dictated by the state plan. Incidentally, the amount of independent sales of steel materials in 1979 only accounted for 3.6% of the total amount of domestic sales. However, ten years later in 1989, the percentage had risen to 34.2%. By 1995, the figure had risen to over 90%.<sup>22</sup> In other words, the sale of the steel materials was almost completely liberalized from the latter half of the 1990s.

Additionally, by the middle 1980s, not only had the sale of the steel materials been freed such that sales were being made to entities that were not related enterprises, it had also moved beyond geographical limitations. This freedom in sales had come about by the state’s approval in 1984 of the establishment of a steel materials market (i.e., a market for the purchase and sale of steel materials). The independent sales centers for steel materials were first established in Shijiazhuang-city (Hebei Province), Tianjin, Shanghai, Shenyang (Liaoning Province), Wuhan (Hubei Province), Chongqing (Sichuan Province), and Xi’an (Shanxi Province). Subsequently, trading markets for steel materials were established one after another across the whole country, bringing the total number to 294 by 1990.<sup>23</sup> In other words, Chinese-style gradual transition economics was a process whereby, in addition to the introduction of the market mechanism for product

prices, there was also the building of locations where transactions could be made and enterprises could be developed so that they could become the principal actors in the market. Steel and iron producers from throughout the country were invited into each region, and the trading of steel materials became very active. Thus, along with the reform of the overall economy and the opening up of the country towards the outside, especially after 1990, the former system of state-controlled distribution was done away with, and the independent sales of steel materials was fully developed. Thus, economic agents were able to enter freely the trading market for steel materials.

With steel material producers shouldering the sales market as the market mechanism was introduced into the distribution of production goods, they would seek to expand their sales region and increase their production volume. As a result, one could expect major changes in the organizational management of enterprises, their price behavior, and their transaction practices. The conversion of the industry's price-decision mechanism is considered to have begun from the inter-department cost control practices of the Handan Steel Group (HDS).<sup>24</sup> At HDS, the decision process to set the sale price to correspond to the production cost began with some poor selling wire material. Next, the practice was adopted for stick steel and then for a medium-thickness board, before finally being expanded to all products.<sup>25</sup> By first basing it on the expected market price, prices were calculated by adding up the production costs of each stage of the production process. Based on this figure, an amount that could be cut from costs was set, and cost reduction was pursued thoroughly in each production department.<sup>26</sup> In short, product prices were set according to costs by department and product type. A price-decision mechanism of this sort is characterized by having the ability to deal with market fluctuations.

The above analysis demonstrates that the policy of the liberalization of prices was also being called on to create a new price-decision mechanism in place of the previous state-controlled price system. Clearly, enterprises were participating in the price decision of market transactions, and after a stage where the price decisions of enterprises were adjusted according to state-controlled prices (which at that time were called historical prices), a new price-decision mechanism, one based on enterprise production cost, was gradually being formed. Under this new price-decision mechanism, nearly all enterprises set their prices at different levels from their competitors and engaged in management efforts to reduce costs in order to gain surplus profits. In other words, as the adjustment function of the price mechanism in economic activity increased in strength, the competition between enterprises also became markedly more severe.

## 2. The price-decision mechanism and the buyers' market

As described in the previous section, the way of determining prices based on enterprise departments and product types led to cost reductions and improvements in product quality in the steel industry. This fact



led to the mechanism spreading to other industries bringing about a new level of fierce widespread market competition. The diffusion of this new method of determining prices reached the point where profits among enterprises were being normalized. Additionally, since the production of steel materials had been in an extended phase of continuous expansion, the low-value added sector of the product market became saturated. Most enterprises moved from the seller's market to the buyer's market, and the market price rapidly decreased. From 1996, capital investment in the steel industry in China declined markedly. The total investment figure for 1998 was only 70% of the total for 1995. It is worth noting that there was a decrease of over 80% of the share of the total investment figure that was coming from self-funding or domestic borrowing.<sup>27</sup> Both self-funding and domestic borrowing are related to the profits of the enterprises, and their drastic decrease makes it clear that profits from the sale of steel materials were declining.

In an effort to stop the fall of market prices, enterprises in the steel industry began to behave in a new manner, and formed something akin to an inter-firm agreement on pricing. This new inter-enterprise cooperation on prices first appeared in the pale board market of the Huabei area. The Anshan Steel Group (ASS), the Benxi Steel Group (GXS), and the Taiyuan Steel Group (TYS) were the main manufacturers of pale board in the Huabei area. In 1995, ASS produced 1.91 million ton of pale board; GXS produced 1.76 million ton and TYS produced 664,000 ton. The production of these three enterprises accounted for 37.8% of the total production in the country and 96.3% of the production of pale board in the Huabei area.<sup>28</sup> Since the Baoshan Steel Group (BSS) and Wuhan Steel Group (WISCO), which are the primary manufacturers of pale board in the southern part of China,<sup>29</sup> aren't able to compete effectively with these three enterprises in the north due to transportation costs, it is not an exaggeration to say that these three enterprises, based on production volume, monopolized the pale board market in the Huabei area. It can be said that the fact that each of the enterprises intentionally maintains the capability to freely increase production volume over its market share lends supporting evidence to this statement.

For that reason, the market-leader ASS struggled to construct market policies to fight against the competition of member enterprises and maintain its leading position. Likewise, TYS sought to promote the opening of new markets to increase its production volume. Thus, it would seem impossible to avoid harsh competition as the enterprises fought to take the lead position among the three. Thus, it can be said that in the continued evolution of the economy in China, by enterprises coming together to form inter-enterprise organizations to regulate prices, a structure of many competing enterprises changed to a new competitive structure of a few competing enterprises.

Incidentally, the overproduction of low value-added products brought along the depression of the price of steel material. After 1998, the decrease in market prices extended to wire products and stick steel. In other words, in the harsh competition among enterprises for market share under the liberalization of prices,

conditions where the overall production volume exceeds the demand had spread, thus making it impossible to avoid the destruction of prices. As a response to this situation, by government regulation, manufacturers were required to set their selling prices above average cost.<sup>30</sup> In other words, it was the intention of the state to force enterprises to conclude cooperative agreements on prices in order to halt the fall in the prices of steel materials and bring stability to the industry.<sup>31</sup>

Accompanying the dismantling of the state-controlled price system, an environment began to form in which enterprises could compete for profit under market principles. Accordingly, the standard for the setting of prices left from state-controlled prices, and moved towards the decisions of enterprises given their production costs in individual department and for product types. The accumulated funds in the industry, caused by increases in volume and improvements in quality, flowed from the enterprises using, at their own discretion, profits gained from their sales structures. However, it is notable that due to the increasingly sophisticated and complex market behavior of enterprises, the trend toward more “organized markets”<sup>32</sup> gradually strengthened. Thus, it can be said that it is a characteristic of the systematic change of the Chinese economy that, in this stage of development of economic organizations and price institutions, there can be seen a process by which products are trending toward behavior characterized by commodity economics.

#### IV. Conclusion

It is well known that until 1978, all production and distribution of goods, education and hiring of people, and allocation of funds, was done by the state under the reindustrialization of the national economy. China began to realize that there was a defect in the fundamental framework of such a system, and more broadly, “Socialist economies... are attempting to grapple with ways to restructure the institutional framework to redirect incentives that in turn will direct organizations along productivity-increasing paths.”<sup>33</sup> However, it appears that China did not initially intend a broad-based introduction of market principles into the reindustrialization process of the national economy.<sup>34</sup> So, the institutional framework was not immediately reconstructed with a market system as its goal.

Nevertheless, accompanying the transformation of formal institutions, market principles began to permeate into economic activities. The reason for this was that state-owned enterprises were allowed step-by-step to assume authority over production and sales decisions, and furthermore, the entrance of non-state-owned enterprises was permitted. Therefore, there was a gradual increase in the number of reindustrialization activities that were not concentrated on state plans for production and distribution. As a result, economic actors were developed, and there was also the gradual formation of management customs that were able to cope with the demands of the market.

Needless to say, the formal institutions were not themselves responsible for the establishment of the new management customs of the economic actors. As described earlier, once industry began to engage in economic activities that played a mediating role in the market, a cycle of autonomous development began, whereby the expansion of production, lowering of costs, improvements in quality, etc., led to the maintenance of positive profit flow. Following the formation and development to maturity of the new price-decision mechanism, it became clear that price liberalization alone would quickly reach a limit in fostering industrial accumulation. To build anew the structure of the industry's accumulation, a further "change in the quality of the price-decision mechanism"<sup>35</sup> was also required. In other words, management customs had to develop while they coped with the conditions and variations in the progression of industrial accumulation brought about by fluctuations in market supply and demand.

If the formation of individual management practices can be called the result of the fluctuations in the individual product markets and accumulation of capital in industries, then it should be appropriate to call the changes in the reindustrialization activities of the national economy and the fluctuation of the overall market the object of the formal institutions. However, since the overall picture of the market formation cannot somehow be predicted during the course of the gradual progression of economic transition, there is a conspicuous tendency for there to be a delay in the adjustment of laws that deal with the market. It is because "the institutions may be changed rapidly; yet if they are to endure they must be appropriate to man."<sup>36</sup> Furthermore, in particular in the case of China, it cannot be denied that the ideology of the state, which composes formal institutions, is challenged and forced to adjust as the economy grows by the changes occurring in economic organizations and in the structure of activities. Thus, it can be said that, "They (the informal constraints) appear to have a pervasive influence on the institutional structure."<sup>37</sup>

On the other hand, certainly once the economic practices of individual business organizations and inter-organizational transactions become dependant on supply and demand, the state becomes unable to intervene directly in the market. However, this in no way means that the state is completely unable to exercise control over the economic activity of the market, including pricing decisions. As shown elsewhere in this paper, a further result of the unceasing transformation of rules, regulations, and laws related to the activities of the national economy in China was the guidance, regulation, and supervision of the market and the behavior of business organizations.

It is also necessary to pay attention to the dynamic way in which formal institutions are formed. This paper has shown the role administrative regulations and laws play as formal institutions. Administrative guidelines and the like are government policies to quickly deal with changing phenomena. Especially in the case of transition economies, where for whatever reason laws cannot be adopted at once, administrative regulations are able to play the role of substitutive institutions as a cushion between the law and national

economic activities. In addition, these administrative regulations become the foundational materials of future laws. Restated, in order to establish a fully equipped legal system it is necessary for the state during economic transition to write laws which have the learning-by-doing experience of continuously writing and rewriting administrative regulations. Otherwise, it will be impossible to capture fully the “adaptively efficient characteristics of the institutional matrix (both the formal rules and the informal constraints embodied in attitudes and values) that created an economic and political environment that rewarded the productive activity of organizations and their development of skills and knowledge.”<sup>38</sup>

Since 1978, when a transition economy began in China, the country’s economic performance has been remarkable, and the Chinese economy has emerged as one of the world’s high-growth economic centers. One cannot say that this good economic performance is completely unrelated to the dynamic transformation of the nation’s institutions. Nevertheless, there still seems to be, as before, a strong tendency of the state to take a leading role in the system that is being formed by the broad-range of institutions generated in the reindustrialization process of the national economy. Once new institutions take root, that inertia will continue to work. For that reason, there remains the ongoing issue of how the balance between the functioning of the market mechanism and desire for state control can be achieved.

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  - 13 Gang Ye, 2000a,op. cit., pp. 105-6.
  - 14 The fall of the market price of the low value-added steel material didn’t stop at first in the case of the steel material, which are the stick steel of building materials. The fall of the price of color televisions also began, and it gradually unfolded gradually in the case of home electrical appliances, such as VCD players, refrigerators, washing machines, and air-conditioners.
  - 15 For example, there are “The regulation about the stopping of unjust price behavior of the product duplication industry,” (November, 1998), the “Notification about the strengthening of price autonomy in the business world,” (November, 1998), “The regulation about the stopping of duplication” (August, 1999), the “Notification about the way of authorizing a duplication industry product cost” (February 23, 1999) (in Chinese), and so on.
  - 16 *People’s Daily Overseas Edition*, January 25, 1999 (in Chinese).
  - 17 Ibid.
  - 18 The author would like to emphasize on two points about state-owned enterprises here. First, the actual production activities of the economic reforms vary in the state-owned enterprises according to the enterprises that the government manages. Second, state-owned enterprises cease to be a kind of national (production, circulation) function sector, as they are changing, since the management actors are now independent.
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  - 33 Douglass C. North, 1990, op. cit., p. 110.
  - 34 Gang Ye, 2000b, op. cit., p. 10.
  - 35 Juro HASHIMOTO and Haruhito TAKETA, eds., 1985, op. cit., p. 412.
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  - 37 Douglass C. North, 1990, op. cit., p.138.
  - 38 Douglass C. North, 1990, op. cit., p. 136.